The Japanese financial system:
Financial markets and institutions in historical perspective

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FINANCIAL MARKETS AND INSTITUTIONS IN HISTORICAL PERSPECTIVE

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ABSTRACT

In this article, we analyzed the development of the structure of the financial system and the implementation of monetary policy in Japan. Firstly, the pre-reform financial system was discussed extensively. Secondly, a classification of financial institutions according to their business features and customers was given. Thirdly, we concentrated on the money markets because of their importance for monetary policy making in Japan. These markets were divided into the interbank and open money markets.

Fourthly, regarding the process of financial reform five strongly interrelated sub-processes were distinguished: financial innovation, financial liberalization, financial globalization, financial concentration and restoring of financial reputation.

Fifthly, an analysis of the monetary policy transmission mechanism in Japan was presented for the whole post World War II period. Regarding the implementation of monetary policy a distinction was made between three subsequent periods: the traditional (1953-1975), new (1975-1981) and modern monetary policy (1981-present).

Finally, we will discuss the relationship between the monetary authorities in Japan against the background of recent developments.
INTRODUCTION

Until the eighties Japan was mainly concerned with high economic growth promoted by considerable exports to the United States and Western Europe. After the rapid appreciation of the yen, following the Plaza agreement of September 1985, Japan's economic growth was mainly supported by the expansion of domestic demand. The Japanese companies and financial institutions could finance the required investments from the voluminous household savings and could also accumulate substantial reserves. These reserves enabled Japanese companies and financial institutions to extend strongly their direct foreign investments. Furthermore, after the rise of Japanese industry, the second half of the eighties were characterized by the advance of Japanese banking and securities business. The financial institutions were primarily focused on domestic developments, but during recent years they became more conscious of their dominance in the global financial system. Measured by the size of assets, no less than nine of the ten biggest banks in the world were of Japanese origin. Furthermore, the big four Japanese securities companies all belong to the world top ten. Moreover, the monetary policy by the Bank of Japan increasingly affects the international monetary system. On the one side the domestic credit expansion in Japan influences the global money supply, on the other side Japanese exchange and money market management plays a prominent part in the process of international monetary coordination within the Group of Three (G3) and the Group of Seven (G7).

In this article we will discuss the evolution of the financial system in Japan during the whole post World War II period and its consequences for the monetary policy implemented by the Bank of Japan. Firstly, the structure of the Japanese financial system during the high growth period (1953-1972) and the Japanese financial institutions and markets are set out with emphasis on depository institutions and on interbank and open money markets because of their relevance for monetary policy. Secondly, we describe the progress of the process of financial reform in Japan which took off in the late seventies and early eighties. Thirdly, the objectives, indicators and instruments of monetary policy by the Bank are analysed with special reference to the transmission mechanism of monetary policy. A distinction is made between the traditional (1953-1975), new (1975-1981) and modern monetary policy (1981-present).

THE PRE-REFORM FINANCIAL SYSTEM

The financial system of a country can be defined as the whole structure of financial institutions and markets. In the first part of this article, we will concentrate on the structural characteristics of
financial institutions and markets in Japan. Before presenting a survey of the actual situation, the pre-reform financial system will be analysed. This analysis will serve as background for the understanding of the contemporary Japanese financial system.

The end of World War II brought the occupation period in Japan (1945-1952). During this period, the Supreme Commander of Allied Powers (SCAP) introduced several reforms with respect to the structure of the financial system. Some reforms were embedded in explicit, western style laws, which would determine an important part of the postwar financial framework in Japan.

The most important legal reform was undoubtedly the enactment of the Securities and Exchange Law in 1948, which established the legal separation of banking and securities business, in particular by Article 65 of that law. The Securities and Exchange Law was partly based on the Glass-Steagall Act which separated banking and securities business in the United States. Article 65 prohibits banks from engaging in the securities business, unless there is an investment motive or a trust contract. In the prewar period, there was no legal provision which separated Japanese banking and securities activities.

The purpose of the legal confirmation by the SCAP of the banking-securities separation was according to Suzuki (1987) and McCall Rosenbluth (1989) firstly to protect bank depositors from banks' risky holdings of equities or long-term securities, and secondly to stimulate the development of securities companies and the level of direct finance (disintermediation) in Japan.

Other legal reforms were the promulgation and the implementation of the Anti-Monopoly Law and the Temporary Interest Rate Adjustment Law in 1947. The Anti-Monopoly Law established a formal anti-trust framework in Japan. Its revised version of 1976 restricted the holding of equity of any company by Japanese banks to a maximum of 5% (formerly 10%). The Temporary Interest Rate Adjustment Law, which is still not officially abolished, placed upper limits (ceilings) on some loan rates and most deposit rates.

Examples of other reforms introduced by the SCAP are the dissolution of the prewar Zaibatsu conglomerates, the reorganization of specialized banks into long-term credit banks and new public financial institutions. Furthermore, the establishment of the so-called Dodge Line, i.e. the adoption of a balanced budget policy in 1949, banned the flotation of government bonds to cover current deficits. The Dodge Line was abolished in 1965.

The SCAP reforms were only a part of a larger group of factors which determined the structure of the postwar financial system, such as the prewar financial structure and the unique economic, social and cultural environment of Japan.

The evolving structure of the postwar financial system was expected to fulfil three important requirements. Firstly and most importantly, the system had to supply sufficient long-term funds to realize economies of scale for developing industries, using borrowed technology (the "catch-up" process). The second role assigned to the financial system was enhancing the availability of funds in low productivity
and traditional areas. Thirdly, the financial system was required to be safe and stable. 

The financial system during the postwar period of high economic growth, the so-called high growth period (1953-1972), has been characterized in numerous publications of the Bank of Japan by four distinctive features. 

The first and dominant characteristic of the Japanese financial system, or, more specifically, of the Japanese banking system during the period 1953-1975 was the so-called situation of overloan. Overloan can be described as "... the existence of loans and investments funded from sources other than deposits and equity capital, so that reserve assets (taken as the sum of central bank money plus second-line reserve assets minus borrowed funds) are consistently negative" [Suzuki (1980), p.5]. Borrowed funds include loans from the central bank and borrowing from the money market. It is important to stress that in the case of Japan overloan not only existed at a micro level, i.e. a situation of overloan of individual banks, but also at a macro level. The macro based situation of overloan implied that the banking system as a whole was in debt to the Bank of Japan and depended very much for its funding on central bank credit. 

A second characteristic of the financial system during the high growth period was the predominance of indirect finance (intermediation), mainly resulting from the underdevelopment of capital markets. This preference for indirect finance can be explained partly by the domination of the flow of funds by transactions based on customer relationships rather than on funding through the capital market. The emphasis on customer relationships can be found in the so-called main bank system. Most companies had a very close relationship with one or more main banks. These banks operated as a kind of lender of last resort and supported their clients in many ways. Furthermore, the underdevelopment of capital markets was caused by the low level of flotation of government bonds, the use of interest rate and foreign capital controls, and the reduced level of asset accumulation after World War II. As a result, the development of the bond market was seriously hampered. 

The situation of overborrowing was a third characteristic of the financial structure during the high growth period. Overborrowing refers to corporate finance and indicates a condition of heavy dependence of the corporate sector on bank borrowing, in Japan resulting from the low level of internal financing and the predominance of indirect finance. 

The fourth and final characteristic of the financial system during the high growth period has been the permanent imbalance of liquidity between financial institutions. One group of financial institutions (i.e. the city banks) was chronically in need of funds, while another group (i.e. the regional, sogo and shinkin banks and other financial institutions) was in surplus of funds. 

The classification of the Japanese financial system during the high growth period on the basis of these four characteristics has been questioned by Royama (1988). 

Royama warns for interpreting these superficially observed characteristics as structural features and
questions whether the four characteristics were uniquely applying to Japan. For example, the imbalance of bank liquidity has also been observed in the United States since the late sixties. However, this situation has not been explicitly mentioned as an unique characteristic of the U.S. financial system. Furthermore, the predominance of indirect finance in Japan from an international perspective has been doubted by Kuroda and Oritani. They have pointed out that a more consistent definition of indirect finance and adjustment for different accounting methods in the United States and Japan show more or less equal levels of indirect finance in both countries. Against the background of these remarks, we will present an additional classification of the high growth period financial system. This classification is mostly based on the regulation of the Japanese financial system. As regarding the structure of regulation, the financial system during the high growth period has been regulated on several points. Essentially, five kinds of regulations can be distinguished:

- regulation of structure and activities of financial institutions
- regulation of interest rates
- regulation of entry into financial markets
- regulation of international capital movements
- regulation of creation of new financial instruments

Based on Teranishi (1986b) and (1990)

Firstly, regulations existed with respect to the structure and activities of financial institutions. One can speak of a functional segmentation of financial institutions. We already discussed the separation of securities and banking business. Furthermore, banking and trust business have been separated and a specialization of lending areas for financial intermediaries has been established. Some financial institutions have specialized in long-term finance, while others became occupied with short-term lending activities. Moreover, specialization of lending areas can be found in special financial institutions for small and medium-sized firms and agricultural business.

Secondly, the high growth period was characterized by a system of interest rate regulation. The Temporary Interest Rate Adjustment Law (TIRAL) established upper limits (ceilings) for various deposit interest rates. Since 1970, deposit interest rates are informally regulated according to guidelines from the Bank of Japan, within the limits of the TIRAL. Furthermore, the TIRAL limited lending interest rates in cases of loans of more than one million yen in amount or shorter than one year in length. Below these ceilings, the Federation of Bankers' Associations of Japan voluntarily fixed their maximum lending rates. This system was in 1959 replaced by a standard rate system, more or less comparable with the prime rate system in the United States. According to Royama (1983/1984), in
1975 the cartel-like agreement with respect to the establishment of the standard rate was abolished.

It has to mentioned that compensating deposits were used to evade the regulation of lending rates. By raising the amount of required deposits of borrowers, banks were able to increase effective lending rates. Furthermore, during the high growth period about 60% of bank loans were beyond the scope of regulation. Therefore, it may be concluded that regulation of lending rates was not effective and that effective loan rates in fact cleared the market.

Another aspect of interest rate regulation was the issuing of bonds with prices artificially higher than prevailing market prices, causing issue rationing by the Council for the Regulation of Bond Issues (Kisaikai), and hampering the development of secondary bond markets.

The specialization of bank lending activities combined with interest rate regulation has been called the "artificial low interest rate policy" and can be outlined as follows. In financial markets, such as the market for bank deposits, interest rates were explicitly fixed by monetary authorities. On the contrary, in the market for bank loans and the interbank money market, interest rate regulation was rather weak and took a more implicit form.

The "artificial low interest rate policy" resulted in a so-called dual interest rate structure, consisting of relatively free but higher interest rates in interbank markets, and strictly regulated and artificial lower interest rates in other markets, such as deposit markets.

Thirdly, the regulation during this period referred to the entry into financial markets. As we have seen, the Kisaikai regulated the issue of bonds. Furthermore, the primary market for equity was restricted to relatively large firms. With respect to short-term financial markets, the money market was not open to non-banks until the rise of the Gensaki-market in the early seventies.

Fourthly, during the high growth period international capital movements to and from Japan have been strictly regulated. According to the Foreign Exchange and Foreign Trade Control Act of 1947, all financial transactions with foreign countries were forbidden in principle, with freedom of international financial transactions as an exception. The regulation of international capital flows enabled monetary authorities to sustain the structure of the postwar financial system by closing the loopholes of interest rate regulation and controlling the foreign source of the money supply.

Fifthly and finally, the creation of new financial instruments during the high growth period was strictly regulated and thus financial innovations were suppressed. As a result, the variety of financial instruments was very limited.

In addition, the financial system of the high growth period can be characterized by two other factors, i.e. a complementary relationship between private and public financial institutions and an accommodating stance of monetary policy. This complementary relationship meant that private financial intermediaries were mostly focusing their lending activities at market interest rates (through compensating deposits) on the growing and modern sector of the economy, whilst public financial intermediaries...
directed their funds at regulated interest rates towards the declining, traditional sector and supplied funds for social provisions. The structure of the high growth period financial system changed during the second half of the seventies. This process of financial reform will be discussed after the following description of Japanese financial institutions and markets.

FINANCIAL INSTITUTIONS

The Japanese financial institutions can be divided into financial intermediaries and other institutions and the intermediaries can be subdivided into depository and non-depository institutions. A classification of financial institutions according to their business features and customers is given in Figure 1.

FIGURE 1

Together with the Ministry of Finance and the Ministry of Posts and Telecommunications, the Bank of Japan constitute the monetary authorities in Japan. According to the Bank of Japan Law, Article 1: "The Bank of Japan has for its object the regulation of the currency, the control and facilitation of credit and finance, and the maintenance and fostering of the credit system, pursuant to the national policy, in order that the general economic activities of the nation might adequately be enhanced." Although the Bank of Japan is mainly occupied with implementing monetary policy, and the main task of the Ministry of Finance implies the regulation and supervision of the Japanese financial system, the Ministry of Finance can exercise influence with respect to the implementation of monetary policy through its administrative guidance (gyoosei shidoo) and legal constituted power.

The city banks are the largest of all commercial banks and hold from the end of March 1991 approximately 25% of the total deposits of all financial institutions. These banks are based in large cities. They possess extensive branch networks within Japan and have also international business networks. The city banks provide the greater part of short-term finance to domestic companies and belong all to the world's 25 largest banks. It has to be mentioned that about 70% of the outstanding loans of city banks has a maturity of longer than one year, i.e. the traditional orientation of city banks on short-term lending is fading. Furthermore, the degree of concentration of city banks is increasing, as can be seen from the merger between Mitsui Bank and Taiyo-Kobe Bank into Mitsui Taiyo Kobe Bank in 1990, and the merger between Kyowa Bank and Saitama Bank of April 1, 1991.

The regional banks have their headquarters throughout the country not only in large cities, but also in smaller cities. These banks mostly operate in local areas, i.e. their prefectures. They conduct the same
business as city banks, although on a smaller scale. For the most part, the regional banks lend to individuals and small-to-medium-sized business. Their main source of funding are individual deposits.

The member banks of the Second Association of Regional Banks are former sogo or mutual savings banks, all of which but one were changed in commercial (regional) banks after February 1989. On April 1, 1991, the first merger between a regional bank (San-in Godo Bank) and a member of the Second Association of Regional Banks (i.e. Fuso Bank) came into effect.

The long-term credit banks (LTCBs) are the most important group within the long-term financial institutions. The three LTCBs were organized under the Long-Term Credit Bank Law of 1952 to provide long-term finance to domestic manufacturers. They carry out their funding mainly by debentures, but are also allowed to accept deposits from the Japanese government, local governments, private companies, and from individuals when the deposits are related to the purchase of debentures.

The seven trust banks are another group of long-term financial institutions. These banks are -unlike the LTCBs- permitted to conduct both ordinary banking and trust businesses under separate accounts. Their trust activities consist of the management of loans and funds and include e.g. money trusts, securities investment trusts and pension funds. The Ministry of Finance approved in June 1985 the establishment of foreign trust banks. The first foreign trust banks (i.e. Morgan Trust Bank and Japan Bankers Trust Company) opened in November of that year.

The financial institutions for small businesses comprise four groups: the sogo banks, the shinkin banks, the credit co-operatives and the Shoko Chukin Bank. The sogo banks used to be mutual non-profit organizations, but were converted in 1951 into profit-oriented corporations. As we have seen, after February 1989 the Sogo banks converted their status to that of commercial (regional) banks with the exception of one (i.e. Toho Sogo Bank). With the announced merger of Toho Sogo Bank with a regional bank (Iyo Bank) in April 1992, sogo banks will disappear from the Japanese financial system. The shinkin banks are mutual associations of small businesses and provide ordinary banking services and installment businesses to their members. The credit co-operatives are cooperative financial institutions on a mutual base for small businesses and accept deposits and installment savings from their members to lend or discount bills to them.

The Zenshinren Bank and the National Federation of Credit Co-operatives act as the central bank for respectively the shinkin banks and credit co-operatives. Zenshinren Bank is expanding internationally, as can be seen from the start on July 31, 1991, of its first securities subsidiary, Zenshinren International Ltd., in London.

The Shoko Chukin Bank is a kind of central bank for co-operatives of small and medium-sized businesses. Most of its activities are financed by the issue of debentures.

The financial institutions for agriculture, forestry and fishery are organized on national, prefectorial and municipal level. They provide financial services to farmers, foresters and fishermen on a mutual base.
The Norinchukin Bank acts as the central bank for these institutions. The main non-depository institutions are the insurance companies, which are legally divided in two groups: the life insurance companies and non-life insurance companies (fire and marine insurance companies). The insurance companies use their premiums to lend to industrial corporations and, recently, to invest in securities. They hold the largest portfolio of Japanese stocks. The securities companies belong to the other private financial institutions. They dominate the primary and secondary markets for domestic stocks and bonds, but also play a role in the open money markets. The "big four" securities companies are Nomura, Daiwa, Nikko and Yamaichi and conducted about 70% of the total underwriting and half of all trades on the Tokyo Stock Exchange. However, with the securities scandal of 1991 things are changing. For example, the Big Four's share of daily trading has plummeted to about 30% in August 1991.

The tanshi institutions are money market dealers which are according to Suzuki (1987) active as specialized transaction intermediaries in the short-term money markets. The tanshi fulfill an important role regarding the actual implementation of monetary policy by the Bank of Japan. Banks cannot deal with each other for most purposes, and have to conduct most money market transactions through the tanshi institutions. The money market operations of the Japanese central bank are performed through these intermediaries. According to Hollerman (1988), staff members of the tanshi are mainly former Bank of Japan people who are strongly sympathetic to the policies of the Bank.

The most important public financial institution is the Postal Savings System with a network of approximately 24,000 local post offices and around 16% of all deposits by Japanese households. This institution is under the supervision of the Ministry of Posts and Telecommunications.

FINANCIAL MARKETS

The Japanese financial markets are to be divided into the money markets for (very) short-term finance and the capital markets for medium- and long-term finance. The money markets with assets of less than one year maturity can be subdivided in the interbank and open money markets. The capital markets with assets of more than one year maturity may be split up into the primary and secondary markets for stocks and bonds and other markets based on these markets, such as the bond futures market. Hence, we shall concentrate on the money markets because of their importance for monetary policy making in Japan. The heart of the money market are the interbank markets where only financial institutions borrow and lend short-term funds. The main borrowers in the interbank markets are the city banks and large regional banks, e.g. the Bank of Yokohama, and the most important lenders are trust banks, the Zenshinren Bank and the Norinchukin Bank.

The interbank markets comprise three parts: the call (money) market, the (commercial) bills market and
the dollar call (money) market.
Since 1927 the call market requires as collateral government bonds or bills emitted by corporations. However, in July 1985 an uncollateralized call market was created which became attractive for foreign banks because of the lack of collateral.

Both on the collateralized and uncollateralized call market funds were traded with a very short maturity, from overnight till three weeks. However, with the money market reforms of November 1988 and April 1989 the maturity range of collateralized call money transactions has been shortened to the unconditional - six weeks range, and uncollateralized transactions have now maturities between overnight and one year. Of course, most transactions are for funds at the short end of the maturity range.

The bills market began in 1971 as a market for discounting commercial bills with a maturity from one to six months. The Bank of Japan is the main buyer in the bills market and uses this market for its money market operations. In recent years, with the money market reforms, the maturity range for bills transactions has been enlarged to one week - one year.

The dollar call market was created in 1972 to borrow and lend foreign currency funds -mostly US dollars- with a (very) short maturity in Tokyo. Only domestic and foreign banks have access to this market.

Besides the interbank money markets, there are also the open money markets in which both financial and non-financial institutions can participate. The open markets include eight different submarkets: the gensaki market, the certificate of deposit (CD) market, the Euro-yen market, the banker's acceptance (BA) market, the financial bills (FB) market (Seifu tanki shoken), the treasury bills (TB) market (Tanki kokusai), the Japan Off-shore market (JOM) and the commercial paper (CP) market.

The gensaki market was officially established in 1949 as a market to sell/buy temporarily securities. These securities will be repurchased/resold at a predetermined time and price within six months after the sale/purchase. In May 1979 CDs were introduced by depository institutions, especially city banks. Because the CD rates are unregulated and negotiable, the CD market became an important open market in successive years. On the Euro-yen market off-shore transactions can be conducted without collateral and withholding tax. This market may be considered as one of the most liberalized open markets and thus functions as an substitute for domestic open markets.

The BA market was created in June 1985 for trading BAs, i.e. a fixed-term bill of exchange issued by an exporter or importer to settle a trade transaction and then underwritten by a bank. Because of several limitations such as complicated issuance procedures and the progressive stamp tax on the issue of BAs, the volume of this market has shrunked since its establishment.

On the FB market seasonal or temporary shortages of government funds are covered by discount bills with a maturity of mostly 60 days. The FB rates are below the level of the discount rate and money
market rates and therefore virtually all issued FBs are subscribed by the Bank of Japan. The volume of this market is relatively limited.

Treasury Bills have been introduced in Japan in February 1986, especially to refinance the large amounts of long-term Government bonds coming due from 1985 onwards. Originally TBs had a maturity of six months, but in August of 1989 the MoF introduced three month bills. The TB market reached a volume of Yen 8.2 trillion by end-April 1991. To stimulate private investment in both FBs and TBs, the minimum unit of these securities has in March 1990 been lowered by the Ministry of Finance from 50 to 10 million yen.

The JOM, which was established in Tokyo in December 1986, is a relatively non-regulated market for transactions between non-residents. The JOM is separated from the domestic financial markets by the establishment of specific accounts and has become one of the leading off-shore centers of the world.

In November 1987 the CP market was established and its volume has grown considerably since then. CPs are short-term assets issued by non-financial institutions to replace bank loans. They allow more flexible funding to corporations at lower costs. The CP market is often called a quasi-interbank market, because CPs are mainly traded among banks. On January 31, 1990, the Ministry of Finance relaxed the qualifications with respect to issuance of commercial paper and approved CP issuance by securities companies.

FINANCIAL REFORM

Till the end of the sixties the pace of financial reform was slow in Japan. From 1973 this changed by the transition to floating exchange rates and the rise of inflation rates throughout the world. Furthermore, the first oil crisis marking the end of the high growth period resulted in large issues of Japanese government bonds to finance public debt. The shift to lower economic growth and higher levels of public debt, combined with the increasing accumulation of financial assets by individuals and the growth of internal reserves of Japanese companies, and high levels of monetary growth, raised the degree of interest rate sensitivity in the private non-financial sector. In addition, there was a development towards open money and capital markets, in particular Euro-currency markets. Furthermore, the shift to the floating exchange rate system stimulated the internationalization of money and finance and resulted in a substantial increase of international capital flows. Finally, the rapid progress of computer and information technology resulted in lower costs of financial innovations and higher profit opportunities for financial institutions.

With respect to the process of financial reform from a Japanese perspective, five strongly interrelated sub-processes can be distinguished:
- financial innovation
- financial liberalization
- financial globalization
- financial concentration
- restoring of financial reputation

Firstly, since the mid-seventies the Japanese financial system has experienced many financial innovations, i.e. the introduction of new financial products, techniques and markets. Examples are respectively the introduction of such different financial products as certificates of deposit (CDs) and financial derivatives (options and futures), the use of new techniques of asset and liability management, and the establishment of new markets, e.g. the Japan Off-shore market and the Tokyo International Financial Futures Exchange (TIFFE).

Secondly, the last 15 years have shown the abolishment or lessening of many financial regulations in Japan. This so-called process of financial liberalization has affected the regulatory framework regarding the structure and activities of financial institutions, interest rates, entry into financial markets, international capital movements and creation of new financial instruments.

A third aspect of financial reform is formed by the process of financial globalization. The process of financial globalization "... indicates a further strengthening of the ties among national financial markets so that they have actually changed into a unified financial system on a worldwide scale" [Suzuki (1989), p.158]. The lifting of exchange and international capital controls and limitations on entry by foreign financial institutions into domestic markets, the growth of off-shore markets, the development of 24 hour global trading, the increased use of national currencies outside the country of issue and of new internationally traded financial products have all contributed to the globalization of financial markets 35.

Fourthly, in recent years the Japanese financial system has been characterized by an increasing number of mergers between financial institutions, resulting in a substantial higher level of concentration of financial institutions.

Fifthly and finally, as a result of the stock compensation and fake deposit scandals during the summer of 1991 the Japanese financial system will have to restore confidence among investors. This rebuilding of financial reputation will have consequences for the future structure of the Japanese financial system.

With respect to financial innovations, the most important were the introduction of CDs in May 1979 and money market certificates (MMCs) in March 1985 by banks and the creation of so-called chukoku funds -i.e. portfolios containing medium-term government bonds- in January 1980 by securities companies 36. The process of financial innovation and liberalization had its impact on the Japanese financial system. At first this meant a gradual relaxation and abolishment of interest rate regulations -
i.e. interest rate ceilings - for large bank deposits. Hence, interest rates for deposits of three months to two years maturity with a minimum amount of one billion yen were fully liberalized in October 1985. Furthermore, this minimum for large time deposits was gradually reduced to 10 million yen in October 1990. The Ministry of Finance has already decided to deregulate fixed term deposits of three million yen or more in the fall of 1991. Moreover, interest rates on time deposits of less than half a million yen are to be liberalized by the summer of 1992. The liberalization of time deposits will likely be completed in 1993. The Ministry wants to liberalize interest rates on checkable bank deposits by the spring of 1994. A complete liberalization of interest rates had been hampered by the existence of attractive savings accounts with the non-profit-oriented Postal Savings System. However, study groups from the Ministry of Finance and the Ministry of Posts and Telecommunications have made recommendations to resolve these problems, and continuing negotiations between both ministries will ultimately end in some kind of compromise. Another aspect of liberalization was the reduction of the minimum amount for CDs to 50 million yen and for a new type of small MMCs (the so-called Super-MMCs, introduced in June 1989) to half a million yen from April 1991, and the abolishment of the maximum volume for issues of CDs and MMCs.

Furthermore, with respect to interest rate liberalization the introduction by Mitsubishi Bank in January 1989 of a new short-term prime rate system has to be mentioned. As a result of the process of financial innovation and liberalization, Japanese banks have to raise a growing proportion of their funding through the selling of liberalized financial instruments with (money) market related interest rates. The old short-term prime rate system was not flexible enough to reflect this shift to a market based funding structure. Under the new short-term prime rate system, interest rates are related to market developments and determined by the weighted average of funding costs. As regarding long-term prime rates, i.e. interest rates on loans with a maturity longer than one year to most preferred customers, Fuji Bank introduced a new system in April 1991. To cope with the inverted term structure of interest rates Fuji Bank has related its long-term prime rate to its short-term prime rate by adding a certain spread. Reportedly, also other city banks will introduce this new formula in the near future.

As a result, both short- and long-term prime rates will be related to money market developments.

As examples of new financial techniques, the increased use of funding instruments with market related interest rates (liability management) and spread based lending rates (asset management) and the introduction of securitization in the banking sector can be mentioned. To help banks to improve their capital adequacy ratios against the background of the requirements of the Bank for International Settlements (BIS), the Ministry of Finance has besides permitting banks to issue subordinated loans, allowed the securitization of housing loans (October 1988), loans for municipal governments (July 1989) and corporate loans (March 1990).

With respect to the regulation of the structure and activities of financial institutions, it is clear that the
functional segmentation of Japanese financial institutions has been blurred by financial innovation, liberalization and globalization. The segmentation between short-term and long-term financial activities and between banking and securities business is slowly but steadily losing importance. In various reports of the Financial System Research Council (affiliated with the Banking Bureau of the Ministry of Finance) and discussions by the Securities and Exchange Council (affiliated with the Securities Bureau), this desegmentation process is extensively discussed. The second interim report by the Second Financial System Committee of the Financial System Research Council focused on two possible approaches, i.e. the establishment of separate subsidiaries for each field of operation and a multifunctional subsidiary. The Committee concluded that the separate subsidiary approach is the best strategy for commercial banks, long-term credit banks and trust banks to diversify into each others’ markets. In its report of June 1991 commercial banks, trust banks and securities firms are allowed to set up subsidiaries to enter each others’ business. Long-term credit banks will set up trust bank and securities subsidiaries.

The internationalization of the Japanese financial system has developed rapidly, especially since the enactment of a new Foreign Exchange and Foreign Trade Control Law in December 1980 which provided freedom of international transactions unless explicitly prohibited (freedom in principle). Under financial globalization Japanese financial markets have become more and more integrated with world markets, and both Japanese financial institutions and corporations can now freely choose among various national financial systems to conduct their transactions. The process of financial globalization with respect to the money market in Japan has been stimulated by two important reforms. Firstly, the removal in June 1984 of the so-called swap limits or yen conversion limits, which restricted the amount of foreign currency that could be converted into yen by financial institutions, increased arbitrage between interbank markets and Euromarkets. Secondly, the internationalization of Japanese money markets has been stimulated by the abolition in April 1984 of the so-called real demand doctrine, which allowed forward exchange transactions only for trade (or real) finance.

Another aspect of financial reform in Japan is the process of financial concentration. Some mergers between various large banks have already been mentioned. Furthermore, smaller financial institutions have been hit by the ongoing reform of the financial system, with interest rate liberalization narrowing their margins and larger financial institutions taking away their traditional business. Hence, small financial institutions are mostly either merging, being acquired by bigger institutions (for example the announced take over by Tokai Bank of Sanwa Shinkin Bank) or converting their status to an ordinary bank (for example sogo banks and Yachiyo Shinkin Bank). Consequently, the number and diversity of financial institutions in Japan are decreasing.

Finally, the scandal-ridden Japanese financial system will have to restore its reputation amongst Japanese and international investors. Reformers want the establishment of a Japanese equivalent of the
U.S. Securities and Exchange Commission (SEC) as an independent body from the Ministry of Finance and modifications in the regulatory legal framework. However, the specific consequences of the scandals for the structure of the financial system in the years to come are not clear yet.

MONETARY POLICY

In this section, attention will be paid to the channels of transmission in the monetary policy process. In the transmission mechanism of monetary policy a number of monetary variables play an important role. These variables provide the central bank with the necessary information about the orientation and effectiveness of its monetary policy. Figure 2 shows the transmission mechanism.

FIGURE 2

The indicator is the starting point of the monetary policy process. This monetary variable is close to the central bank and is directly affected by the policy instruments. The relationship of the indicator with the goals of monetary policy, i.e. the final policy objectives, is according to Suzuki (1987) somewhat unstable. Therefore, the target is used as an intermediate objective. The target is farther from the control of the central bank and is not directly affected by the policy instruments, but its relationship with the goals of monetary policy is relatively stable.

In the following subsections, a brief analysis of the monetary policy transmission mechanism in Japan is presented for three subsequent periods. A distinction will be made between the traditional (1953-1975), new (1975-1981) and modern monetary policy (1981-present).

THE TRADITIONAL MONETARY POLICY 1953-1975

The traditional monetary policy coincided with the high growth period, the already mentioned period of high economic growth which started in 1953. During this period the main source of corporate finance was bank credit. As we have seen, the heavy dependence of the corporate sector on credit from depository financial institutions, i.e. the situation of overborrowing and the predominance of indirect finance, was mainly caused by the underdevelopment of the capital markets.

It will become clear from the following analysis that the heavy dependence of the corporate sector on bank credit and the situation of overloan were of great importance for the implementation of the traditional monetary policy. On the basis of figure 2 we will present a brief review of Japanese monetary policy during the period 1953-1975.

The starting point of the traditional monetary policy was formed by the interbank (money) markets.
The Bank of Japan used the interbank interest rates, i.e. the call rate and after 1971 the bill discount rate, as indicators.

The Bank of Japan exerted great influence on the interbank (money) markets through its lending policy. Of great importance in this policy was the reserve system of the Bank, which is still effective today. The commercial financial institutions are under the reserve system required to hold non-interest bearing deposits at the Bank of Japan against their private deposits.

The financial institutions are free to decide the daily amount of these deposits, if at the end of the reserve period the compulsory amount of reserve deposits is attained. The reserve deposits consist mainly of credit of the Bank of Japan, so the lending policy of the Bank has a great impact on the reserve position of financial institutions. It is important to stress the focus of the lending policy of the Bank of Japan at the so-called reserve progress ratio, i.e. the ratio of the actual amount of reserve deposits to the compulsory amount of reserve deposits. By changing the amount of its credit, the Bank of Japan exerts great influence on the amount of reserve deposits at financial institutions and so on the interbank interest rates. For example, rationing of credit by the Bank of Japan decreases the sum of the individual reserve progress ratios of the various financial institutions. When the end of the reserve period comes nearer, financial institutions with an insufficient amount of reserve deposits (i.e. below the compulsory level at the end of the reserve period concerned) are forced to borrow in the interbank markets. As a result, interbank interest rates will rise.

The lending policy of the Bank of Japan was very effective during the period 1953-1975, mainly as a result of the macro situation of overloan. This situation implied that banks were heavily dependent on central bank credit, and therefore changes in the amount of credit of the Bank of Japan had great consequences for the reserve and funding positions of banks and consequently for interbank interest rates.

Besides the lending policy the Bank of Japan did have other policy instruments to control interbank interest rates. The various instruments are presented in figure 3. The main instrument was the lending policy of the Bank of Japan. The securities and bills operations, i.e. the buying and selling of securities and bills by the Bank of Japan, were focused on neutralizing money market surpluses and shortages. Because these operations took place between the Bank of Japan and depository financial institutions, they did not have a direct effect on the money supply. Consequently, these securities and bills operations of the Bank of Japan were not open market operations in the true sense. A better qualification might be quasi-open market operations.

Changes in the official discount rate were intended to give signals about the policy intentions of the Bank of Japan (so-called announcement effect). Changes in the reserve ratios, which determine the amount of reserves banks have to deposit at the Bank of Japan in relation to their deposits and other liabilities, only had a modest effect on interbank interest rates.
The implicit interest rate regulation was an informal instrument of the Bank of Japan to regulate interbank interest rates. The interbank interest rates were fixed after close consultations between the Bank of Japan and the tanshi institutions. The Bank of Japan did have a great influence on the tanshi, so that the interbank interest rates could be fixed according to the policy objectives of the Bank.

The target of the traditional monetary policy was the broadly based lending by banks, mainly to the corporate sector. Broadly based corporate credit included ordinary bank credit to the corporate sector and the absorption of corporate bills and securities by banks. The main argument in favour of this specific target was the situation of overborrowing and predominance of indirect finance. Because of these situations broadly based corporate credit was a good proxy for the volume of business investments and the level of economic growth.

FIGURE 3

The process by which the interbank interest rates (the indicators) affected the direction of the broadly based lending by banks was very clear and stable and can be presented as follows. Interest rates on broadly based bank credit were, mainly as a result of legal regulations, informal agreements and cultural customs, inflexible compared with interbank interest rates. The rigid structure of credit interest rates resulted in substitution effects between on the one hand activities of banks in the interbank money markets and on the other hand the amount of broadly based lending by banks. For example, when interbank interest rates rose as a result of monetary policy actions by the Bank of Japan, the inflexibility of credit interest rates caused a shift out of bank credit towards investments in the interbank money markets. This increase of funds in the interbank market could be neutralized by offsetting operations of the Bank of Japan.

The end of the monetary policy process is the link between the target(s) and the goal(s). The main goals of the traditional monetary policy were the achievement of price stability (CPI) and equilibrium in the balance of payments (BOP). Through regulation of the broadly based lending by banks the Bank of Japan was able to control the level of business investments, i.e. the main impetus of the high economic growth, and therefore aggregate demand, inflation and the balance of payments.

An additional instrument to control the broadly based lending by banks was the so-called window guidance, in the words of Suzuki (1987) "... guidance to the financial institutions to keep the increase in their lending to clients within limits that the Bank of Japan feels to be appropriate". Window guidance is a kind of moral suasion, but as a result of the situation of overloan, this form of monetary policy can be very effective.

Figure 4 shows a review of the traditional monetary policy.
THE NEW MONETARY POLICY 1975-1981

During the first part of the seventies the collapse of the Bretton Woods system and the oil crisis had a great impact on the world economy. Economic growth in Japan slowed down and the government was forced to introduce an accommodating Keynesian oriented monetary and economic policy. As a result, the rate of inflation increased rapidly.

The crisis in the Japanese economy had great consequences for the economic and financial structures. The shift to lower growth reduced the corporate demand for credit and resulted in a sharp decline in the situation of overborrowing. The large-scale issues of government bonds, necessary to finance the accommodating monetary and economic policies, stimulated the development of the securities market and decreased the predominance of indirect finance, i.e. increased direct finance in Japan. The decline in the situations of overborrowing and indirect finance decreased the importance of credit in the monetary policy process.

The process of financial reform, which started around 1975, increased the flexibility of interest rates. This development decreased the effectiveness of the channel between interbank interest rates and broadly based lending by banks of the traditional monetary policy.

Another problem for the effectiveness of the traditional monetary policy was caused by the large-scale issues of government bonds. The main part of these issues was absorbed by banks, i.e. money creating financial institutions. As a result, the money supply increased rapidly.

It will be clear that the target of the traditional monetary policy, i.e. the broadly based lending of banks to the corporate sector, neglected the money creating effect of the government bond issues. It was mostly for this reason that the Bank of Japan introduced in 1978 a new target, namely the money supply: from July 1978 to the third quarter of 1979 the broad based money supply $M_2$ and from the third quarter of 1979 the monetary aggregate $M_2+\text{CDs}$. The Bank of Japan started to publish its forecast of $M_2+\text{CDs}$ in 1978. These forecasts have the status of projections and should not be regarded as targets in the context of a strict monetarist policy. Officials of the Bank of Japan have stressed this fact in several publications and mentioned the pragmatic attitude of the Bank towards control of the money supply.48

It has already been mentioned that the process of financial reform decreased the effectiveness of the influence of interbank interest rate changes on broadly based lending of banks, and therefore also decreased the impact of changes in interbank interest rates on the money supply. Financial reform caused the creation of more open, relatively non-regulated financial markets with more flexible interest rates. As a result, two additional channels of transmission between interbank interest rates and money supply
were established. The first was the channel of financial disintermediation. Because open market interest rates were more flexible than bank deposit interest rates, which were still regulated, changes in interbank interest rates had a greater impact through interest rate arbitrage on open market interest rates. Depositholders were more inclined to invest funds on the open markets when a rise in interbank interest rates caused open market interest rates to rise. As a result, the funding position and consequently the amount of bank lending deteriorated. Of course, the supply of funds to the open market increased. These funds could be borrowed directly from the market by big corporations through the issue of securities or commercial paper to replace the decrease of bank credit (increase of direct finance). However, selling operations of the Bank of Japan absorbed these additional funds in the open market49.

The second channel included the effects of changes in interest rates on private expenditure. Interbank interest rate changes caused open market interest rates to change and eventually influenced even interest rates of broadly based lending by banks. Hence, the opportunity costs of expenditures by surplus sectors (i.e. the yields on open market investments) and the costs of financing of expenditures by deficit sectors changed. These changes influenced the amount of private expenditures and eventually the level of national income, money demand and money supply.

The transmission process of the new monetary policy is presented in figure 5. Seen against the background of the inflationary experiences in the first part of the seventies, the main goal of the new monetary policy became the achievement of price stability, reflected by the Consumer Price Index (CPI) in figure 5. A secondary goal was the level of economic growth. The yen/U.S.dollar exchange rate was introduced as a secondary target to stress the importance of preventing import inflation.

FIGURE 5

THE MODERN MONETARY POLICY 1981-present

The year 1981 was the turning point towards a new type of monetary policy, the so-called modern monetary policy. In May of that year the Bank of Japan started to sell financing bills on the open market to absorb liquidity surpluses. According to Suzuki (1987) "... This was the first time since the end of the Second World War that the Bank of Japan had engaged in an open-market operation in the true sense of the term" [Suzuki (1987), p.322]. Open market operations are the purchasing or selling of securities by the central bank on the open market from non-depository financial institutions and the non-financial private sector, and influence directly the money supply.

As we have seen, the already mentioned securities and bills operations (quasi-open market operations)
are engaged between the Bank of Japan and money creating financial institutions, and in contrast to open market operations do not directly influence the money supply. However, the securities and bills operations do have indirect effects on the money supply.

Firstly, buying or selling by the Bank of Japan of securities and bills in possession of money creating financial institutions increases or decreases the amount of reserves of these institutions. The money creating financial institutions will try to compensate the changes in their reserves on the interbank money markets. As a result, changing interbank interest rates will induce portfolio adjustments by these financial institutions and will consequently change the amount of their lending and eventually the the size of the money supply. However, the process of liberalisation of interest rates will make this channel less important.

Secondly, the above mentioned changing of interbank interest rates will influence interest rates on the open markets and in the end the level of private investments, money demand and money supply.

The Bank of Japan uses the securities and bills operations - more specific the outright purchase of government bonds from financial institutions - as an instrument to provide the Japanese economy with additional base money without directly disrupting the growth of the money supply.

Because of the underdeveloped state of the government bond market in previous decades, open market operations could be introduced only in 1981. The Dodge Line prohibited government deficit financing before 1965. After 1974 the return to a balanced budget financing policy was seriously debated.

The main reason to introduce open market operations by the Bank of Japan was the development of open, less regulated financial markets in Japan, such as the market for certificates of deposit (1979) and the Euroyenmarket and later on the introduction of markets for bankers acceptances (1985), money market certificates (1985) and commercial paper (1987) and the Tokyo offshore market (1986). The interest rates on these markets are relatively free. As a result, the share of the open markets in the total money market increased from 1984. This development continued until the autumn of 1988 when the volume of the interbank market, especially the bills market, shrunk as a result of increasing open market rates, compared with relatively stable interest rates in the interbank market. The decreasing volume of the interbank market reduced the influence of the Bank of Japan on the money market rate and compelled the Bank to deregulate the interbank market as from November 1988. The elements of this introduction of the so-called new monetary control regime can be summarized as follows.

Firstly, the Bank liberalized the interest rate of (commercial) bills which was regulated till then (abolition of quotation). Secondly, the range of maturities for the collateralized call market and the bill market was adjusted in order to realize more fine tuning in the money market. Thirdly, the quantitative restrictions and quotation system for the uncollateralized call market were abolished and the permitted maturity for this market was extended from overnight-three weeks to overnight-six months to reinforce the arbitrage between interbank and open markets. These swift and radical measures by the
Bank of Japan resulted in more than a doubling of the interbank market volume during the period November 1988-July 1989. Moreover, the arbitrage between interbank and open markets strengthened in that period as appears from the narrowing difference of interbank and open market rates. See for this difference Figure 6.

FIGURE 6

The November reforms permitted the Bank of Japan to maintain the controllability of short-term interest rates in spite of the ongoing financial reform process. Before the reforms, interbank transactions with a maturity of less than one month had been mainly conducted in the call market, and not in the bills market. Therefore, for its bills operations the Bank of Japan had to rely on bills with maturities of two or three months. As a result, market participants regarded especially the two-month bill discount rate as a policy target by mid-1988, and sometimes interpreted technical adjustments as being deliberate, or deliberate adjustments as being technical. Furthermore, according to Suzuki (1989b) the two and three month bills operations by the Bank of Japan revealed its interest rate view two or three months ahead. Under the new monetary control regime, the Bank concentrates on the shortest maturities (overnight call rates and one to three week bill discount rates), and leaves the rates of longer maturity instruments to move freely in accordance with market conditions and expectations.

With respect to open market interest rates, the Bank of Japan could influence them to a certain extent through the mechanism of interest rate arbitrage between interbank and open markets. However, the mechanism of interest rate arbitrage alone is not sufficient to control the interest rates on the open markets. Other factors, including differences in market expectations and different characteristics of various segments of the open markets, determine also open market interest rates. Furthermore, the declining share of the interbank markets in the total money market made it more difficult for the Bank of Japan to influence the interest rates on the open markets only by use of interest arbitrage. Therefore, the last decade saw the introduction of open market policy by the Bank of Japan as an instrument to exert direct influence on open markets. The Bank has used in its open market policy various instruments, such as sales of FBs with repurchase agreements (first in May 1981), CDs (not used anymore since February 1989), purchases of CPs with repurchase agreements (firstly May 1989) and purchases of TBs with resale agreements (first in January 1990). The Bank of Japan intends to extend the use of TBs as an open market instrument. For this purpose the market for TBs, which is still relatively small and underdeveloped, will have to expand and gain in importance. To facilitate the open market policy of the Bank of Japan, the Ministry of Finance has introduced in August 1989 three month TBs, has promoted the development of a secondary market by increasing the number of TB issues from one to two when the monthly issue volume exceeds two trillion Yen and considers to expand the issue of TBs...
in the fiscal year through March 1992 to Yen 9 trillion.

The open market operations of the Bank of Japan have great consequences for the money supply. The money supply is influenced through three channels by these operations.

In the first place, the existence of a direct mechanism has to be mentioned. For example, when the Bank of Japan sells for example TBs directly to the non-financial sector the money supply will decrease. When the Bank of Japan sells TBs to money creating financial institutions, which received permission from the Bank to resell the bills to the non-financial sector, the money supply will also decrease. The consequence of this operation is a deteriorating reserve position of the financial institutions concerned (decrease of deposit at Bank of Japan). As a result, these financial institutions will borrow funds on the interbank money market to make up their deficits. The resulting increase in interbank interest rates will lead through the mechanism of interest rate arbitrage to rising open market interest rates, i.e. rising costs of private expenditures. It will be clear that in the end the level of national income, money demand and money supply will tend to decrease. This indirect mechanism is the second channel between open market operations and money supply. In the third place, the open market operations have great consequences for the supply and demand relations on the secondary market of TBs and consequently for the interest rates on this market. Through the channel of interest rate arbitrage the other open market interest rates will be influenced and finally (the familiar effects of interest rate fluctuations on private expenditures) the money supply.

With respect to the transmission channels, the exceptional rise during the eighties of prices of assets such as equities and real estate strengthened the importance of wealth effects. Changes in interest rates influence the value of various assets and consequently the amount of private non-financial sector expenditures.

The process of financial reform, especially the liberalization of interest rates, has made the effects of interest rate changes on private expenditures (direct channel) and these effects on asset values and consequently on private expenditures (indirect channel) much more important. The new short-term and long-term prime rate systems and the increased use by banks of funding instruments with money market related interest rates have made the transmission of changes in money market interest rates to lending and borrowing behaviour of the non-financial sector more effective. Thus, the transmission of monetary policy will increasingly take place through the effects of interbank and open market operations of the Bank of Japan on interest rates in all markets.

The focusing of the Bank of Japan on market interest rates has been mentioned in Tamura (1991) and Nakao and Horii (1991). Furthermore, as a result of the financial reform process these officials of the Bank of Japan mention an increased number of caveats applying to the interpretation of the money supply since the mid-1980s.

The modern monetary policy is presented in figure 7. Under the modern monetary policy market
interest rates and as a consequence of financial globalization also exchange rates have gained importance. Despite the caveats regarding the interpretation of the money supply the Bank of Japan still emphasizes the stabilization of money growth in the medium term\textsuperscript{56}. Therefore, it is shown that both the money supply and the (U.S. dollar/yen) exchange rate are used as targets by the Bank of Japan. The Japanese central bank wants to achieve the goal of price stability on the one hand by controlling the growth of the money supply (the internal track) and on the other hand by keeping the yen sufficiently strong against the U.S. dollar to prevent import inflation (the external track). For example, according to Hutchison (1986) the Bank of Japan has not relied fully on the internal track but has also systematically focused on the external track.

The increasing emphasis of the Bank on interest rate management is also reflected in the official ending of the window guidance in June 1991. From now on, the Bank of Japan has to rely solely on indirect credit control.

**FIGURE 7**

**EPILOGUE**

In this article, we analyzed the development of the structure of the financial system and the implementation of monetary policy in Japan. Firstly, the pre-reform financial system was discussed extensively. Secondly, a classification of financial institutions according to their business features and customers was given. Thirdly, we concentrated on the money markets because of their importance for monetary policy making in Japan. These markets were divided into the interbank and open money markets.

Fourthly, regarding the process of financial reform five strongly interrelated sub-processes were distinguished: financial innovation, financial liberalization, financial globalization, financial concentration and restoring of financial reputation.

Fifthly, an analysis of the monetary policy transmission mechanism in Japan was presented for the whole post World War II period. Regarding the implementation of monetary policy a distinction was made between three subsequent periods: the traditional (1953-1975), new (1975-1981) and modern
Finally, we will discuss the relationship between the monetary authorities in Japan against the background of recent developments.

The double digit growth of the aggregate M2 + CDs from 1987 was accompanied by an until recently gradual appreciation of the yen vis-à-vis the U.S. dollar and contributed only to a limited extent to an increase of domestic inflation in Japan.

At the midst of 1989 the appreciation of the yen turned into a depreciation against the dollar and other currencies, such as the Deutsche Mark. Thereby, the price level of import goods to Japan rose sharply in 1989. The higher import price level combined with the increased stock of liquidity at the end of the eighties meant a considerable threat to the goal of price stability (CPI). The potential inflation conceived by the Bank of Japan was mainly responsible for the origin of a conflict between the central bank and the Ministry of Finance. In February 1990 contradictory statements by the Governor of the Bank of Japan and the Deputy Minister of Finance led to a public controversy between both monetary authorities. During 1990, this remarkable lack of consensus regarding future monetary policy resulted in much turmoil on the Japanese financial markets. The crux of the conflict was a deep-lying difference of opinion between the authorities with respect to the relative weight of price stability and economic growth as goals of monetary policy. Traditionally, the Bank of Japan attaches great importance to the goal of price stability. On the contrary, the Ministry of Finance attaches greater value to the goal of economic growth. The Ministry is of the opinion that the central bank has to provide for ample money supply and unimpeded economic growth and should raise the official discount rate only in case of ultimate necessity.

The conflict between both authorities ought to be judged against the background of the process of financial reform in Japan and the changing balance of power regarding the decision-making and implementation of monetary policy. The influence of the Ministry of Finance is mostly based on financial regulation ('regulatory leverage') and is gradually declining by the progress of financial innovation and liberalization in recent years. However, the Bank of Japan derives its influence from the guidance and steering of financial markets ('market leverage') and is able to conduct step by step a more independent policy. The rising autonomy of the central bank is obstructed by the Ministry of Finance to a large extend by using its administrative guidance. The conflict focused on the official
discount rate, because this monetary instrument can only be changed with the formal approval of the
Policy Board - in which the Ministry is represented - and the informal consent of the Minister of Finance. The specific nature of the relationship between the Bank of Japan and the Ministry of Finance is
still subject of further discussion. The monetary authorities in Japan are aware of the urgency to clarify
their relationship and to restore and maintain their credibility in the financial markets.

FOOTNOTES

1) However, measured by the strength of capital only six Japanese banks are placed in the world top 10.
See: 'Top 1000 world banks', The Banker, July 1989, pp. 38-105. At the end of 1990, only seven of
the ten biggest banks in the world were of Japanese origin.

2) With respect to the influence of the SCAP policy on the structure of the financial system see for

the Glass-Steagall Act "... financial institutions were permitted to buy only negotiable securities, were
not permitted to buy more than a certain amount of these securities of any given issuer, and were
forbidden to hold equities. Article 65, however, places no controls whatsoever on the acquisition of
securities and equities for investment purposes".

4) According to McCall Rosenbluth (1989), p.40, the Ministry of Finance gave banks 10 years to get
below this limit, but in 1986 city banks were over by 2-4 percent for many firms in their conglomerate.

5) These reforms are mentioned by Sakakibara and Feldman (1983). The Zaibatsu, according to Cargill
and Royama (1988), p.45, "... a type of holding company made up of manufacturing, trading, and
financial entities under the control of wealthy families", were officially dissolved because the SCAP viewed them as anticompetitive and closely involved with Japan's militarist and expansionist policies, and preserving an unequal distribution of income. The dissolution of the Zaibatsu brought according to Sakakibara and Feldman (1983) an end to the private placement of equities with wealthy individuals, Zaibatsu corporations, and Zaibatsu holding companies, and resulted in an increase of indirect finance. However, the dissolution of the Zaibatsu has been followed by the establishment of more informal oriented conglomerates, the so called Keiretsu, with one of the city banks at its center. See for further information for example Johnson (1982), Viner (1987), Wright and Pauli (1987) and Cargill and Royama (1988) for further information with respect to the Zaibatsu and Keiretsu.

The specialised banks were half-governmental and half-private banks, and conducted specific activities such as trade finance and long-term finance.

6) The Dodge Line was named after J. Dodge, an American banker who was commissioned by the SCAP to assist the Japanese government in its effort to implement General MacArthur’s nine-point Economic Stabilization Plan, and to monitor its progress. The balanced-budget policy lasted until 1965, and hampered the development of Japanese capital markets. See Johnson (1982) and McCall Rosenbluth (1989).


9) See for example Bank of Japan (1973), Suzuki (1980) and Suzuki (1987). This classification will be used to explain the traditional monetary policy during the period 1953-1975.

10) Cargill and Royama (1988), p.44. These authors mention also several other factors which caused the undeveloped state of financial markets, for example the lack of a financial disclosure system, and collateral requirements for all debt. See chapter 2, especially pp.40ff.


18) The Council for the Regulation of Bond Issues (Kisai Chosei Kyogikai, or Kisaikai) is comprised of the bond related financial institutions, i.e. trustee banks and underwriting securities companies. Kisaikai determines the amount of new bond issues for each fiscal year and each month, the number of issues per year and the issue terms [Suzuki (1980), p.51]. Further information is provided by Viner (1987), pp.109ff.

19) Royama (1983/1984), p.7, pp.8-11. Horiuchi (1984) has called this policy the "low interest rate policy" (tei-kinri seisaku) and defined it as a combination of regulation on some interest rates and comprehensive control on financial allocation.

20) Suzuki (1980), p.44ff. There still exists uncertainty about the specific nature of the relationship between the "artificial low interest rate policy" and postwar economic growth. For example, according to Horiuchi (1984), p.350, the conventional view that the "artificial low interest rate policy" stimulated economic growth in Japan lacks a solid foundation. Due to strong demand for funds during the pre-reform period, both real and nominal Japanese interest rates were at substantially high levels during the
1950s and 1960s. Horiuchi concludes that there is need for "... more thoroughgoing reconsideration with respect to the low interest rate policy in postwar Japan". The analysis in Teranishi (1986b). pp.162-164, with respect to the relationship between economic growth and financial regulation has produced inconclusive results. And also according to Royama (...), p.81, "... there are still numerous issues that have to be clarified surrounding the policy of artificially low interest rates". In Teranishi (1990), p.23, it is carefully concluded that the postwar financial system "... has had some favorable effects on growth and employment".

21) Hollerman (1988), p.25. Therefore, until 1980 international capital flows were under a so-called negative regime.


25) From a explicit legal point of view, the Bank of Japan is not independent from the Ministry of Finance. For further information regarding administrative guidance and relationship between Bank of Japan and Ministry of Finance see the excellent studies of Hollerman (1988) and Cargill (1989) respectively. In this article, we will focus mainly on the policy of the Bank of Japan.


27) This group includes the Bank of Tokyo which is really a foreign exchange bank to finance international trade. See: Y. Suzuki (1987), pp.163-304.

28) Furthermore, on October 31, 1990, the Ministry of Finance licenced two non-Japanese investment trust companies to manage investment trusts in Japan. See: Zenginkyo Financial Review, Financial

29) Toho Sogo Bank was not allowed by the Ministry of Finance to change its status into a commercial bank because of its poor financial condition. According to Japan Business Today, NHK, July 24, 1991, funds from the Deposit Insurance Corporation (DIC) will be used to facilitate this merger, following the Ministry of Finance's revision of the DIC, which enabled the corporation to mediate mergers between financial institutions in Japan. See also Japan Economic Journal, February 23, 1991, and the Nikkei Weekly, August 3, 1991.

30) For example, only a few years ago Nomura and its affiliated companies together accounted for roughly 40% of daily volume in the Tokyo stock market. In August 1991, Nomura's share had dropped to just 8%, slightly larger than that of its three other Big Four rivals. See Wall Street Journal Europe, August 30-31, 1991.


33) Maturities of bills eligible for BOJ operations are one week-three months, with emphasis on the shorter range (mainly one-three weeks).


36) These financial innovations and their effects on monetary policy are extensively discussed in: Y. Suzuki & H. Yomo (ed.), Financial Innovation and Monetary Policy: Asia and the West, Tokyo, 1986,


40) Liberalization measures with respect to the interbank market will be discussed in the section of modern monetary policy.

41) According to Kanda (1990), p.1, securitization generally means the creation of marketable securities, for example when traditional asset-based lending by a bank is replaced by marketable securities, the payments of which are linked to the underlying assets.

42) According to the BIS regulations, Japanese banks involved in cross-border business are required to meet capital adequacy ratios of 8% by the end of fiscal year 1992 (end of March 1993). Japanese banks are permitted to include 45% of unrealized profits on their stock portfolios in total capital. However, the collapse of the Tokyo stock market has seriously deteriorated the capital adequacy ratios of Japanese banks.

43) See for example Federation of Bankers Associations of Japan (1988) and (1990).


45) However, according to Hollerman (1988) the new FEFTCL refers to freedom of exchange, foreign trade, and other external transactions, with necessary but minimum control, and does not contain the phrase freedom in principle. Hollerman even suggests that the new FEFTCL "... is a glorified legal authorization for more administrative guidance" [Hollerman (1988), p.26].

47) Suzuki (1987), p.320. However, the securities and bills operations do have indirect effects on the money supply. See the subsection of modern monetary policy for further analysis.

48) For example, this pragmatic orientation has been stressed by Shimamoto (1982), p.82: "... Thus, the attitude of the Bank of Japan toward the money supply is, in a word, pragmatic." And also by Okabe (1990), p.16, p.18: "... the formula now employed in Japan is more aptly called a money-focused monetary policy rather than a monetary-targeting policy. ..., the Bank of Japan has, in fact, managed its monetary policy in a pragmatic fashion." In Suzuki (1985), p.9, the policy attitude of the Bank of Japan is described as follows: "..., is in my interpretation neither that of post-Keynesian "discretionary fine tuning" nor that of a "x% rule". ... An appropriate term may be "eclectic gradualism"."


50) The maturity for collateralized calls was changed from overnight to three weeks into overnight to six days and for bills from one-six months into one week-six months. Thus, the overlap in maturity between calls and bills was eliminated. In April 1989 the maturity for bills and uncollateralized money was extended to one year.

51) Batten et al. (1989), p.31.


53) During the first nine months of 1990, emphasis of bills operations is on two week instruments. See Nakao and Horii (1991), table 6, p.39.


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FIGURE 1  A classification of major Japanese financial institutions (as of the end of April 1991)

Central bank

Private
Financial
Intermediaries

Private
Financial
Institutions

The Bank of Japan

Commercial banks

City banks (11)
Regional banks (64)
Member banks of the Second Association of Regional Banks (67)
Foreign banks (88)

Long-term financial Institutions

Long-term credit banks (3)
Trust banks (7)
Foreign trust banks (9)

Financial institutions
for small and medium-sized businesses

Sogo bank (1)
Zenshinren Bank (1)
Shinkin banks (449)
National Federation of Credit Co-operatives (1)
Credit co-operatives (381)
Shoko Chukin Bank (1)

Financial institutions for agriculture, forestry and fishery

Norinchukin Bank (1)
Agricultural co-operatives (3493)
Fishery cooperatives (1687)

Non-depository
Institutions

Insurance companies

Life insurance companies (26)
Non-life insurance companies (25)

Securities companies (267)

Tanshi institutions (6)

Postal Savings System

FIGURE 2 The transmission mechanism of monetary policy

\[\text{Instruments} \rightarrow \text{Indicator(s)} \rightarrow \text{Target(s)} \rightarrow \text{Goal(s)}\]
FIGURE 3 The control of interbank interest rates

Lending policy
Securities and bills operations

Reserve progress ratio

Changes in reserve ratios

Changes in official discount

Call and bill-discount interest rates

Implicit interest rate regulation

Partly based on Fukui (1986)
FIGURE 4 The traditional monetary policy 1953-1975

<table>
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<tr>
<th>Instruments</th>
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<td>Call and bill discount rates</td>
<td>Broadly based lending by banks</td>
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<td>Discount rate</td>
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<td>Securities and bills operations</td>
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<td>Implicit interest rate regulation</td>
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FIGURE 5 The new monetary policy 1975-1981

**Instruments**
- Amount of Bank of Japan credit
- Discount rate
- Reserve ratio operations
- Securities and bills operations
- Implicit interest rate regulation

**Indicators**
- Call and bill discount rates

**Targets**
- Money supply
- Exchange rate

**Goals**
- CPI
- Economic growth

Window guidance
FIGURE 6 The interbank and open market rates before and after the reform of the Japanese money market

Source: The Bank of Japan
FIGURE 7 The modern monetary policy 1981-present

**Instruments**
- Amount of Bank of Japan credit
- Discount rate
- Reserve ratio operations
- Securities and bills operations
- Implicit interest rate regulation
- Open-market operations

**Indicators**
- Call and bill discount rates
- Money supply
- Exchange rate
- Open market interest rates

**Targets**
- CPI
- Economic growth

**Goals**
- Money supply

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<td>N.M. van Dijk</td>
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