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Development of Japan's Financial System

Development and Finance

One major problem regarding development is finance. If a country has a source of funds, obviously the problem is solved. Otherwise, it must depend on loans, assistance, or direct investment from foreign enterprises. Depending on the terms and conditions, these funds can have vicious effects on development. This is one reason we have emphasized national sovereignty as a decisive factor in the development of economic and technological independence. Although some countries have adopted development policies that leave them vulnerable to financial subordination, others have stubbornly rejected foreign capital, technology, and management funds, leading to retarded development. We live in an age of unprecedented interdependence and so must pursue a new international economic order. Because mutual dependence should be established on the logical assumption that each nation is the holder of independent politics and an independent economy, independence is the starting point.

Economic independence is not isolation; moreover, immersion into the international economy compels a nation to contend with rapid change. A country working toward self-reliance, even where a national consensus has been formed, must face a variety of difficulties. We have examined the sorts of experiences that arise as a result in the context of various industries. Turning now to the Japanese financial system and the financial institutions—after much trial and error, sacrifice, and loss, they have managed to achieve independence in the international arena.

In early Meiji, the Japanese yen had no international creditability, and therefore little investment in Japan was made by foreign enterprises, while an overwhelming deficit made the government dependent on foreign funds.

In 1899, the thirty-second year after the establishment of the Meiji government, direct foreign investment began. This was made possible by two important political and economic events that occurred late in 1898.

One was the adoption of the gold exchange standard, using the gold obtained as reparation from the Sino-Japanese War as reserve. The second was the revision of the unequal treaties after, indeed, their 40 years of existence. (The acquisition of rights for an autonomous customs tariff had to wait another 10 years.) Foreigners living in Japan were no longer forced to live in concessions, but they lost their extraterritoriality. In his *Naichi Zakkyo-go no Nihon* (Japan after the opening of the concessions), Yokoyama anticipated and warned of the severity of "free competition."[61]

Enterprises, too, at this time lacked international creditability and could therefore not float bonds in other countries; they had to depend on direct foreign investment for the introduction of foreign capital. The first instance of this was Nippon Denki Co., Ltd., which was established in 1899 with an investment by Western Electric of the United States to manufacture telephones and switchboards. Nippon Denki was modeled after Miyoshi Denki Kojo, famous for its high-level machine-manufacturing technology. Nippon Denki eventually became NEC, which, now under complete Japanese control, has long been a leading company in the Japanese electronics industry.

Standard Petroleum made a lone investment in 1900 and started the development of oil wells. "The introduction of foreign capital begun in this way was soon being used to supplement the insufficient accumulation of capital and the low level of production technology" (see Hattori Kazuma in Arisawa Hiromi et al., eds. 1967: 141).

Also at this time, the classification of banks by function, with the Bank of Japan as the core, into commercial banks, *kangyo* banks (investment and promotion of industry), and savings banks was established. It has been said that "in no other country was the banking system consolidated in terms of legislation as it had in Japan." This is one example of the advantages of being a late comer.[62]

The financial institutions organized in the 1890s were the crystallization of ideas worked out when the Bank of Japan was founded (1882) and paralleled the secondary rise of industry and the increased number of banks after the Sino-Japanese War. The first rise of industry, which followed the period of the Matsukata financial policy in the 1880s, saw the establishment of approximately 10 private railway companies and the same number of banks.

Later, forced by the intervention of Germany, Russia, and France to abandon its dominion of the Liaotung Peninsula after the peace treaty between Japan and China in 1895, Japan determined to adjust to this loss by producing weapons domestically, which led to the construction of ironworks and brought about Japan's second surge of industrialization. This included creating an integrated system of iron and steel manufacturing, the enlargement and improvement of the national railways, the reinforcement of sea transportation and shipbuilding, enlarging the communications network, and developing Taiwan, with priority on strengthening armaments.

To attain these targets, the full-scale transfer of technology and increased imports of machines and equipment were required. But the fall of the price of silver on the international market meant a sharp increase in the prices of imported goods (which, however, was advantageous for the export industry).

Before the Sino-Japanese War, the propriety of a move to the gold standard had been discussed in government circles, and a fierce debate on how to proceed had resulted. With the sharp increase of machinery imports in the private sector after this war, the group advocating a shift to the gold standard became predominant. On the other hand, it was in the interest of the cotton-spinning industry, the only industry that had international competitive power, to adhere to the silver standard since many Asian countries—especially China— which were its biggest market, were under the silver standard.

However, when India, from which Japan was importing its raw cotton, shifted to the gold standard in 1893, and when increased imports of raw cotton precluded the cotton-spinning industry from staying with the silver standard, the time for a shift to the gold standard had arrived. The Sino-Japanese War reparations provided the point of transition. Thus was the consolidation of the financial system effected. Let us briefly examine the process of technological transfer that led to this consolidation.

Exchange Companies

The earliest banks in Japan were called "exchange companies," that is, currency exchange companies. In 1869, exchange companies were established in Tokyo, Yokohama, Niigata, Kyoto, Osaka, Kobe, Otsu, and Tsuruga to finance the promotion of domestic and foreign trade. Their business was deposits, loans, foreign exchange, and nickel silver, old gold, and silver coin transactions. The companies were given the rights to issue gold, silver, coin, and nickel silver notes.

At this time, deposits had not developed, and civil strife and political changes had brought about a state of confusion that affected currencies, and thus the amount invested in the exchange companies was smaller than the amount required as working capital. The exchange companies therefore depended on huge loans from the government. For example, the capital of the Tokyo Exchange Company was 948,500 *ryo* in 1872, of which the government had contributed a total of 332,000 *ryo*. The company's investors were exchange companies that had been authorized by the Tokugawa shogunate, such as Mitsui, Ono, and Shimada. The Tokyo Exchange Company offered financing for the production of export goods (silkworm-egg cards, raw silk, tea, and seafoods) at an interest rate of 0.15 per cent per month, which was much lower than the prevailing rates.

Despite the interest-free government financing, the authorization to issue notes, and the government's easiness about returning the money, it was not possible for the exchange companies to establish themselves and grow.

Takizawa Naoshichi and other banking experts attributed the failure to the companies' being established merely on the basis of a combination of traditional Japanese money exchange practices and European institutional features, which did not properly fit the Japanese commercial structure of the time; moreover, there were few men qualified to conduct the business. Furthermore, as a result of the rationalization of the administration, the government's trade department, which had been the leading division for the scheme, was abolished.

The new government lacked stability; it was a time of rapid political and social changes. The foreign trading firms were in an overwhelmingly advantageous position in business negotiations, protected as they were by gunboat diplomacy. Finance for leading agricultural export products had an extremely speculative nature. These were hostile circumstances for the establishment of a true banking system. Nevertheless, there were a few bankers, able to overcome the instability and risks, who survived the upheaval en route to the modern age. The successful bankers had a management strategy, abundant funds, and the ability to evaluate the situation accurately. Ono and Shimada failed because they lacked these abilities.

In 1872, only three years after their establishment, the exchange companies were forced to dissolve because they could not develop their credit systems and supply the necessary funds to stimulate industry. Nevertheless, a general awareness was created that this type of business organization as an incorporation, though incomplete, was necessary and effective. It made ordinary people more aware of business organizations, the banking business, and the operation of funds, and gave impetus to the establishment of private banks.[63] For Mitsui especially, it was this first experience of the "modern age" that led to the formation of Mitsui Bank's management philosophy.

From a National Bank to the Bank of Japan

Because the new Meiji government had inherited the foreign debts incurred by the former regime, it had to guarantee these debts, as new governments around the world had done. However, unless Japan's new government could successfully deal with the accumulation of inconvertible notes that it had issued during its revenue deficit, the resulting inflation would undermine its economic foundations. Therefore, the treatment of these notes became a political life-or-death question for Japan.

To study the problem, important figures were sent abroad. Ito Hirobumi, one of those sent overseas, found in the United States that "the national bank has the privilege of issuing notes and both functions of amortizing government notes and of financing," and he recommended adopting this system as a "measure of serving two ends."[64]

In the United States, there was a need for a policy to deal with the inflation caused by the Civil War and with the over-issue of wartime bonds (to maintain their price). The new Meiji government had the same problem. It was discovered that the US national banks could capitalize the bonds issued by the government. While the bank deposited bonds with the government and the government issued the bank notes, there arose a demand for bonds, which enabled their price to be maintained. Ito eagerly embraced this system.

Proponents of a central bank to be modeled after the Bank of England opposed Ito's plan of decentralizing the note-issuing system. The points at issue were note conversion or specie conversion and decentralized or centralized issuing. A compromise was made between the two, the government hopeful of realizing the two goals simultaneously, and a plan for a national bank system was adopted. A number of national banks were expected to be established, and a huge amount of inconvertible notes were to be collected to establish the system of specie conversion and to make the banks profitable.

Nevertheless, only four national banks were established. Why were the government's expectations disappointed? The reason that Yasuda, a famous financier, for example, was not interested in participating in establishing a national bank was due to the condition of being required to convert the notes immediately after their issue, which obviously would have greatly hindered business.

Until 1872 or 1873, there had been no difference between the gold specie and note, but because of the government's reckless issuance of notes, a premium of ¥17.8 per ¥1,000 of gold specie occurred in June 1875. With the increase of imports, an immense amount of gold specie flowed out, and for this reason, the Yokohama Second National Bank, for example, could not issue notes at all.

In 1876, because of a fear that the issuance of hereditary pension bonds would lower prices in the bond market, it became permissible to allocate pension bonds for banking capital (up to 80 per cent), and the rate of specie reserve was lowered (to 20 per cent). To summarize, the government changed its policy from one of establishing a conversion system to one of increasing the number of national banks, and thus increasing the supply of currency, which was expected to enable the government to raise funds for development.

As an immediate result, 153 banks were established, and the national banks, provided with many privileges, attained good results. For some time after that, businessman meant banker—until the 1920s, when the industrialists were added.

There is the story that, after studying the banking business in a foreign country, the son of a wealthy merchant proposed to his father that they open a bank, and the father warned that, because it was a risky business to keep others' gold and silver, a storage fee should be charged. The idea of paying interest was out of the question. This is a story from early Meiji, and represents the state of the time: there were funds (bonds), but no one knew anything about banking business practices. So the government had to begin with an introduction to banking business practices and the thinking behind them. In 1872, Allan Shand, a British banker, was invited to Japan to provide guidance in bank bookkeeping, and, as a result, British banking principles gained some currency.

But the banking system itself was American, and problems arose because of the differences between the two systems. Nevertheless, the British banking system, which had been established during the Industrial Revolution when Great Britain was the leader in international trade, was considered to be not easily transferable to Japan. Despite the problems, the mixed American-British banking system sufficed to meet the requirements of raising funds for the Meiji government's industrial promotion policy.

In spite of the government's efforts, inflation continued, and, in 1877, restrictive measures had to be imposed on the national banks. Since the gross capital amount was limited to ¥40 million and the gross amount of notes to be issued was limited to ¥34 million, the Kyoto 153rd National Bank, established at the end of 1879, was the last authorized national bank.

When the Bank of Japan was established in 1882 as a central bank, it monopolized the right to issue notes, and the decision was made to limit the period of operation for the national banks to 20 years from the time of the Bank's establishment. After that, any national bank could be reorganized as a private commercial bank, but it was compulsory for each bank to redeem all notes issued by the time of reorganization. From then on, the banks were under the pressure of rationalization.

Although the national banks had been provided privileges and protective measures, they were not active in the deposits business (because they had government deposits), and, because their loans were centred on specific enterprises (whose directors were also bank directors) that mortgaged land and buildings, the funds lacked liquidity. Further, such features of commercial banking as discount promissory notes and bills of lading were not present.

Often, the national banks could not meet fund demands, and it was a general practice for small or medium-sized banks to borrow money from a larger bank—and the larger bank from the Bank of Japan—to lend at a high rate of interest. These banks were, it could be said, merely brokerage earning banks. One banking professional commented, in fact, that the national banks had the appearance of incorporated usury.

The Bank of Japan was established by Matsukata Masayoshi. As he saw it, the establishment of finance (and the consolidation of inconvertible notes) and the idea of the establishment of a central bank were inseparable. While in charge of local administration in Kyushu immediately after the Meiji Restoration, he fully realized the damage an excessive issue of inconvertible notes could cause.

In 1878, Matsukata, then vice-minister of finance, visited Europe as the assistant general director for the international exhibition in France. He inspected the financial systems of different countries and was advised by the French minister of finance, Leon Say, of the need for a central bank system and for a convertible bank note system. He was advised not to model on the French system, which was very old and would have been difficult to transfer, but to follow the system used by the Belgian National Bank, which had been recently established and for which the experiences of several countries had been considered. Here again, Japan enjoyed the advantages of a late comer.

At the time of the establishment of the Bank of Japan, Matsukata reorganized the existing banks into a tripartite system of commercial banks, with the Bank of Japan as their centre, investment, and savings banks.

Although the Bank of Japan had begun as the core bank of the commercial banks, it became the central institution for industrial financing when, after the first modern economic recession hit Japan in 1890, it began discounting promissory notes, receiving the stocks of 15 sectors, including the railway, sea transportation, and insurance, as security.

In summary, the banking system formulated by Matsukata consisted of the following:

1. The Bank of Japan and city banks as commercial financing institutions
2. Investment banks as long-term financing institutions
3. Savings banks as savings institutions for the general public

Of the three, the investment banks were the development banks. Their purpose was "to finance the capital for the initiation of business, to promote the reclamation of agricultural land or assist in its geological improvement, and to promote such businesses as silk reeling and canal and port construction, receiving houses and land as mortgage."[65] It is noteworthy that agricultural and industrial development were given an important place in this tri-partite system of banks.

This division of banks was modelled generally on the German mortgage bank and the French movables credit and immovables bank, but in many of its details, it was original. There was a tendency to view this arrangement as being too far ahead of its time, it being based more on future prospects than on an awareness of the economy of those days.

After twists and turns, however, the arrangement was realized. Clearly stating that "the promotion of industry is the aim, and the bank is the means for it" in the Japan Kangyo Bank Law promulgated in 1896, the investment bank began its business of stimulating industrial development. The Kangyo Bank of Tokyo was the central bank, and an agricultural and industrial bank was established in each prefecture. As stated in the Bank's charter, "when more than 20 farmers or industrialists wish to borrow money on joint responsibility, insofar as the applicants are credible, the loan is to be provided without mortgage on the basis of periodic repayment within five years." Thus, the Kangyo Bank was a long-term financing institution for the encouragement of industry, with immovables as mortgage.

In newly settled Hokkaido, where capital was in extremely short supply, the Hokkaido Takushoku Bank was established. As with the agricultural and industrial banks of other prefectures, it provided long-term loans with immovables as mortgage. Also, with agricultural products, stocks, and bonds as securities, it made loans, subscribed for bonds, and handled deposits and bills of lading. Before this bank was established, the demand for funds was so great and the local financial resources so poor that interest rates were as high as 20 to 30 per cent per month. Under these circumstances, the development effects of this bank were extremely significant.

When tenant issues came to the fore after World War I, neither the Kangyo Bank nor the agricultural and industrial banks would finance agriculture and farmers because of the profit-making characteristics of these banks. This gave rise to a national federation of agro-credit and development co-operatives (Chiba 1983). The circulation of funds among members may have been an ideal form of finance by the co-operative associations, but actually, financing by these organizations generated competition with other banking institutions, which led to a change in the character of the co-operatives. Their significance, however, should not be neglected.

In addition to the banks discussed in the preceding, there are a few others in need of mention. The Industrial Bank of Japan, for example, was founded in 1900 as the "central bank for industry" and its function was to introduce foreign capital, in accordance with the policy to limit direct investment of foreign capital (Asai 1983). In addition, this bank was soon playing the leading role in reinvesting foreign capital in the Japanese colonies.

The Yokohama Specie Bank (now Bank of Tokyo) was a special bank established to (1) promote direct exports in competition with foreign trading firms, (2) recover commercial rights through exchange, and (3) stabilize the market in gold and silver coins (Saito 1982).

Finally, there were the colonial banks in Korea and Taiwan (Namigata 1981).

Generally, in late-comer capitalist countries, certain social issues will arise earlier than as experienced in the advanced countries. One response by ordinary citizens to such issues was the formation of the mutual financing associations. The activities of the mutual financing companies, an advanced form of these associations, were important (Asajima 1983). The mutual financing companies grew to a rank equal to that of a commercial bank and secured for themselves a particular niche based on specific locations and areas of industry and business.

There were also pawnshops, which were highly popular with the common people as sources of funds. In addition, the role and significance of the postal savings system in Japan's development were extraordinarily great. Modeled on the British postal savings, the Japanese system has been operating since 1875, and is said to be unique for having been established as a savings institution for ordinary citizens by the government at an early stage. What is more important, however, in relation to development policies is that savings accumulated in the system were used for investment through the Savings Department of the Ministry of Finance. The government was able, on several occasions, to overcome a financial crisis with these savings.

In 1905, the per capita amount of savings was ¥9.29 (an arithmetic average, which was equivalent to a half-month's wages for a male worker in the manufacturing industry), and depositors whose saved amount was less than ¥3 made up 70 per cent of the total. (In terms of deposits per person, this was as small as one-twelfth what it was in Great Britain.) Nevertheless, the postal savings system held 30 per cent of the savings of ordinary citizens. One might add that farmers occupied an overwhelming majority of the depositors.

Because petty deposits are costly, the commercial banks were not interested in such deposits. The reason the postal savings system, which invested in public bonds and other equities at a low interest rate, could guarantee the same interest as other banking institutions was that the expenses were borne by the government's general accounts. In 1984, 110 years after the establishment of the savings system, the balance of its deposits amounted to ¥89 trillion, and, if the postal savings system may be regarded as a banking institution, Japan's is the world's biggest. Now that the government's postal savings banks are, in terms of total holdings, on a par with the major commercial and trust banks, the opinion that the postal savings system has outlived its traditional function might be expected.

Shibuya (1981) states that the division of banks modeled on the advanced countries was not based on the distinction between banks for long-term loans and those for short-term loans. The division was made on the basis of types of industry, such as agriculture or commerce, and on location, such as home country or colonies; the commercial banks, which originally should have been short-term loan banks, have become institutional banks to supply long-term loans. Shibuya (1981) holds that a special Japanese-type structure can be observed in this.

Since World War II, although the Japanese financial system has undergone marked changes, its basic nature and structure have not changed. Now, however, faced with international financial problems and the great changes in the world situation as a whole, Japanese financial institutions and the system are being tested.

Before leaving this section, I should add that, although the Hokkaido Takushoku Bank played an important role in the development of the large island of Hokkaido, it was not included in our research. At the beginning, I considered conducting a study of the development of Hokkaido as an interdisciplinary area study. I thought that such an area study would be done better mainly by scholars and researchers living in Hokkaido. But, as it was too big a burden in terms of distance, time, and expense, the study was terminated during preliminary surveys. Now, however, I must say this was a serious omission: More than 70 per cent of the deposits now made in Hokkaido are not used there; they are invested in Honshu, the main island. It is clear that there are still problems of development in Japan.