

Japanese Modernization Lecture Series

Chapter 13. Modernization in Japan-The Fiscal and Monetary Field

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Introduction

In order to establish an effective financial system, an appropriate balance must be found between domestic deepening and internationalization.

Each country should make an effort to first deepen its system based on the domestic rules and customs already practically applied to financial activities.

If such deepening is done well prior to any internationalization, which is a necessity these days to adapt the system to the global economic and financial environment, the system that is established will be both stable and resilient.

In order to modernize its system, Japan has been successfully integrating its domestic activities since the Edo era.

So, today I would like to begin by introducing the system that existed during the Edo era.

This system provided a firm foundation upon which the Japanese financial system was then based.

I will then explain the further developments that occurred after Japan ended its closed-door policy in the late 19th century and began integrating the new idea of developed

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economies.

This will then be followed by a look at the post-World War II period, which illustrates the positive developments in both public and private financial mechanisms.

Finally, I will briefly touch upon a new financial area which widened the scope the financial system, namely securities business.

Section 1: The financial system in the pre-Meiji Restoration period

The Edo era, which lasted from the 17th century to 19th century under the Tokugawa Family, saw the development of Japan's financial system.

A number of factors that were already in place, encouraged development:

First, in proportion to its narrow landmass, Japan had a rather large population.

One historical survey stated that Edo was the most highly populated city in the world in the 18th century.

In addition, there were two more large cities, namely Kyoto, the symbolic capital and Osaka, a prosperous commercial city.

It was in this environment that a good communication system for exchange of information on financial transaction was established.

During the Edo era, the basic product of Japan's industry was rice.

By 1730, the world's first future market based upon rice transactions had been created in Osaka.

The city also had a securitization business based upon rice transaction that was built up over a period of time.

The players in the rice market, who were mainly currency exchangers, provided sizable loans to the central and local governments.

In Edo city, they lent money to developers for the building of infrastructure, such as housing and water supply facilities.

Second, during the Edo era, three metals, namely gold, silver and copper were used as coins.

Copper coins were used throughout the nation and had a standardized solid value.

High-valued coins were made of gold and silver; these were the coins preferred and chosen by specific local governments.

At that time, the two precious metal coins had a standardized exchange rate.

Significant numbers of market players became accustomed to a “currency exchange system”.

Already during the Edo era, people widely shared a belief in the principle that a “stable mind was confirmed by the possession of firm assets”.

Many people had a good orientation of or actually made savings.

The national saving rate was high in comparison to other countries and even higher among Japan’s Asian neighbors.

In this environment, currency exchangers started to enlarge their business and by extending loans to companies and later to individual entrepreneurs in big cities, like Edo and Osaka.

However, currency exchange operations were not active in the rural areas.

Instead, people intensified the use of the mutual lending scheme “Mujin”, the mutual aid financing association.

In the latter half of the 19th century, with its rather advanced and deepened financial system, Japan entered the modernization period brought in by the Meiji Restoration.

Section 2: Developments from 1868- 1945

After the beginning of Meiji Restoration, the private financial system was significantly developed and expanded.

In 1873, the central government encouraged and ratified the establishment of national

banks.

Each bank was given a name containing a number, such as the First Bank or the 135th Bank.

These banks were formed using private funds, with the authorization of the government.

Within seven years, 153 banks had been established throughout the country.

National banks established a remarkable branch network throughout the nation.

People could have very easy access to banking operations such as deposits and money transfers.

At first, national banks were allowed to issue bank notes as legal tender for circulation.

However, in 1882, the Bank of Japan was established as a central bank and it subsequently monopolized the issuing of bank notes.

After the first financial crisis in 1890, national banks started to drastically decrease in number, and new types of private banks were rigorously established subject to real monitoring by the government.

By 1901, the total number of private banks had reached 2383, with each one of them creating and maintaining a branch network.

Private banks provided ample finance to those industries that were looking to make significant investments as a way of promoting real industrial development in Japan.

In 1930, the government decided to allow the free trade of gold, which put the banks into deep difficulty.

This, in combination with the Great Depression being played out in the USA, meant that Japan's economy experienced its worst ever conditions; most of the banks barely survived.

Looking at the public side of the economy, the government created and developed a postal saving system, which began to operate in 1875.

By 1911, there were more than 7000 postal savings branches throughout the country, the majority of which were engaged in the deposit and money transfer business.

In contrast to the national banks and private banks, post offices did not have the capacity to lend money.

Rather, they were a vehicle for collecting real deposits.

In 1941, the post offices created a form of special time deposit which has proven to be a very favorable financial instrument for the public.

Private banks and post offices have jointly offered good access to the public and really promoted the importance of increasing the size of deposits among the population.

Section 3: Design and development of public finance after World War II

[Active Operation of Public Finance]

After losing World War II, Japan's economy as a whole was in a massively damaged state; the country needed to use its full force in order to try and reconstruct it.

Even though the private banking system had been somewhat maintained, the volume of funds in the private sector was very limited.

In contrast, the public finance sector had a surplus.

Although the sector was not large, the government decided nonetheless to enhance public financial operations.

A key feature of public finance is that operations are undertaken by government-affiliated financial institutions.

The operations were designed to cope with specific policy needs, such as housing, SME-Micro enterprises, and agriculture.

The institutions operated within the framework of the Financial Investment Loan Program (FILP), which was run by the central government.

[FILP]

As a special account of the central government, FILP accounts received revenue from the

issue of bonds, transfer of sales of stocks which government has and compulsory deposits from the postal savings and pension reserves run by post offices.

Their largest source of revenue came from deposits of postal savings.

Deposits of insurance premiums from the post insurance system were also significant.

The Postal Savings Bank had an extensive network of branches throughout the country and received vast amounts of individual savings.

In many cases, post office station masters were notable people in each region.

This helped with developing and maintaining the trust of local post office clients.

Since the postal savings system did not have a lending function, it did not directly channel funds to industries.

However, funds from the system were deposited into the FILP, which in turn, extended numerous loans to industries, namely corporations and individual entrepreneurs.

FILP operations have two channels.

The first was lending to public project corporations, such as housing construction, railroad extensions, water supplies, and sewerage construction.

The second was lending to public financial agencies, which were government affiliates designed to cope with the specific needs of private corporations and individuals, such as housing and SME-micro enterprises, as well as encouraging investment in the slowly developing local areas.

In addition, support was also given to the issue of bonds by local governments.

The government budget policy was that of a “single-year operation”.

All revenue and spending needed to be matched exactly in every single year and the holding-over of funds into the following year was not allowed.

In contrast, through the operation of government affiliated agencies, the public finance

system was given more flexibility in its operations through multi-year programs, which allowed it to assist with the implementation of government projects.

FILP was therefore referred to at times as the “second budget”.

The largest FILP program amounted to 40.5 trillion Yen in 2007.

In the same year, the budget size of the central government was 75.1 trillion Yen.

[Operation of FILP Financial Institutions]

The following is a brief outline of some of the financial institutions within the FILP finance system.

The Development Bank of Japan supported infrastructure construction and significant facility investment by key industries through the provision of long-term funds.

The Export-Import Bank of Japan promoted international trade among companies and subsequently, the financing of direct investment into developing countries.

The bank was later reorganized into the Japan Bank for International Cooperation (JBIC).

I was the CEO of this institution for 8 years from 2008.

During that time, the Bank supported the recovery operations of Japanese companies and assisted developing countries to gain stability in the aftermath of the Great Financial Crisis.

The National Life Finance Corporation provided funds for micro-businesses including individual entrepreneurs.

The Japan Finance Corporation for Small and Medium Enterprise sustained the operation of SMEs, which provided the largest job opportunities to Japanese workers.

The Agriculture, Forestry and Fishery Finance Corporation provided financing to corporations and individuals engaging in business in the areas of agriculture, forestry and fisheries.

The Japan Housing Finance Corporation provided long-term loans to individuals for building houses.

The Japan Finance Corporation for Municipal Enterprises provided funding to public works such as water supply, municipal transport, and hospitals, and supported the development of industrial parks.

It also funded small local governments that have limited access to the money markets necessary for funding operations.

The Okinawa Development Finance Corporation channeled funds to accelerate the development of Okinawa prefecture.

All the above-mentioned institutions reviewed their mission on a continuous basis and redefined their scope by making necessary changes to the organization.

Some were privatized and active mergers were implemented.

[Review of FILP]

Between the 1950s and 1980s, the public financial system operating through the FILP worked well.

There were, however, a number of criticisms about the system that arose:

- 1) Some agencies had completed their assignment and were ready to withdraw.
- 2) Their operation became inefficient, and
- 3) Since they offered very favorable terms and conditions to borrowers with political motivations, such as SME support policies, market rates and conditions were not reflective of the real market decisions formed by supply and demand.

This in turn blocked the risk-conscious operation of private banks.

The operations of post offices also came under criticism:

- 1) They held the advantageous position of “public institutions”, and
- 2) They offered too many client-favorable conditions to deposit holders and as a result, oppressed the private banking system’s operation.

Post offices became an unfairly large presence in the financial market.

By way of comparison, the size of postal saving deposits in 2007 was 130 trillion Yen, while the total deposit size of all private banks was 550 trillion Yen.

In 2007 the FILP system was reformed.

The post office and its financial operations were privatized, and deposit amounts were no longer automatically transferred to FILP accounts.

Post offices would voluntarily purchase bonds issued by the government for the funding of FILP revenues.

Additionally, there was an intensive business review of each government-affiliated agency, and the coverage of operations was reduced.

At the same time, a number of institutional mergers were undertaken based on the understanding that private banks and financial institutions now possessed the capacity necessary to offer support measures by industries, which up until that time, had been offered by the government-affiliated agencies.

[Taxation]

The non-taxable deposit was created to promote saving amongst Japan's citizens.

Over time, the maximum amount of non-taxable deposits per depositor in private banks was raised in response to an increase in private assets.

Postal savings deposits were set as tax-free, but the total deposit amount is set at the same level as non-taxable amounts for deposits in private banks.

Later, the government set a third category of non-taxable financial instruments, namely government bonds, at the same level.

With these three groups of non-taxable savings options available, more than 90% of the population did not pay any income tax on the receipt of interest payments.

These non-taxable systems strongly encouraged people to make savings.

Yet, in the 1980's, there was strong criticism of this system.

First, the extremely large proportion of financial assets that were free from taxation raised inequality concerns amongst the public.

Second, the management of controls on the maximum amounts was poor, and misuse of the system was widely observed.

So, in late 1980's, these non-taxable systems were fundamentally reorganized and only people aged 65 years or older were allowed to have non-taxable savings.

Additionally, interest payments became subject to a 20% flat taxation rate.

I have worked in the Tax Bureau of the Ministry of Finance for a long time and oversaw the reorganization of these individual income taxes on financial returns.

Promotion of savings and deposit

As previously discussed, Japanese people have long shared the view that savings are important.

After World War II, the government accelerated the enlightenment program for school pupils and students.

The Bank of Japan organized the committee for savings promotion and conducted educational activities.

A learning activity for students to get to know the function of banks was also implemented.

Additionally, the government allowed non-financial companies to receive deposits from their employees at a somewhat favorable rate of interest.

On the whole, the government firmly held its position of encouraging people to make savings.

Section 4: Reconstruction and development of private finance after World War II

After World War II, Japan's private financial system was rebuilt.

An effective network system, which had been established over the preceding 70 years, was already in place.

However, this system suffered significant damage during war time.

While the physical damage was extensive, system management skills were well preserved.

Consequently, the network of banks and other financial institutions was smoothly reestablished.

The characteristics of this system are its multiple layers and compartmentalization.

In addition to regular banks (nationwide or local) there were many banks with specific operational foci, such as long-term financing and trusts.

Mutual savings banks and credit union-type special banks (the Credit Union and Credit Association) were built on narrow local bases.

Furthermore, cooperative organizations based on agriculture, forestry, and fisheries also had their own financial networks.

Japan's defeat in the war meant that its economy had suffered tremendous damage.

The Japanese people put significant effort into reconstruction and development, which required investment in infrastructure and basic industrial capacities.

As the total supply of funds was somewhat limited, the government decided to implement a policy of "priority production systems".

In the field of industrial production, the government chose two industries, namely steel and coal.

Investment and backing finance were then concentrated into these two specific areas.

Moreover, special types of banks that could provide long-term loans to support these investments were formed and actively operated through long-term financing banks and trust banks.

As these banks had a long-term instrument for financing their funds, they were able to supply long-term loans to companies.

At that time, regular banks mostly offered one-year term deposits, whereas these special banks could issue 5-year bonds and offer 5-year trust program.

Coupled with FILP operations, Japanese long-term finance institutions provided sufficient funds to industries.

Therefore, Japan did not have to rely on foreign capital to promote extensive industrial development.

[Financial cliques; ZAIBATSU]

In the first half of the 20th century, Japan's industrial development was to some extent sustained by the *Zaibatsu*, a financial clique or cartel.

After World War II, these *zaibatsu* were dissolved to avoid unfair concentration of economic power.

However, even in the absence of a headquarter office, the grouping of companies has remained and cooperation among these companies.

During deeper cooperation, the leading or flagship company of each group was a nationally operating bank.

[Position of local financial institutions]

While supporting and financing the activities of the local economy, local banks also expanded their operations.

These companies provided a dense network to the local community.

Local banks collected large savings in the form of deposits, and most had an excess fund holding.

Any excess funds in their holdings were transferred to the large banks whose operations were nationwide.

Private banks established a "call market" whereby local banks sold excess funds to the banks who needed more funding.

Big industries sought large amounts of funds, and they often turned to the nationwide operating banks that were based in the major cities.

Transfers of funds in this way between the local areas and major cities helped ensure the

mobility of funds.

As a result, this demand-supply matching function significantly contributed to maintaining a stable market.

The credit unions and finance arms of cooperative organizations also received a considerable number of deposits.

They reformed the central organization and subsequently transferred to them all excess funds from local side branches; the transferred funds were then used for largescale loans, investment into securities transactions, and overseas operations.

[Interest rates]

The government aimed to set interest rates at a low and stable level.

This policy assisted active investment within industries.

First, there was no scale premium in receiving deposits.

Both small and large deposits were subject to the same interest rates - large-scale finance was therefore not costly.

Second, in the early days, the rate of each instrument was not decided by market operation based on real supply and demand relations, but rather, the government provided a “rate hierarchy”.

Instruments that operate over a longer timeframe always had to bear the higher rates.

The central government bonds attracted the lowest rate compared to government guaranteed bonds, local government bonds and private company bonds.

Market players were able to recognize the interest rate setting without monitoring market figures.

Nonetheless, after the large-scale issues with central government bonds arose, markets began to work to provide the “market rate” to the players.

Another issue around interest rates was the creation of depositor-friendly instruments.

Originally, timebound deposits were only offered for a one-year term.

The post office created a new type of instrument in the form of the “*Teigaku* Deposit”.

The characteristics of this deposit were:

- a) The length of the deposit was for 7-10 years,
- b) Every half-year interest payment was automatically added to the principal so that depositors did not have to reinvest received interest, and
- c) During the deposit period, when interest rates were revised up, depositors were able to change the terms of the contract without penalty.

This mechanism was quite advantageous for depositors and it encouraged the promotion of savings amongst the population.

Later, private financial institutions also followed the same methods as described in b), above.

It should be noted that this instrument placed a heavy burden on deposit-receiving institutions.

As a result, they were later totally reviewed and changed.

[Recent development]

In the 1980s, Japan's banking business was expanding, and it was ranked number one in the world for asset size.

As the living standard of Japanese citizens rose, so too did the volume of total deposits.

However, financial businesses began to diversify and the banking business itself reached a turning point.

The sector attempted to expand external business mainly into North America and South-eastern Asia.

However, while the number and size of loans were expanding, Yen business was not prevailing, and banks struggled to receive US dollars.

This significantly delayed the globalization of the banking sector and forced banks to seek out new ways of carrying out their business.

Particularly in the 1980s, banks were heavily engaged in real estate-related business and the size of total loans was expanded significantly.

Unfortunately, this then brought about the financial crisis of 1997 and 1998.

Not only small credit unions but also large city banks and a major security house were bankrupted.

In order to overcome this crisis, major merger operations continued and every effort was made to strengthen the fiscal soundness of financial institutions.

At that time, I was an Executive Secretary to the Finance Minister, Miyazawa Kiichi and witnessed personally the critical discussions around these operations.

On the one hand, globalization or the opening up of the market is important for smooth operation and enriching the scope of business.

On the other hand, any deepening of the system should be carried out before internationalization, in order to ensure sound and stable operations.

In contrast to some other developing countries, Japan was able to deepen its financial system before facing the challenges that accompany the entry of foreign institutions.

This was one of the reasons behind Japan's self-help recovery after the financial crisis occurred in the late 90s.

Japan was able to save its own systems without needing to make any urgent calls to other countries to ask for financial support.

However, this remarkable deepening of the financial system became a negative legacy when banks tried to change their function to cope with the ongoing historical challenges in financing.

Japanese banks were not so active in the Yen business, as they enjoyed a significant amount of Yen deposit savings, which were definitely preferred by the Japanese people.

Moreover, banks focused on Yen business and could not establish nor keep access to international key currencies, such as the US dollar, necessary for vital external business.

Since 1971, the Japanese Yen has steadily increased its value on the foreign exchange market; it was therefore, advisable for individuals and businesses to keep Yen in their assets.

Moreover, the interest levels of Yen finance have been more stable and slightly lower in comparison with other currencies.

In contrast, people living in countries with a depreciating currency found that holding foreign-denominated instruments would produce a large profit.

Furthermore, holding debt in foreign currencies caused considerable issues when their own currency significantly deteriorated.

Governments should not encourage people to have debt denominated in foreign currencies, regardless of whether the interest rates at the time are lower.

Section 5: Direct and indirect financing in Japan

Finance is the action of transferring funds from excess accounts to shortage accounts.

There are two forms of financing: direct financing and indirect financing.

The difference between the two forms of financing is the existence of intermediaries between investors on the excess side and those on the shortage side of funding.

Typically banks act as the intermediaries in financial markets.

They receive deposits and collect funds and then transfer these funds to users in the form of loans.

In the direct finance scheme, users issue stocks or float bonds to receive funds directly from the investors in the form of purchase payments.

In a similar manner to other countries, Japan pursued indirect finance during the first stages of the development of finance markets.

Channeling funds through banks was the primary mechanism for providing funds to the industries.

Of course, the establishment of many corporations led to mounting stocks.

However, the size and scale of stocks was very limited, and corporations borrowed their needed funds from banks in the form of loans.

In 1869, the first corporation was established, and others soon followed.

In 1878, Stock Exchanges were established in both Tokyo and Osaka.

Trading in stocks first appeared in the 1880s, and by the 1920s, security companies had been set up.

After World War II, the security markets were also gradually revived, security exchange laws were formulated, and stock exchanges were rebuilt.

However, trade in stocks and bonds did not become common for the ordinary public and only a limited number of investors rushed into the markets, whilst continuing to act in a speculative manner.

In 1965, the stock market faced its first crisis, which led to the government tightening regulations and setting up a licensing system for securities companies.

Within few years, the number of security companies was nearly halved.

The creation and offering of investment and bond trusts were delayed, and the general public were scarcely able to find a sound access point into the security market.

However, the continuously declining interest rates after 1980, did increase people's interest in the securities markets, as did the tremendous numbers of national bonds issued in 1975.

Additionally, the introduction of medium-term government bonds in the early 1980s provided the stimulus for people to enter into the securities markets.

[Massive issue of government bonds]

After World War II, the government was very cautious about issuing government bonds.

It realized that the large volume of bonds issued in the 1930s and 1940s, only helped fund an irresponsible expansion of warfare expenditure.

Due to the hyper-inflation induced by the massive issuing of bonds, the government prohibited the issue of bonds for deficit financing.

Even when it was permissible for bonds to be issued for the financing of infrastructure construction, the government refrained from doing so.

Then, in 1966, in the wake of the economic downturn caused by the first security market crisis in 1964, the government decided to issue government bonds.

This was a single year operation and the issuing of these bonds in subsequent years remained quite small.

Originally the government issued only one type of bond, namely a 7-year interest-bearing bond.

In 1972, the maturity of government bonds was extended to 10 years.

However, after the first oil crunch in 1975, the government was again forced to issue the bonds to finance enormous fiscal deficits.

The volume of issue then increased, and the government wanted to diversify the type of bonds issued for smooth purchases.

In 1977, the government introduced a 5-year discount bond and in 1978, a medium-term (two, three or four years) interest-bearing bond.

When the supply of bonds exceeded the demand in the markets, and the secondary markets were further developed, the rate of government bonds began to reflect the rates decided by the markets.

Medium-term bonds, in particular, were welcomed by individual investors.

As the market interest rates continuously decreased, investments in government bonds became the firm preference for individuals.

When I was in the Financial Bureau of the Ministry of Finance, I led these operations for diversifying government bonds.

In addition, the government issued a short-term (less than one year maturity) discount bond to finance short-end fiscal operations; these bonds were traded by financial institutions, large companies, and financial funds.

[Active trading of stocks]

Lowering interest rates encouraged individuals to shift their savings investments from deposits in banks to the purchase of stocks.

Eventually the government decided to sell off stock from government-affiliated agencies, namely the rail, telecommunication and tobacco companies, which were undergoing a process of privatization.

Individual investors saw these companies as first-rate and the purchase of these stocks increased.

At the time, money supply was abundant and was largely put into stock markets.

The highly appreciating stock price undoubtedly enticed investors to rush into the stock market.

By the end of the 1980s, prices had reached unprecedentedly high levels.

However, in the years that followed, the market experienced a drastic decline in prices, and many individual investors withdrew from the stock market.

Closing remarks

This lecture provided a brief history of developments in the fiscal and monetary field in Japan up to the end of the 20th century.

Since that time, an enormous number of new challenges have arisen in those fields.

Japan's systems have made, and continue to make efforts to adapt to these new challenges, which are now universal and common to every economy.