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DEREGULATION AND MARKET RESPONSE
IN CONTEMPORARY JAPAN:
ADMINISTRATIVE GUIDANCE,
KEIRETSU, AND MAIN BANKS

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Deregulation and Market Response in Contemporary Japan: Administrative Guidance, Keiretsu, and Main Banks

By Yoshiro Miwa and J. Mark Ramseyer*

Abstract: Change is in the air in Japan, claim many observers: the government is radically deregulating crucial sectors of the economy, the large firms are unwinding their keiretsu corporate groups, and firms and banks are dismantling their main bank arrangements. Some observers see all three as exogenous institutional shocks, while others treat the last two as behavioral responses to the first. In fact, although the first phenomenon would constitute an institutional change if it occurred, it has not -- for Japanese bureaucrats had no substantial regulatory power to abandon. Although the last two would constitute market responses if they occurred, they have not either -- for firms and banks maintained no groups or main-bank arrangements to unwind or dismantle.

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Administrative Guidance, Keiretsu, and Main Banks

Can Japan change its ways, asked a recent Brookings study (Carlile & Tilton, 1998a). Can it (Carlile & Tilton, 1998b: v) "dismantle its developmentalist regulations so as to open its markets meaningfully ... ?"

Its markets may or may not be open, reply many journalists, scholars, and commentators, but regulators have indeed begun to dismantle. Since the 1990 stock and real-estate market collapse, institutional change has run rampant: bureaucrats have cut the role they play in several crucial industries; the keiretsu corporate groups have started to unwind their ties; and firms and banks have begun to dismantle their main-bank relationships. Some observers describe all three phenomena as exogenous institutional shocks. Others characterize the last two as rational responses to the first. All seem to agree that all this has in fact occurred.

In fact, none of this has occurred. Bureaucrats have not substantially abandoned their control over the economy -- for they had little control to abandon. The keiretsu firms have not unravelled their groups -- for they had no groups to unravel. And firms and banks have not dismantled the main bank system -- for they maintained no system to dismantle. Studying the effect of regulatory change on market behavior is fine, but only if one rightly identifies the regulatory framework economic actors face, and the market choices they make. In post-war Japan, most observers have done neither.

We begin by distinguishing institutional change and market response (Section I). We then discuss the power Japanese bureaucrats wielded over the economy (Section II), the etymology of the keiretsu (Section III.A), and the substance of Japanese bank-firm relations (Section III.B).

I. Introduction:

A. Why Institutions Matter:

For empiricists, institutional change promises a godsend, a gold mine of articles begging to be written. Absent that change, they likely face an equilibrium, and equilibria seldom generate interesting results. Change institutions, and results start turning publishable.

Institutional change shifts observed equilibria because institutions shape the choices people make. More specifically, institutions structure the relative payoffs to the alternatives people face. Change those payoffs, and people will begin to change the options they choose. Change institutions, and changes in observed behavior will follow

B. What Institution?

Properly to make sense of the changes they see, however, empiricists will need properly to distinguish institutions from behavior. The distinction may be harder than it sounds. Confuse the two (confuse the constraints actors face, with the choices they make in response), and they risk turning the analysis tautological. Years ago, reminisces Clifford Geertz (1973: 249-50), Talcott Parsons warned legions of students that "interpret[ing] the way a group of human beings behave as an expression of their culture while defining their culture as the sum of the ways in which they have learned to behave is not terribly informative." Alas, interpreting the choices people make as a result of institutional constraints while defining those institutions as the sum of the behavior they choose is not much better.

In studying economic choice, scholars can usually take the state-enforced regulatory framework as an institutional given. Obviously, the regulatory framework is not exogenous to all analysis. Voters choose legislators, and legislators pass regulatory statutes and hire regulators. To study that political process, scholars would not want to take the regulatory framework itself as given. Yet to study the choices economic actors make within market settings, in most cases they safely can take the regulatory structure as exogenous.

Although as an "institution" the regulatory framework is properly exogenous to economic market analysis, the choices the actors make within that framework are not. A firm may choose whether to borrow from Bank A or Bank B. It may choose whether to borrow from one bank or several, whether to negotiate a short-term loan or long-, whether to make a given component within the firm or to buy it on the market. All these choices it makes within the institutional context; the choices do not themselves provide that context.

C. Japanese Institutions:

Now recall the purported institutional changes commentators describe in contemporary Japan: (i) widespread economic deregulation, (ii) the dismantling of the keiretsu, and (iii) the collapse of the main bank system. In time, we shall return to the question of whether any of this occurred. Preliminarily, consider which of the supposed changes involve institutions.

As noted in above, the first of the three is indeed institutional. Except to the political scientist, any deregulation is exogenously institutional. Because the regulatory framework structures the relative payoffs to the choices market actors make, any change in those payoffs constitutes institutional change.

Yet observers often describe the changes to the keiretsu and main bank systems as institutional as well. Paul Milgrom and John Roberts (1994: 32) describe the keiretsu as the "institutionalized form" of the "long-term relations that exist among Japanese companies." Thomas Cargill (2001: 146) describes "the keiretsu or main bank system" as a set of institutions, and so too do Magnus Blomstroem, Byron Gangnes and Sumner La Croix (2001: 7).

In fact, neither keiretsu nor main banks are institutional. Keiretsu firms allegedly tie themselves to each other through shareholdings, loans, and trades. They invest, borrow, buy and sell with the firms they do, however, by choice. The term "keiretsu" merely captures the observed consequences of the choices they purportedly make.

Exactly the same point applies to the main bank system. Japanese firms choose whether to borrow from one bank rather than another. They choose how much to borrow from banks, and how much to finance through equity, through trade credit, and through loans from insurance firms. Banks choose whether, how much, and to whom to lend.

Banks and firms together negotiate the many terms and the resulting price of the loans they actually conclude. The term "main bank system" merely captures the observed consequence of the many deals they supposedly cut.

None of this is affected by the fact that a firm structures the options it faces in later periods through the choices it makes in the present. To be sure, a firm that enters a long-term arrangement (whether group trades or bank loans) in t_1 will find its cost-effective options limited in t_2. Yet that it does so does not transform the initial choice into an "institution." In choosing among its options, a rational firm present-values the costs it expects to incur in the future, and the benefits it expects to accrue. Long-term or short-, the choice remains a choice -- the response it makes to its institutional context rather than part of the institutional context itself.

Suppose, then, that peculiarities in the Japanese regulatory framework drove firms and banks to chose the behavior that led observers to posit main banks and keiretsu. If the government changed that framework, those firms and banks might plausibly make other choices. In so doing, they might plausibly choose behavior that observers would now characterize as a "break down" in the keiretsu and main bank system.

That break down, of course, is exactly what many observers claim to observe. As we explain below, they claim wrongly. They rightly note that contemporary firms do not structure their actions within keiretsu, and that banks do not follow the dictates of main-bank theory. They wrongly conclude that they ever did anything else.

II. Deregulation in Japan:

A. Introduction

Few changes in contemporary Japan capture as much attention as the purported deregulation. Japan had long assigned, the recent Brookings study explained (Carlile & Tilton, 1998b: 9), "high levels of discretion" to its regulators and maintained "a high degree of informality in administrative activities." That discretion and informality, in turn, had "extend[ed] well beyond that which is stipulated in laws." Through the resulting web of informal regulation (area specialists call it "administrative guidance"), "Japanese officials [had] actively pursued industrial policies that encourage[d] concentration and oligopolistic practices."

Had Japan done this? In fact, it had not. Western scholars do not err in positing a relatively competitive, unregulated economy in current Japan; they err in positing that since 1950 it has been anything else. They do not err in positing a deregulated economy in the current; they err in positing a rigidly regulated economy in the past.

We begin by exploring the three cases most often cited to illustrate the ostensibly heavy hand of the bureaucracy (Section B). We then outline how Japanese courts treat bureaucratic intervention (Section B), and how the government regulated the financial markets (Section C). Finally, we discuss the loan program (Section D) and limits on foreign exchange transactions (Section E) by which bureaucrats purportedly enforced their policy preferences.

B. Three Case Studies:[1]

[1] More fully developed in Miwa & Ramseyer (2002c)

As with so much western scholarship on Japan, the work on government power depends heavily on anecdote. Given the massive government power observers posit, one might have expected a correspondingly massive number of anecdotes. Not so. Instead, in the English-language press the legend hinges primarily on one: the mid-1960s confrontation between MITI (the Ministry of International Trade & Industry) and Sumitomo Metals Industries. In the Japanese press, observers add two others: the disputes involving the Nisshin spinning and Idemitsu oil firms.

1. Sumitomo Metals.[2] -- a. The legend. To most Western observers, MITI used its 1965 dispute with Sumitomo Metals to show firms what it could and would do to those that flouted its will. It enjoyed more power at the time than it would ever again, they explain, because of its power over foreign exchange. The statutes governing the field delegated such broad discretion to it that it could use that power to enforce even entirely unrelated dictates. So broadly did they delegate that the ministry could, as the Japanese aphorism put it, "take Edo's revenge in Nagasaki."

In early 1965, observers typically begin, Japanese steel makers faced a drop in demand. To address the problem, they organized a trade association committee, and that committee reported to MITI. In turn, MITI ordered it to organize a cartel to prevent "excess competition."

Through the committee, MITI then coordinated production cuts. It expected firms in the industry to comply, and most planned to do just that. Sumitomo Metals, however, wanted to produce more. By the fall of 1965, it decided to act alone. The cartel, it announced, it would ignore. Instead, it would produce as it wished.

MITI was not about to suffer independent firms. If Sumitomo thought it could do as it pleased, it thought wrong. Did not Sumitomo need coking coal? Should the firm try to ignore the cartel, it -- MITI -- would cut the foreign exchange it needed to import that coal. Absent coal Sumitomo could not make steel, and absent foreign exchange it could not buy coal. Recognizing its hopeless position, Sumitomo caved. Duly chastised, it pledged its cooperation.

For would-be renegades, the moral was clear. Should they buck MITI's leadership, MITI could and would retaliate. Even over matters that had nothing to do with foreign exchange, the ministry could and would use its power over that exchange to enforce compliance. By making an example of Sumitomo Metals, concluded Frank Upham (1987: 176), the ministry showed any firm with dreams of independence that it could and would manipulate its "abstract legal powers" to "ensure compliance." Vehemently, it demonstrated that it faced "virtually no statutory restrictions on [its] regulation of foreign trade" (id.: 179).

b. The history. As critical a rhetorical role as the tale of Sumitomo Metals may play, the tale is too tall by half. If MITI enjoyed any control over foreign exchange, it had not used it earlier to induce firms to accept its unrelated dictates. It did not start now. And if Sumitomo Metals faced any vulnerability, it did not show it now. Instead, it refused to back down, and within a few weeks MITI capitulated.

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[2] This discussion draws heavily from Miwa & Ramseyer (2003b).

MITI's role. At root, the tale of Sumitomo Metals is simply false. Begin with the question of why MITI intervened. The ministry did not intervene to implement any "industrial policy" Instead, it intervened to enforce a private cartel.

Steel firms had cartelized their market for several years. Sumitomo Metals, however, increasingly found the quotas unsatisfactory. Having invested aggressively in new facilities, it wanted a chance to expand its market share. Domesticly, it was willing to follow quotas. Overseas, it wanted none (Asahi, 7/13/65; Mainichi, 11/16/65).[3] Nonetheless, in mid-1965 it agreed again to acquiesce. With the lone dissident in line, the others set the quotas for the second fiscal quarter (July-Sept., 1965): production volumes set at 90 percent of the amounts they had each sold sold during the previous fiscal year's uncartelized third quarter.

The steel producers needed to agree not just on price and quantity, but on enforcement as well. If they formed a private agreement, they faced potential criminal liability. They could avoid that risk by forming a "depression cartel" under the Antitrust Act, but could not then enforce the cartel's terms on any dissident. To avoid criminal liability while enforcing compliance, they instead decided to ask MITI to enforce their arrangement unofficially (Asahi, 7/13/65; 12/16/65). In the process, reasoned they (wrongly, as we explain below), they would both bind recalcitrant firms and protect themselves from criminal charges.

Despite its acquiescence, Sumitomo Metals continued to press for export exclusions. When by November its competitors still refused, it simply withdrew from the cartel. Exclusions or no exclusions, it would sell as it pleased. MITI promptly ordered it to comply with the cartel, but Sumitomo indignantly replied that "production cutbacks should be decided strictly by agreement among the firms" (Mainichi, 11/16/65) Let MITI try to enforce the cartel, it declared. "We intend immediately to file suit" (Nikkei, 11/28/65).

The punishment. MITI faced a defiant Sumitomo Metals, but it did not punish the firm. It did not even try. Although it threatened to punish the firm, it never did. Instead, it simply caved.

To force Sumitomo Metals to comply, MITI would have had to take measures far more drastic than it even threatened. Suppose it gave Sumitomo only enough foreign exchange to buy the coking coal it needed for the authorized steel. Given that Sumitomo maintained a full two months' worth of coking coal in reserve (Nikkei, 11/20/65) and wanted to produce only 10 percent more than its cartel quota, it could safely have ignored the cartel for another 20 months.

Even if MITI tried to exhaust its coal reserves, declared Sumitomo, it still would not comply. At that point it would just import pig iron directly (Nikkei, 11/20/65). After all, by the mid-1960s, it faced no limits on pig iron imports (or most other imports, as we detail in Section D.3). Coal imports were subject to the foreign exchange limits only because of the role mining villages played in keeping the Liberal Democratic Party (LDP) in power.

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[3] Parenthetical references are to contemporary newspapers.

<u>The victor.</u> Ultimately, Sumitomo -- not MITI -- won the dispute. Notwithstanding the many accounts to the contrary, MITI did not obtain the result it wanted. Sumitomo did.

Most basically, Sumitomo Metals wanted steel exports outside the quotas. It did not object to cartels in principle. It wanted a cartel in the domestic market, and the ability to sell as it pleased abroad. Eventually, that was exactly the framework MITI and the steel industry offered it.

MITI talked conciliation from the start. Already in early December it announced it would consider keeping the export market uncartelized (<u>Mainichi</u>, 12/3/65). In its January deal with Sumitomo, it did just that. During the third quarter (Oct.-Dec., 1965), Sumitomo had exceeded its quota by 88,000 tons, and of that excess had exported 55,000 tons. For the next quarter, MITI forgave Sumitomo the exported 55,000 tons, and docked it only by the 33,000-ton excess (<u>Nikkei</u>, 1/12/66). Less than two months after declaring defiance, Sumitomo had obtained what it wanted.

Defiance paid. Soon, Sumitomo Metals tried the ploy again. When market demand rose unexpectedly in early 1966, Sumitomo decided that even its revised quotas cut profitability. Rather than comply with the cartel to which it had just agreed, it decided to go its own way. Its rivals complained, but to no avail. "Even if the industry decides to continue the crude steel adjustments into October," announced the Sumitomo president, "we do not intend to comply" (<u>Nikkei</u>, 8/25/66). By their original terms, the cartel would have lasted through September. Duly chastened, MITI dropped the quotas at the end of Augsut (<u>Nikkei</u>, 8/30/66).

2. <u>Nisshin Spinning.</u> -- According to some accounts of Japanese bureaucratic power, in the mid-1960s MITI not only intervened to enforce its policies on a non-compliant Sumitomo Metals, it enforced them on the Nisshin cotton-spinning firm too. Through early 1966, 174 spinning firms had maintained a “depression cartel” authorized by the Antimonopoly Act. With the cartel expiring at the end of March, MITI proposed to extend it. When Nisshin refused to cooperate, it intervened and pressured the firm to comply. Nisshin recanted, and MITI obtained its cartel.

In fact, MITI did not actively pressure Nisshin. First, the textile industry was too widely dispersed. In cotton spinning 350 legal firms (<u>i.e.</u>, excluding the black-market firms, discussed below) competed, and the top 13 produced only half the industry output (1966 figures; Tsusho, 1966: 24). Second, MITI had no obvious way to compel compliance. At least in steel it could plausibly threaten to cut Sumitomo’s coking coal. In cotton spinning Nisshin had been able freely to import what it wanted since 1961. Last, on a long-run basis MITI did not want to cartelize the industry (<u>Nikkei</u>, 1/26/66, 2/3/66). Through the 1950s, it had allocated the foreign exchange for raw cotton imports among the spinning firms according to the number of spindles they registered. In 1961 it voluntarily abandoned that power. It did not do so because it had to abandon it. It abandoned it to further the LDP's largely free-market policies.

Although the LDP relied in part on small firms for political support, it set its small-business policies within a capitalist, free-market context. Japanese voters did not want an interventionist government, and the LDP knew that. Socialist and Communist candidates regularly offered them interventionist alternatives, and they regularly rejected them. Reflecting their policy preferences, the LDP instead maintained a fundamentally non-interventionist course. As its faithful agent, so did MITI.

Nisshin opposed the planned cartel, but for the same reasons that the other big firms opposed it too (Mainichi, l/21/66; Nikkei, 1/23/66, 1/26/66). First, the cartel favored the less efficient firms. Fundamentally, the industry had too much capacity. Of the 12.8 million total spindles, industry insiders estimated that only three-quarters would survive in a competitive market. The cartel mandated production cutbacks, but because it mandated them uniformly they fell on the efficient and inefficient alike. If the industry could eliminate the cartel, market competition would instead force the cutbacks on the inefficient firms -- eventually driving them out of business. What the larger firms (and MITI) wanted were policies that tracked that market competition (Nikkei, 2/15/66).

Second, the cartel favored the black-market shops and the legal firms that had not joined the cartel. Since the 1950s, firms could legally spin cotton thread only on those spindles they registered with the government. That ban, however, the government had enforced haphazardly, if at all -- resulting in an estimated 500,000 unregistered spindles by the mid-1960s (Mainichi, 1/21/66). Yet the cartel applied only to participating firms. The black-market firms obviously did not participate, and neither did over 170 legal firms -- who probably used another half-million spindles (Tsusho, 1966a: 24). By requiring only participating firms to cut back, the cartel effectively expanded the market into which the black-market and non-participating legal firms could sell.

At least before 1961 the black-market firms could not import raw cotton directly. Because they lacked registered spindles, MITI would not allocate them foreign exchange. Once MITI abandoned its control over cotton imports, they could freely obtain their cotton. In truth, though, even under exchange controls MITI had not stopped firms from reselling the cotton they imported. As a result, the less efficient legal firms had simply re-sold the cotton they imported to more efficient black-market firms.

Although Nisshin eventually acquiesced to the cartel, it did so only after the trade association and MITI gave it much of what it wanted. It had hoped to eliminate all controls, and the association and MITI agreed to work toward that end. Even the structure of the cartel reflected Nisshin's aims. In exchange for Nisshin's cooperation, the association and MITI specified in the cartel that firms could sell on the market only 70 percent of their output (Nikkei, 3/10/66). Because the larger firms maintained vertically integrated weaving operations, the limit left them largely untouched (none of the ten largest firms sold 70 percent of their output on the market; Mainichi, 3/4/66). It hit instead the independent smaller firms.

True to the LDP's non-interventionist policies (and consistent with its actions in the Sumitomo Metals dispute), MITI never seriously tried to sway Nisshin. When Nisshin first announced that it would not comply with a new cartel, MITI talked to Nisshin. Never did the ministry never do more than talk. Fundamentally, it agreed with Nisshin, but the smaller firms stood in its way. By making its compliance with the cartel contingent on market-liberalization reforms, Nisshin gave MITI the leverage it needed to pursue policies it supported anyway.

As had Sumitomo Metals, Nisshin soon put the lessons it learned to further good use. In the rayon fiber industry as well, in 1966 several firms tried to coordinate capacity cuts (Nisshin, 1969: 930). Nisshin refused to cooperate, and the group dropped its proposal (Tsusansho, 1966b: 132). When they raised it again the next year, several remaining firms did agree to scrap facilities. Nisshin scrapped none (Tsusansho, 1967: 142-43).

3. Idemitsu kosan. -- From time to time, observers also use the dispute over Idemitsu kosan petroleum firm to tell the story of Japanese government power. Readers should recognize the tale: MITI ordered the industry to cut production, a nonconformist firm refused, MITI threatened to punish, and the firm complied. The story did not describe Sumitomo, did not describe Nisshin, and does not describe Idemitsu kosan.

Through the 1950s, MITI had used its foreign exchange powers to control crude oil imports. In October 1963, it lifted those controls and substituted the authority it gained through one of the few industry-specific post-war control statutes -- the 1962 Petroleum Industry Act.[4]

The Act gave MITI dubious control over short-term production. It allowed the ministry to set five-year supply plans, to issue refining licenses, and to allocate new facility permits. It required refiners to submit annual production plans to the ministry. It authorized MITI both to recommend changes if those plans seemed excessive, and to determine non-binding standard sales prices.

Crucially, the Act authorized MITI neither to force firms to follow its production recommendations, nor to require that they follow its standard prices. The recommendations it authorized were instead just that -- recommendations. To force an adamant firm to comply, MITI would have needed to use its power over new investments to penalize non-compliance. Hence the crucial issues: could it have done so, and did it try?

For its suggested production plans, MITI sought to use quotas developed by the industry trade association, the Petroleum Federation. As in cotton-spinning, however, the trade association was split. The larger more efficient firms wanted a looser structure that rewarded firms for new investment -- if they wanted quotas at all. Many of them, like Idemitsu kosan, wanted none. The smaller less efficient firms wanted a straightforward cartel. With the firms unable to agree among themselves, MITI found itself in a quandary.

For the October 1963-March 1964 period, MITI adopted quotas that largely tracked its April-September 1963 numbers. Idemitsu kosan promptly refused to comply. It was the second biggest firm in the industry, and one of the most aggressive. It had just opened a new plant in February, yet the quotas ignored the plant almost entirely. We will "produce as much as we can sell," announced company president Sazo Idemitsu. MITI's quotas "completely ignore our special circumstances" (Nikkei, 10/6/63).

Idemitsu kosan did not just refuse the quotas. It cancelled its Federation membership, and on November 29, 1963, announced its withdrawal (Nikkei, 11/30/63). Repeatedly, MITI pleaded with it to rejoin and follow the quotas. Repeatedly, it refused. Declared its president, the production restraints potentially violated the Antimonopoly Act (he was right, as we note below). MITI pressure or no, he would never agree. After all, the Petroleum Industry Act gave the ministry no authority to make him comply (Nikkei, 12/12/63). Idemitsu "opposed the production adjustments themselves," he

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[4] Sekiyu gyo ho [Petroleum Industry Act], Law. No. 128 of 1962.

explained. "Unless those adjustments are themselves abolished, we cannot agree to any compromise" (Nikkei, 1/12/64).

MITI talked and pleaded, but -- crucially -- that was all it did. Never did it threaten to penalize Idemitsu when next it applied for approval on new facilities. Never did it threaten otherwise to penalize it for non-cooperation. Instead, it recognized that it could not force Idemitsu kosan to comply. As the minister himself told the press, the ministry hoped Idemitsu would compromise. If it refused, he would issue a ministerial recommendation under the Petroleum Industry Act. If it ignored the recommendation, there was nothing he could do (Nikkei, 1/14/64). "Because a ministerial order carries no penalty or other legal force," explained the Nikkei newspaper, "MITI believes that Idemitsu would ignore it and continue with its own production plans" (Nikkei, 1/19/64).

A few days later, Idemitsu kosan did agree to quotas -- for the time being (Nikkei, 1/25/64). To induce it to agree, MITI promised to produce new quotas that reflected Idemitsu kosan's concerns and hiked its allocation from 113,000 barrels a day to 131,000 (Nikkei, 1/24/64). Provided Idemitsu cut output during the low-demand summer months, calculated the Asahi newspaper, it could now produce almost what it could with no cartel at all (Asahi, 1/26/64). As a further part of the deal, Idemitsu demanded that MITI agree to abolish production restraints as soon as possible.

Yet "as soon as possible" is not now -- and the persistence of the restraints proved the deal's undoing. From the outset, MITI refused to say when it would actually abolish them (Nikkei, 1/24/64). Neither would Idemitsu kosan rejoin the Federation until it did. Instead, when sailors struck the next year, Idemitsu used the pretext to cancel the deal. Consumers needed their oil, it declared. With supplies now uncertain it would again produce whatever it could sell. Over the intervening year MITI had raised its quota to 192,000 barrels a day. It would produce 240,000 (Mainichi, 1/21/66).

MITI pleaded its case, but the company president seemed determined to kill the cartel. "Ever since freeing crude oil imports," he complained (Mainichi, 1/21/66), "MITI has used administrative guidance to control production. Our firm left the Federation because we opposed this. ... We cooperated only on the condition that MITI promise to abolish the production controls .... That promise it still has not kept."

This time MITI did keep its promise and Idemitsu cooperated. As soon as the sailors returned to work, Idemitsu agreed again to the cartel (Nikkei, 2/1/66). MITI abolished the price controls at the end of the month (Nikkei, 2/2/66) and the production restraints at the end of the next biannual period. With the restraints dead at the end of September, Idemitsu kosan rejoined the Federation.

C. Judicial Review of Bureaucratic Intervention:

1. Introduction. -- According to the anecdotes recounted in Section B, bureaucrats used the power they had in one area to force firms to comply with their dictates in another. According to the facts, they did nothing of the sort. According to the facts, they did not even try.

Bureaucrats did not use unrelated retaliation to induce compliance for two reasons: the courts would not have let them retaliate, and they had few powers (even unrelated powers) that they could have manipulated anyway. We turn to the latter in Section D, and focus first on the discretion courts gave bureaucrats: on their willingness to review informal regulatory measures (i.e., "administrative guidance"; Section 2), on the legality of those informal measures (Sections 3 and 4), and on criminal liability for complying with illegal regulatory measures (Subsection 5).

2. Justiciability of informal regulation. -- Despite occasional references in the literature to the contrary, when MITI regulated informally it did not do so to avoid judicial review. It regulated informally for the same reason most regulators everywhere regulate informally: informality saves costs.

MITI could not have stayed informal to avoid judicial review, because informality would not have stopped that review. If a Japanese firm wants to contest an informal instruction in court, it need simply ignore it. By doing so, it will force the government's hand. To induce it to comply, the government will then need to take more formal steps. When it does, in most cases courts will review what it does.

This is not peculiar to Japan. Rather, it is as true in the U.S. as in Japan. If an American firm wants to contest an informal government action, it must first force the government's hand. Until it does, American courts will not review the action. When it does, they generally will. The point is true in the U.S. It is true as well in Japan.

3. The case law on informal regulation. -- Nothing better illustrates the way Japanese courts handle informal regulatory measures than the travails of Musashino mayor Kihachiro Goto. In late 1971, Motoharu Yamada marched into Goto's office. As a bedroom Tokyo suburb Musashino had boomed over the last decade, and as head of the local Yamaki construction firm Yamada had played his part. He built condominium buildings. Now, however, the city wanted his money.

As Goto explained it, the city wanted developers like Yamada to do two things: to get their neighbors' consent before they built new buildings, and to donate money for school facilities. If they potentially inconvenienced their neighbors, they should make sure those neighbors did not mind. If they packed more students into the already crowded schools, they should do their part to build more. Many Musashino voters opposed the new construction projects, and Goto owed his position to local voters.

Given that the Musashino government had made these demands informally, Yamada opted not to comply. He continued to build his condominia. Although he sometimes tried modestly to placate his neighbors, he seldom gave on issues that mattered and sued those neighbors who tried to block his crew. When he did, the courts forthrightly ordered the neighbors to pay him damages.[5] Rarely did Yamada give to the city's school fund either. When the city stalled his applications in response, he sued it too.

Yet if Yamada could play to the courts, Goto (quintessentially, a politician) could play to the cameras. When Yamada proved particularly obdurate, he went to the construction site personally. With a handful of wet cement, he plugged Yamada's water pipes. Not that it stopped Yamada. He simply marched back into court. The city had a legal duty to provide the water, he demanded, regardless of whether he paid off his neighbors or donated to the schools. The court agreed, and ordered Goto to unplug the pipes.[6]

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[5] Yamaki kensetsu, K.K. v. Suzuki, 1151 Hanrei jiho 12 (Tokyo High Ct. Mar. 26, 1980).

[6] Yamaki kensetsu, K.K. v. Musashino, 803 Hanrei jiho 18 (Tokyo High Ct. Dec. 8, 1975).

Alas for Goto, the local prosecutors noticed the dispute. Rather than commend him for promoting the local welfare, they thought his behavior criminal. He had a legal duty to run water to Yamada's apartments, they reasoned, whether Yamada talked to his neighbors or not, whether he gave toward the schools or not. Forthrightly, they filed criminal charges. The Tokyo District Court convicted, and the Tokyo High Court affirmed. By 1989, so did the Supreme Court.[7] In enforcing the city's informal regulatory regime, Goto did not just break the law. According to the Supreme Court, he committed a crime.

Yamada then sued Goto on behalf of the city. Under Japanese law, taxpayers can sue derivatively on behalf of their community those local officials who misuse funds. When the prosecutors filed charges against Goto, Musashino had paid his defense costs. After all, he was responsible for promoting the town's welfare, and had made his demands on the contractors to carry out that responsibility. To Yamada, however, the regulatory framework was illegal -- and if Goto broke the law in enforcing it, then the city broke the law in paying his legal fees. As a Musashino taxpayer, he filed a taxpayer derivative suit to force Goto to refund his attorney's fees. Again Yamada won, and again the High Court and Supreme Court affirmed.[8]

And still Yamada continued. When Musashino tried to force the informal regulatory policies on him, argued Yamada, he incurred a variety of costs. For those damages, the city owed him damages. To the court, the case was easy. It had already held the city's actions illegal. If Yamada had lost money, the city had a duty to pay. This time, Musashino did not even bother to appeal.[9]

In all this, Musashino's policies were not unusual: city governments had adopted them the country over. Neither was the Tokyo District Court's response (declare attempts to enforce the policies flatly illegal) unusual: courts adopted it nearly everywhere too. One developer applied to the Tokyo government for construction permits on a couple of condominium buildings. The government cited opposition from his neighbors, and stalled. The developer sued, and in 1982 won.[10] Another developer applied to the Kyoto prefectural government for a hotel building permit. When the government told him to negotiate, he refused -- and this court declared the stalling illegal too.[11]

By 1985, the Supreme Court entered the fray and announced that developers could freely ignore the informal policies. When they did, city governments could not use their intransigence to delay their applications.[12] To be sure, it left open the possibility

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[7] Kuni v. Goto, 1323 Hanrei jiho 16 (S. Ct. Nov. 7, 1989), aff'g 1166 Hanrei jiho 41 (Tokyo High Ct. Aug. 30, 1985), aff'g 1114 Hanrei jiho 10 (Tokyo D. Ct. Feb. 24, 1984).

[8] Yamada v. Goto, 1354 Hanrei jiho 62 (S. Ct. Mar. 23, 1990), aff'g 1186 Hanrei jiho 46 (Tokyo High Ct. Mar. 26, 1986), aff'g 1080 Hanrei jiho 40 (Tokyo D. Ct. May 27, 1983).

[9] Yamaki kensetsu, K.K. v. Musashino, 1465 Hanrei jiho 106 (Tokyo D. Ct. Dec. 9, 1992).

[10] Fujisawa kensetsu, K.K. v. Tokyo, 1074 Hanrei jiho 80 (Tokyo D. Ct. Nov. 12, 1982).

[11] Sankei kanko, Y.G. v. Kyoto, 1116 Hanrei jiho 56 (Kyoto D. Ct. Jan. 19, 1984).

[12] Tokyo v. G.G. Nakaya honten, 1168 Hanrei jiho 45 (S. Ct. July 16, 1985).

that a developer might act so obstreperously that a city could withhold its services after all. Over the next several years, however, the courts made it clear it was a possibility in theory only. Obnoxious developers came and went, but the courts refused to let cities stall applications.

By the early 1990s, the suits had become commonplace. When a firm applied to Tochigi prefecture for a permit on an industrial waste plant, the government told it to obtain its neighbors' consent. The developer refused, sued for its permit, and won.[13] Another developer applied to Yamanashi prefecture for a construction permit on vacation condominiums. The prefecture stalled on grounds that he had not cooperated, he sued, and he won.[14]

A developer in northern Kyushu wanted a condominium complex in suburban Fukuoka. The city told him to reduce the complex's size. He refused, sued, and won.[15] Still others found their plans for a golf course or pinball parlor stymied by the informal policies, sued, and won.[16] The disputes continued even into the next decade -- when a resort condominium developer contested a local regulatory program and in 2001 won.[17]

4. <u>The case law on foreign exchange.</u> -- Although plaintiffs to these disputes over informal regulatory measures most commonly sued local governments, they did not always do so. Sometimes they sued MITI, and in the 1960s at least one set of plaintiffs sued MITI over foreign exchange. In deciding the case, the court did not tell MITI it could use its foreign exchange powers to punish the firm over unrelated matters. It told MITI (and we know of no cases telling it anything else) the opposite: the ministry could <u>not</u> use its power over foreign exchange to enforce unrelated policies.

As part of its cold-war strategy, the U.S. had organized "COCOM": an informal agreement among allies not to export militarily sensitive equipment into the Soviet block. In the 1960s, however, an apparently leftist Japanese group proposed sending COCOM-banned products to two Chinese trade fairs. To do so, it needed foreign exchange clearance. It applied to MITI, but rather than risk U.S.-retaliation MITI refused.

When the group sued MITI for the clearance, the court found for the group. The foreign-exchange statutes gave MITI considerable discretion, reasoned the court. Yet crucially, that discretion did not extend to non-economic concerns. In refusing the foreign exchange to enforce non-statutory political concerns, MITI violated the law. If MITI wanted to enforce COCOM, it needed a statute to that effect -- and a statute it did

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[13] Shiroyama kankyo joka, Y.G. v. Tochigi, 1385 Hanrei jiho 42 (Utsunomiya D. Ct. Feb. 28, 1991).

[14] Arakawa kensetsu kogyo, K.K. v. Yamanashi, 1457 Hanrei jiho 85 (Kofu D. Ct. Feb. 24, 1992).

[15] Toho jutaku sangyo, K.K. v. Shime, 1438 Hanrei jiho 118 (Fukuoka D. Ct Feb. 13, 1992).

[16] K.K. Yasu koporeeshon v. Ego, 1634 Hanrei jiho 84 (Osaka High Ct. May 27, 1997) (golf course); Odaka v. Funabashi, 1513 Hanrei jiho 145 (Chiba D. Ct. Nov. 19, 1993) (pachinko parlor).

[17] Daisei kikaku v. Gunma, 1757 Hanrei jiho 81 (Tokyo High Ct. July 16, 2001).

not have. Accordingly, by denying foreign exchange to enforce COCOM-related concerns, it violated the law.[18]

5. Criminal liability for regulatory compliance. -- Not only did courts let firms challenge informal regulatory programs they hated, they refused to let firms use programs they liked to avoid criminal liability. Take the oil firms. Since the 1960s they had (haphazardly, given the opposition of firms like Idemitsu kosan) cut production and fixed prices. They had managed their deals in the Petroleum Federation, and (like the steel firms) had tried to delegate enforcement to MITI.

In turn, MITI had implemented their cartel through informal regulatory policies. The Fair Trade Commission (FTC), however, decided that the arrangement violated the antitrust statute and launched criminal prosecutions. In 1980 the trial court straightforwardly convicted the firms.[19] Never mind that MITI had told them to follow the pricefixing schedule, explained the court. Never mind either that the Petroleum Industry Act authorized it to advise them to cut output or to set resale prices. Given that they could have ignored MITI's instructions had they wanted, in using the ministry to enforce their cartel's terms they fixed prices -- and pricefixing constituted a crime.

On appeal, in 1984 the Supreme Court duly affirmed.[20] Firms need not follow informal regulatory programs, it noted. Precisely because compliance is voluntary, the programs will shield no one from criminal prosecution.

D. Regulatory Powers:

1. Introduction. -- By most accounts, Japanese bureaucrats controlled an array of powerful measures, and enjoyed wide-ranging discretion in exercising them. Through that combination of controls and discretion, they used their power over issue X to punish a firm that ignored their instructions on issue Y. In the process, they manipulated the economy as they pleased.

In Section C we addressed bureaucratic discretion -- and illustrated how the courts did not give bureaucrats the discretion the conventional literature posits. Turn now to the question of power. Typically, Japan specialists claim that bureaucrats obtained their power through two sources: their ability to ration credit in highly regulated capital markets, and their control (as noted above) over foreign exchange. We begin with the former, and turn to the latter in Section 3.

2. Capital Market Regulation.[21] -- a. Introduction. -- According to the conventional wisdom, in the 1950s and 60s Japanese bureaucrats motivated reluctant

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[18] 1969 nen Hokkyo Jokai Nihon kogyo tenran kai v. Japan, 560 Hanrei jiho 6, 21-22 (Tokyo D. Ct. July 8, 1969).

[19] Japan v. Idemitsu kosan, 985 Hanrei jiho 3 (Tokyo High Ct. Sept. 26, 1980), aff'd in part and rev'd in part, 1108 Hanrei jiho 3 (Sup. Ct. Feb. 24, 1984) (two of the firms and one of the executives were acquitted on appeal); Japan v. Sekiyu renmei, 983 Hanrei jiho 22 (Tokyo High Ct. Sept. 26, 1980) (acquitting the Petroleum Federation).

[20] Japan v. Idemitsu kosan, 1108 Hanrei jiho 3 (Sup. Ct. Feb. 24, 1984) (other than the convictions of two of the firms and one of the executives).

firms by rewarding them in the credit market. There, the bureaucrats could do two things: they could lavish low-interest government loans (particularly from the Japan Development Bank [JDB]) on compliant firms, and they could ensure the firms access to private bank loans.

Bureaucrats could influence private loans, reason observers, because the government had taken three crucial steps. First, it had disabled the securities markets. By strictly regulating both stock and bond markets, it had prevented firms from raising more than limited quantities in either. When firms needed funds, they had little choice but to borrow from banks.

Second, the government used its control over foreign exchange to insulate the capital market from international competition. As Dan Henderson (1986: 132) put it, it had "shield[ed]" the domestic market "from international market forces."

Last, the government capped loan interest rates. Through rigid caps, it had forced banks to lend at rates below those that would have prevailed in a competitive market.[22] Compelled to lend at rates that did not clear, banks had no choice but to ration the credit they provided. By pressuring those banks, the government could then determine which firms borrowed and which went without.

None of this is true. By the 1960s the financial markets did clear. The government did not disable the securities markets, foreign firms did invest in Japan, and the interest-rate caps did not bind. Because banks lent at market rates, the government could not have influenced the allocation of private credit.

b. Equity issues. -- Despite the many references in the literature to highly regulated securities markets, the Japanese government never seriously tried to restrict equity issues. Instead, it merely imposed securities-registration and corporate-law requirements analogous to those in the U.S. Facing no regulatory hurdles, firms issued stock in large amounts. Take just the TSE-listed firms. In 1964, they raised 531 billion yen through 533 issues. In 1970, they raised 681 billion yen through 537 issues, and by 1975 raised 1,001 billion yen through 285 issues (Tokyo, 1985: 110 tab. 37; through 1970, $1 traded for about 360 yen, and in 1975 traded for 305 yen).

Overall, Japanese firms raised about the same fraction of their capital through equity as U.S. firms. Although scholars do claim Japanese firms raise more money through debt than U.S. firms, they mislead. Corrected for "differences in accounting," writes Stewart Myers (2001: 83), U.S. firms in 1991 had a book-debt/capital ratio of 33 percent while Japanese firms had 37 percent. They had a market-debt/capital ratio of 23 percent while Japanese firms had 17 percent.

These numbers do not reflect recent cross-national convergence. Instead, they merely repeat what Japanese scholars noted years ago. As early as 1979, Kuroda & Oritani (1979) observed that U.S. firms maintained equity/asset ratios of 33.0 percent

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[21] This discussion draws heavily from Miwa & Ramseyer (2004a).

[22] So constrained were interest rates, argue some scholars, that banks sometimes circumvented them by requiring borrowers to take more than they needed and deposit the "compensating balance" in a low-interest-bearing account at the bank. Through the ploy, they raised the effective interest rate on the loan. In fact, this largely did not happen -- for the simple reason that the regulated interest rates were not sub-market rates (as we explain below).

while Japanese firms maintained ratios of 47.4 percent. Large U.S. firms had intermediated financing ratios of 50.4 percent while Japanese firms had ratios of 46.7 percent.

c. Bond issues. Japanese firms did face more stringent limits on their ability to issue bonds, but the limits did not reflect regulatory practice. Instead, they reflected anti-competitive efforts by banks. Despite those efforts, TSE-listed firms used bonds to raise substantial amounts. In 1965, they raised 324 billion yen through 467 issues, in 1970 509 billion yen through 306 issues. By 1975, they raised 1,406 billion through 306 straight bond issues, 408 billion through 57 convertible issues, and another 372 billion through 52 foreign issues (Tokyo, 1985: 111).

What is more, those firms that could not meet the bank-mandated issuing requirements could -- and did -- readily circumvent them. Rather than sell bonds, they just borrowed directly from the institutional investors who would otherwise have bought their bonds. When firms issue bonds in the U.S., they primarily sell them to institutional investors like insurance companies. In Japan, although banks prevented many firms from issuing bonds, they did not prevent them from borrowing from insurance firms. Rather than sell those firms bonds, the firms merely borrowed from them directly.

d. The overseas market. To regulate firm behavior through capital market controls, the Japanese government would have needed to insulate the Japanese market from foreign investors. It did not. Although it banned foreign investment "in principle," almost immediately it began to gut that "principle" through a variety of exceptions. It started modestly: from 1952 to 1960, foreign entities invested only $1.01 billion in Japan, and only 16 percent of that as equity.

During the 1960s, foreign investment boomed. In 1961, foreigners invested $581 million. In 1963, they invested $904 million, and by 1967 $880 million. Increasingly, they used the money for equity (and thus long-term) positions. By 1971, they invested $4.3 billion, and 63 percent of that as equity (Tsusho, 1990: 402-10; Nihon ginko, 1974: 210).

"In principle" the government banned foreign investment. By the 1970s, it subjected that principle to an annual $3-5 billion exception.

e. Interest rate caps. - - Whether the government could allocate credit depends crucially on whether the credit market cleared. If banks lent at market interest-rates, anything the government did to direct funds would simply have produced offsetting shifts elsewhere. Because the marginal cost of funds would generally have stayed at market levels, even loan subsidies would seldom have affected investment patterns.

During the 1960s, the government limited the maximum interest rate banks could charge their customers. Subject to a variety of exceptions, it set the limit at 8.4 to 9.2 percent. It applied the limit, however, only to large short-term loans: loans of more than 1 million yen, and for terms of less than 12 months.

The banking association imposed an even-more-stringent set of interest-rate caps, again on loans of more than 1 million yen for terms of less than 12 months: during 1960-86, a maximum of 5.5 to 8.4 percent (Zenkoku, various years; Nakabayashi, 1968). The caps suggest a puzzle. One might expect banks to impose a floor on loan interest rates.

One might expect them to impose a cap on deposit interest rates. One would not expect expect them to impose a cap on loan rates.

In fact, however, the puzzle is more apparent than real. Fundamentally, the caps -- even the bank-association-imposed caps -- did not bind. In 1965, the large money-center banks lent money at modal rates of 8.0 to 8.4 percent within a range of 6.2 to 9.5 percent. During the same period, the smaller regional banks (with their higher-risk borrowers), lent at modal rates that ranged from 8.4 to 8.8 percent within a 6.2-9.9 percent range (Zenkoku, various years).

Banks could lend at these high rates because they could so readily avoid the caps. For smaller borrowers, they could split the loans into smaller segments. For the larger borrowers, they could lend the money for terms longer than one year. After all, most loans they rolled over anyway. Rather than lend at regulated rates for a year, they could lend at market rates for 13 months. And so they did. From 1960 to 1968, the larger banks made one-third to one-half percent of their loans on terms not subject to the bank-association-imposed caps. The regional banks made only one quarter to one-half of their loans within the caps.

Because the restrictions did not bind, firms in 1960s Japan borrowed at rates that reflected the factors that routinely determine interest rates in competitive markets. They paid higher rates if they had volatile performance, for example. They paid lower rates if they had a large stock of mortgageable assets (Miwa & Ramseyer, 2004a).

f. Government loan programs.[23] -- Although the JDB did make subsidized loans, it lent heavily to firms in ocean shipping (Nihon zosen, 1980). From 1961 to 1970, the government routed shipping firms over a third of the JDB's entire loan base (an average of 204 billion yen a year). In addition, to shipbuilding firms preparing vessels for export it routed nearly half its Export-Import Bank loans (a loan base averaging 247 billion yen a year).

Although the loans transferred substantial wealth to the shipping firms, innovative shippers could flourish without them. Indeed, the Sanko steamship firm flourished precisely because it did refuse to take them. To Sanko, the subsidized loans came with too much government control. Take the loans, it reasoned, and it could not offer its customers the services they demanded. Accordingly, by the mid-1950s it decided to do without. Rather than take the government's subsidies and comply with its terms, it would raise its own funds and follow its own plans. While its rivals stayed within the government's orbit, it repaid its JDB loans and turned exclusively to private sources.

Sanko jettisoned government subsidies all the way to the bank. It had opened the 1950s with virtually nothing. It closed the 1960s as the most profitable firm in the industry. During the last half of the decade, it earned shareholder returns of 32 percent a year, and by the early 1970s 62 percent. Its closest rival during the late 1960s was Showa, but it earned only 17 percent and in the early 1970s only 32 percent. Its closest rival during the early 1970s was Japan Lines, but it earned only 50 percent and in the late 1960s only 9 percent.

[23] For more details on the shipping industry and Sanko's history, see the fuller account in Miwa & Ramseyer (2004a).

By the early 1970s Sanko had grown from the sixth ranked firm (in 1964) to the largest. From a stock-market capitalization of 3.59 billion yen in 1964, it had boomed to 514 billion yen by 1973, three-times its nearest rival. Despite making no government-"approved" vessels, it commanded a shipping capacity second only to Japan Lines. Despite collecting no government-subsidized loans, it serviced the third largest debt in the industry.

To be sure, OPEC changed all this. Facing radically higher oil prices, western firms now cut the amount of oil they consumed and shipped. Firms like Sanko that had invested heavily in tankers suffered accordingly. Although in 1985 it filed for bankruptcy, it did have good company. Government-favored firms lost heavily too. By 1988, the government-anointed Japan Lines failed as well.

3. <u>Foreign exchange controls.</u> -- According to the legend of Sumitomo Metals, bureaucrats also motivated recalcitrant firms by withholding foreign exchange. Claims Chalmers Johnson (1982: 194-95), the foreign exchange law constituted “the single most important instrument of industrial guidance and control that MITI ever possessed.” According to Richard Caves & Masu Uekusa (1976: 487-88), a “major sanction until the mid-1960s was the MITI’s authority over the allocation of foreign exchange for the purchase of essential inputs.” Indeed, added they (id., at 489, ital. added), “[c]ontrols over international transactions have <u>often</u> served as a club when gentle persuasion failed.”

To the best of our knowledge, before the Sumitomo Metals dispute MITI <u>never</u> used its powers over foreign exchange and trade to enforce unrelated policies (<u>Nikkei</u>, 11/20/65). To be sure, it did eventually try the ploy once -- in 1969, to enforce COCOM. It tried the ploy, and the Tokyo District Court declared it flatly illegal.

In fact, all this misses the point that by 1969 the issue was almost entirely moot anyway. By then, MITI had few foreign exchange control powers to wield, for the Japanese government had freed most imports. The shift had begun in the late 1950s, when it decided to integrate Japan more fully into the international economy. In 1960, measured by volume 44 percent of all imports were unrestricted. By 1963 that fraction had reached 92 percent.[24] Only exceptionally (coal in the case of the LDP’s core constituents, or militarily sensitive equipment in the case of the COCOM dispute) could it review foreign exchange applications at all.

III. <u>Keiretsu and Main Banks</u>

A. <u>Introduction</u>:

If Japanese politicians gave their bureaucrats little power, then in most sectors those bureaucrats would not have constrained substantially the choices that economic actors faced. If those politicians then chose to deregulate, the economic actors would not have faced substantially changed constraints either -- for there would have been few

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[24] Komiya (1972: 71 tab. 2). Thus, claims that liberalization essentially began in the 1980s (e.g., Schaede, 2000: 2) are simply wrong. The details of industry-specific practice are crucial -- as much as western scholars routinely miss the point. For example, statements like those by Kaplan (197x: 145) that “[u]ntil 1965 MITI directly controlled the importation and allocation of ... [steel] ore ... through the mechanism of foreign exchange import quotas” are flatly untrue. Instead, by 1965 steel had already been freely importable for several years.

regulatory constraints to change. And if through deregulation politicians changed few constraints, then those actors would not have changed their behavior in response.

As noted earlier, when Japan-specialists refer to the keiretsu groups and the main bank system, they do not refer to institutions. Instead, they refer to what they see as idiosyncratic patterns of market behavior. If in the 1980s and 90s Japanese politicians did not substantially change the regulatory framework that constrained economic actors, then those actors should not have changed substantially their market behavior.

Yet what does one see: banks at the center of the keiretsu groups merge, and core members sell their stock. In 2002 the former Sumitomo and Mitsui Banks merged into one bank. The former Fuji and Daiichi Kangyo Banks merged into another. The large Tokyo-Stock-Exchange-listed (TSE) firms sell the stock they own in other keiretsu members to generate paper profits.

And firms -- big, exchange-listed firms -- fail. When they do, no bank offers to save them. According to the main-bank theorists, the firms maintained implicit rescue contracts with their main banks. Those firms now fail in large numbers, yet no bank tries to help.

Watching the spectacle unfold, observers proclaim the disintegration of the keiretsu and main-bank system. In truth, neither phenomenon is disintegrating -- for there were no phenomena to disintegrate. The keiretsu never had economic substance, and the main bank system never existed. Instead, both were figments of the academic imagination from the start.

B. The Keiretsu Corporate Groups:[25]

1. What are they? -- By most accounts, there are (or were) six of them: the Mitsui, the Mitsubishi, the Sumitomo, the Fuji, the Daiichi-kangyo, and the Sanwa. Within each group, a massive money-center bank dominated the others. Around it, dozens of industrial and service firms borrowed, built, and traded among themselves.

The firms also met regularly, the accounts continue. Every month, the presidents of the firms met for lunch. And at least the membership of these lunch clubs was clear enough. A man is either invited or not invited. Come noon on the second Thursday of each month, keiretsu or no keiretsu he must decide where he will eat his lunch.

2. Who do they include? Yet while the lunch-club invitation lists were clear, observers seldom used them. For if they did, no one would have cared about the keiretsu. Moving the keiretsu from an academic sideshow to a central institution in Japanese business instead involved a crucial slight-of-hand: coupling the accounts of regular presidential meetings with lists of hundreds (or thousands) of firms whose presidents were never invited.

For what the lunch-club presidents had in common -- in truth, all they had in common -- was that they each ran a firm that had once been part of a zaibatsu. Many of the firms were minor affairs. As of 1967 (the alleged heyday of the keiretsu, and the earliest date for which we have invitation lists), the lunch clubs included firms like the Hokkaido Colliery and Steamship company (1965 market capitalization of 6.9 billion yen; at the then-current exchange rate of 360 yen/$, about $19 million). They similarly

[25] The following account draws on Miwa & Ramseyer (2001, 2002a, 2002b).

included the Toshoku trading firm (3.0 billion), Mitsubishi Steel (2.8 billion), Mitsubishi-Edogawa Chemicals (3.1 billion), Sumitomo Coal (3.2 billion), Mitsubishi Mining (3.5 billion), and Mitsubishi Plastics (3.7 billion).

The lunch clubs could not conceivably have dominated the national economy. As groups of ex-zaibatsu firms, many of their members competed in industries that had dominated the economy before the war but had since gone nowhere -- industries like mining, ocean shipping, warehousing, and cement. In turn, they missed the firms most central to growth postwar. Again as of 1967, the keiretsu lunch clubs omitted Toyota (1965 market capitalization of 135 billion yen), Toshiba (91 billion), Takeda Pharmaceuticals (61 billion), Kinki Nihon Railway (43 billion), Honda (42 billion), Bridgestone Tire (42 billion), Kajima Construction (37 billion) -- not to mention Matsushita Electric (Panasonic), Sharp, Sony, Kyocera, Suzuki, Cannon, and Nikon.

Even collectively, the lunch-club firms remained modest. Take the number of employees in 1973 at all lunch-club firms, and compare it with the number of employees at several non-Japanese firms (Miwa & Ramseyer, 2002b: 193):

Mitsui	259,084	IBM	268,130
Mitsubishi	269,147	Siemens	302,000
Sumitomo	159,395	ITT	433,000
Sanwa	414,731	Philips	386,500
Fuji	345,549	GM	804,571
DKB	546,312	Ford	458,463

If one added all employees at the Mitsubishi lunch club firms, together they rivaled IBM. None of the groups even remotely approached GM.

For all the innuendo and speculation, we know of no lunch-club decision that mattered. Occasionally, the lunch-clubs collectively decide whether to license the old zaibatsu trade names and trade marks. For the 1970 Osaka World's Fair, they planned group displays. Rumors allege that the Sumitomo group once tried to stop Sumitomo Metals and Sumitomo Chemicals from expanding their aluminum refining, and that the Mitsubishi group once tried to stop Mitsubishi Petrochemicals and Mitsubishi Chemicals from expanding ethylene production. If they did, neither succeeded (Miwa & Ramseyer, 2002b: 193).

As rhetorically crucial as they may be, economically the lunch clubs have always been trivial. To avoid that triviality, most writers thus couple the accounts of the meetings with much longer lists of firms. For those lists, they most commonly turn to the rosters published by the obscure Economic Research Institute (ERI) as the annual Research on the Keiretsu [Keiretsu no kenkyu] (ROK).

The ERI did not obtain its lists from the firms themselves. Instead, it manufactured them. In virtually all cases, it merely grouped exchange-listed firms by the source of their loans. In turn, that loan data it obtained from the disclosure statements required by the Japanese securities law.

In general (it actually provided several quite different rosters), the ERI placed in a keiretsu those firms that borrowed the most from the (now long-independent) banks and insurers that before the war had been part of a given zaibatsu. It classified as independent those that borrowed the most from any other financial institutions.[26] If the total a given firm borrowed from the Mitsubishi Bank, the Mitsubishi Trust Bank, the Tokyo Marine and Fire Insurance Co., and the Meiji Life Insurance Co., for example, exceeded the total it borrowed from any other similarly grouped set of financial institutions, the ERI placed the firm in the Mitsubishi keiretsu. Only if it borrowed more from a non-keiretsu institution (generally, a much smaller regional bank) than the sum of its debt from any of these grouped money-center financial institutions did the ERI consider it independent.

Among observers who do not read Japanese, Dodwell Marketing Consultants posed the stiffest competition to the ROK. Every few years since the early 1970s, it published its own keiretsu roster: Industrial Groupings in Japan. Where the ERI relied on loans, Dodwell apparently (it does not clearly explain the procedure) turned to equity. Apparently, it started with the lunch-club invitation lists. To those lists, it then added those firms where lunch group invitees appeared prominently among the 10 largest shareholders.

If the different keiretsu definitions captured otherwise real but unobservable group characteristics, the ROK and Dodwell's should have produced similar rosters. Yet even the ROK rosters themselves vary. Because the ROK used several different definitions, its own Mitsui keiretsu ranged from 48 firms in 1965 to 82 (1965 data). Because Dodwell's uses yet another definition, its rosters vary still more. Indeed, the Mitsui group in Dodwell's has fewer than half its members in common with the principal ROK Mitsui roster. Only 48 to 65 percent of ROK keiretsu members appear in the Dodwell keiretsu roster of TSE Section-1 firms, and only 49 to 55 percent of the Dodwell members appear in the ROK lists (1975 data).

3. What do they do? a. Trades. -- If the keiretsu mattered so much, one might have thought the members would trade with each other. According to a survey by the Japanese Fair Trade Commission (Kosei, 1994: 139), however, manufacturing firms in 1992 in the six lunch clubs sold a mean 12.58% of their output within the group. They made most of these intra-group sales to the trading company, which then resold the goods elsewhere. Other than sales to the trading company, they sold only 2.38% of their output within the group. The amounts ranged from 5.57% (1.49%, excluding the trading company) for the Sanwa group, to 31.67% (0.61%, excluding the trading company) for the Sumitomo.

These same manufacturing firms bought a mean 6.71% of their supplies within the group. Again, much of this volume they bought from the trading company, which in turn acquired them elsewhere. Other than purchases from the trading company, the firms bought only 2.24% of their supplies within the group. The amounts ranged from 3.67% (1.23%, excluding the trading company) for the Fuji to 15.87% (5.40%, excluding the trading company) for the Mitsubishi.

b. Cross-shareholding. -- By most accounts, the keiretsu firms control each other through stock ownership. Yet most of the non-financial firms invest nothing in the other

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[26] Given that the ERI based its rosters on loans, the firms obviously (by definition) borrowed heavily from keiretsu financial institutions. For that reason, we do not discuss loan patterns below. For more detail on the subject, see Miwa & Ramseyer (2002b).

keiretsu firms. Although the law generally let them buy stock in each other, they rarely did. As of 1965 the 46 Mitsubishi non-financial firms could each have invested in 45 other firms -- for a total of 2070 investment opportunities.[27] Of these, the firms made investments in 219, or 10.6 percent. They made at least 1 percent investments in 61, or 3.0 percent. In only 11 cases (0.5 percent) did any non-financial firm hold more than 5 percent of the stock of another. The Daiichi firms made 1 percent investments in 4.8 percent of the potential cases, Sumitomo firms in 3.7 percent, Mitsui firms in 2.6 percent, Sanwa firms in 2.1 percent, and Fuji firms in 1.8 percent.

Nor did the non-financial firms collectively own much stock of each other. In the Mitsubishi keiretsu, the non-financial firms together held 4.9 percent of all outstanding shares of the group. In the Sumitomo, they held 6.1 percent of the shares of member firms, in the Daiichi 4.8 percent, in the Mitsui 3.5 percent, in the Sanwa 2.1 percent, and in the Fuji 2.0 percent.

Although the financial firms did hold stock in keiretsu members, the point misleads. Where the law banned U.S. banks from holding corporate stock during this period, Japanese law allowed it -- and Japanese banks responded by diversifying broadly. Although they owned stock in keiretsu firms, they owned large amounts of stock in non-keiretsu firms as well. By law, until the late 1970s the financials could have held up to 10 percent of any other firm's stock, and had they wanted to control the firms they would have bought that 10 percent. They did not. Although the Mitsubishi Bank invested in 41 of the 46 non-financial group members, it held more than 5 percent of the stock of only 8, and more than 8 percent of the stock of only 2. The trust bank held more than 8 percent of only 3, the life insurer of only 3, and the casualty insurer of none (1965 data).

If intra-group shareholdings were rare, true cross-shareholding arrangements were rarer still. Equity investments seem consistently highest at the Sumitomo group, and in 1965 there were 11 pairs of cross-shareholdings involving at least 1 percent there. Yet among the Mitsui and Sanwa firms there were only six such pairs, among the Mitsubishi four pairs, among the Fuji three pairs, and among the Daiichi firms two.

4. The invention of the "keiretsu." -- Rather than regulatory bias or cultural idiosyncrasy, the keiretsu instead trace their roots to the academic politics of the early post-war years. Although the right emerged from the chaos of war discredited, the left seemed poised to dominate Japan. Within but a few years, Marxists solidly controlled university social science departments. The extent of their control varied, but at the economics departments they excluded market-oriented scholars when they could. At virtually all the departments, they at least framed the debates -- and they framed a bizarre set of debates indeed. Take a few articles from a standard index of journal articles in economics for first half of 1967: "Lenin's Concept of Imperialism," "Dehumanization in Marx's Concept of Class," "The Method of Monopoly Capitalism," "New Currents in the World of Soviet Economics," "A Study of 'The Capital Accumulation Process' in Part I Section 7 of Das Kapital," and "Lenin's Critique of Rosa Luxembourg's 'Theory of Capital Accumulation,'"

[27] We take the data from the ROK. For shareholdings, it uses a different (and smaller) set of rosters than it uses for other purposes. See generally Miwa & Ramseyer (2002b).

To the contemporary economic scene, Marxists brought a theoretically driven need to find within the "contradictions" of "bourgeois capitalism" the "domination" by "monopoly capital." In the 1930s, they had identified that "monopoly capital" with the zaibatsu. By 1960, they were stuck. Although still caught in the world of "bourgeois capitalism," they faced ruthlessly competitive markets. Their "monopoly capital," it seems, was no where to be found.

Enter the ERI. To a shrewd entrepreneur, a Marxist market niche is as good as any other. If the Marxists could not find their "monopoly capital," the ERI would invent it for them. And so it did. It called the monopoly capital "keiretsu," compiled annual membership rosters, and sold university libraries the expensive subscription.

To the Marxist-inclined, the ERI did have a plausible story to tell. The war had largely bankrupted the family-controlled zaibatsu, but just to make sure the Americans had confiscated (actually, bought on credit and then massively inflated the currency) each family's stock. They then banned the old trade names besides.

Once the Americans left in 1952, the government lifted the ban on the old names. Given the reputational capital the firms had earlier invested in those names, almost immediately they retrieved them. Yet Marxist theory does not deal with reputational capital. It does deal with "monopoly capital." When the formerly zaibatsu firms retrieved their old names, to a good leftist the action signaled nothing so much as a resurgence of the monopoly capital that had so cruelly dominated Japan before.

Among these independently owned and operated formerly zaibatsu firms, the ERI picked the banks and insurance companies. In them and their borrowers, it then located the firms that would dominate its bourgeois capitalist world. The keiretsu, it proclaimed in 1960 (ROK, 1960: 3-4), were nothing other than "monopolistic organizations of giant firms ... that constitute trusts and industrial-capital combines." They "have a bank at their apex, and pursue their domination of capital through loans and their consolidation of that domination through equity ...."

Within 1960s universities, it was an easy sell. And sell the rosters the ERI did, for four decades. In time, the Marxist terminology would disappear. Until the 21st century, however, the rosters themselves did not. Instead, they evolved into a convenient -- indeed mandatory -- set of dummy variables for any regression involving Japanese economic data.

C. The Main Bank System:

1. Introduction.[28] -- Like the fable of the keiretsu, that of the "main bank system" starts with a bank. Every large Japanese firm has a long-term relationship with a leading bank, begins the fable. Call it the firm's "main bank," that bank maintains an set of implicit contracts with the firm. Under that implicit deal, it agrees to monitor the firm (often through board appointments). It promises not just to monitor for itself, but to monitor on behalf of other creditors. It agrees to intervene in governance (again, through board appointments) as appropriate. And as necessary, it agrees to loan extra funds, to subordinate its claims to those of other creditors, and to send in experts to remake the firms.

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[28] For further detail, see Miwa & Ramseyer (2002a, 2003a, 2004b).

By basic logic, the terms to the arrangement should trouble. Given that a bank which commits itself to rescuing defaulting borrowers will attract the highest risk firms, banks would seem to do best if they refused ever to become a main bank. Given that a bank that sends good money after bad usually loses both, banks that did agree to rescue troubled firms would seem to face incentives to renege after the fact. Given that a bank often does best if it quietly pulls its loans at the first sign of trouble, banks would seldom want to promise to monitor "on behalf" of their rival banks -- and those rivals would not trust them if they did. Given all these problems, if firms and banks did negotiate these terms, one would think they at least would do what insurance companies do with their own obligations: draft fine-print contracts about each.

Yet according to the conventional wisdom, banks and firms draft none. Indeed, according to that wisdom they not only leave the "main bank contract" unwritten, they leave it unspoken as well. In the language of the literature, they negotiate their terms "implicitly" -- and to say that they negotiate them implicitly, of course, is to say that they negotiate them not at all.

2. <u>Some examples.</u> -- At the firm level, the evidence at least shows that Japanese banks never tried to save all large troubled firms. Even before the 1990s recession, they did not try to save them. And if they did not try to save the firms that did fall into distress, they could not credibly (albeit implicitly) have promised to save the rest either. Consider several examples from Miwa & Ramseyer (2004b):

> a. <u>Mazda.</u> Consider Mazda. As western observers recount the story (see Pascale & Rohlen, 1983), the firm entered the 1970s with an iron-willed, engineering-obsessed, and somewhat pig-headed CEO from the original Matsuda family. Under his leadership, it invested heavily in rotary engines. Alas, when the OPEC-induced price hikes hit in the middle of the decade, consumers abandoned the rotaries for the more fuel-efficient Toyotas, Nissans, and Hondas. To turn Mazda around, the Sumitomo Bank then stepped in as main bank. It sent personnel, loaned money, repositioned the product line, enforced austerity. Through all that, it ultimately saved the firm.
>
> Yet the way Mazda reacted to the bank belies the notion that they implicitly agreed that the bank would rescue the firm. Had they cut such a deal in advance, the bank should not have faced the resistance it did after the fact. In fact, as Pascale & Rohlen (1983: 233, 236) acknowledge, the firm fought the bank at every turn -- with its managers referring to the new arrivals as the "occupying army."
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> Under pressure in December 1974, Mazda did accept several outsiders to its 30-member board. Yet the new men did not come just from the Sumitomo Bank. Instead, they came from the Sumitomo Trust Bank, two local banks, and the trading companies with which Mazda dealt as well. Although Mazda named a Sumitomo Bank representative vice president in early 1976, it was late 1977 before the outsiders could oust the pig-headed Matsuda as CEO. When they did, they did not fire him or install a banker in his stead. Instead, the firm named him chairman of the board and replaced him with its incumbent third-in-command, a

long-term Mazda engineer. By 1978, Mazda still had only four bankers on its board.

To keep Mazda alive, several institutions helped. The Sumitomo Bank did lend money, but so did the Sumitomo Trust Bank. In November 1979 Ford took a 25 percent equity interest. The director from the Trust Bank supervised capital budgeting issues, one director from the Sumitomo Bank managed exports while another directed accounting and cost-controls, the director from the C. Itoh trading firm coordinated sales, and the director from Sumitomo Trading took charge of managerial consolidation.

The legend in the West characterizes the Mazda "turnaround" as a story of main-bank rescue, but one should wonder. The Sumitomo Bank never had the stake in Mazda that would induce a bank or firm to invest much in saving it. Although it had lent more to Mazda than anyone else, it had long kept its share of Mazda's debt modest: 13.6 percent in October 1974 and 14.5 percent in October 1977. By October 1977 it was <u>cutting</u> the amount it lent Mazda: from 53.6 billion yen in October 1976 to 46.1 billion in October 1977, and by October 1980 to 26.3 billion. As of 1974 (and still in 1977) it held less than 4 percent of the stock. Had it wanted to own more, at the time it legally could have held up to 10 percent. Instead, it kept its share even below that of the Nippon Life Insurance firm.

In truth, the Sumitomo Bank did <u>not</u> rescue Mazda. Instead, the institutions with the greatest stake in the firm <u>collectively</u> rescued it. None of them knew how to make cars, of course, but Mazda's problems did not lie in automotive engineering. Instead, they lay in financial management and marketing. Banks do know how to balance books, and trading companies know how to read consumer preferences and cultivate export markets. What Mazda needed, these others could contribute. They did, and Mazda survived.

b. <u>Eidai Industries</u>: Mazda still makes cars, but troubled firms do not always recover. Sometimes, banks and trading partners intervene and fail. Eidai Industries mass-produced pre-fabricated housing, and by the 1970s listed its stock on Section 1 of the Tokyo Stock Exchange. In the mid-1970s it found itself outcompeted. Out-maneuvered by its competitors, in December 1975 it posted a large loss.

Eidai's banks had known of its travails already by late 1974. To resolve those problems, in the fall of 1975 the largest five creditors agreed collectively to lend it more and to excuse it from its 2 billion yen semi-annual interest payment. True to their word, they lent large amounts. From 1971 to 1977, they boosted their loans to Eidai from 7.5 billion yen to 75.3 billion.

The banks took a variety of other steps besides. They enlisted the help of two trading firms that handled Eidai accounts. They encouraged Eidai to increase its sales force. They introduced clients to Eidai branches. They placed three bankers on Eidai's eleven-member board. They replaced the Eidai president, first with a former president of a Daiwa-Bank-affiliated securities firm, then with the number-four man at Daiwa itself.

But monitoring a borrower effectively is hard. If its rivals outcompeted Eidai, Eidai outfoxed its banks. The second Daiwa-sent president had planned to rebuild Eidai within two years. It was not to be. Despite having had three bankers on its board and a banker in its vice presidential post even before the crisis, despite eventually accepting its president and fourteen other senior executives from the Daiwa Bank -- despite all this, Eidai carried problems that went deeper than any bank knew. By 1978, one year after the ambitious second Daiwa-sent president took office, the banks petitioned the court for its reorganization. “Banks know they’re easy to fool,” a senior Daiwa executive recalled (Chuo koron, Spec. Winter 1978 issue, p. 334). “But they got fooled again anyway.”

c. Sasebo Heavy Industries: When a rescue occurs and a firm does survive, sometimes it survives only by happenstance. During the 1960s and early 70s, the Sasebo Heavy Industries (SHI) shipbuilding firm had thrived. What with the explosive economic growth and the increasing need for large tankers (from firms like Sanko), demand had boomed. Come 1977, however, the Arab oil embargo and the massive revaluation of the yen (from 290.3 yen/$ in January 1977 to 195.4 in December 1978) had turned the boom into a bust. With total industry shipbuilding capacity of 19 million tons, Japanese firms had 1977 orders of only 5 million. At least the largest shipbuilding firms had diversified their product line. Medium-sized SHI had not. By the fall of 1978, it had no orders at all.

Like most large Japanese firms, SHI had borrowed broadly. From over a dozen banks, it had borrowed (as of March 1977) more than 79.7 billion yen. Among the commercial banks, it had borrowed the most from the Daiichi Kangyo Bank (DKB): 3.3 billion. It had four major shareholders: the Kurushima dry-docks firm (25.0 percent), the Nippon Kokan (NKK) steel firm (24.2 percent), Nippon Steel (14.1 percent), and the Nissho Iwai trading firm (10.1 percent). Kurushima had bought its interest because its CEO Toshio Tsubouchi wanted to integrate SHI’s large dock facility into Kurushima. When he had earlier tried to become president, however, NKK had blocked his move and instead engineered the appointment of its own representative.

To deal with the non-existent demand, in early 1978 SHI asked for early retirements. By April 1,600 employees had volunteered, but to finance their retirement package the firm needed 8.2 billion yen. It would also have to finance other changes, of course, and all told could expect to need about 20 billion. When it approached its banks, however, they balked. Rather than volunteer more money, they simply told it to file for bankruptcy.

The banks would agree to lend the money only if SHI’s lead shareholders guaranteed the debt, but the shareholders would not guarantee. NKK controlled SHI, and Tsubouchi -- bitter still about the way NKK had blocked him from becoming president -- was not about to guarantee any loans suggested by its handpicked managerial team. Absent a co-guarantee from Kurushima, neither would NKK guarantee a loan. And if Tsubouchi and NKK would not guarantee, Nippon Steel and Nissho Iwai would not do so either.

In short, neither the firm's creditors nor its shareholders would invest anything more in the firm. Ordinarily, such a firm would promptly go bankrupt. It did not, but only because SHI dominated the city of Sasebo, and Prime Minister Takeo Fukuda owed the city a massive political debt. When the government's nuclear-powered ship "Mutsu" had developed a radioactive leak in 1974, all other ports had refused to take it. With a leaking nuclear ship sitting off the Japanese coast and nowhere to send it, Fukuda faced a political disaster. He averted it, but only when Sasebo agreed to take the ship.

For that favor Fukuda now intervened personally. He struggled mightily to accomplish anything at all. Repeatedly, he urged the banks to fund SHI. Repeatedly, they refused. They would not loan the money unsecured and unguaranteed, they declared, and the firm could not secure and the shareholders would not guarantee.

Tsubouchi eventually did gain control and SHI did survive, but it survived largely without banks and only on a reduced scale. From 79.7 billion in March 1977, by 1979 its debt had fallen to 51.1 billion, by 1981 to 38.7 billion, and by 1983 to 10.2 billion. From 6968 employees in 1977, by 1979 its workforce fell to 4223, by 1981 to 3422, and by 1983 to 2760.

d. <u>Other Cases.</u> <u>Hanasaki.</u> Other distressed firms -- even big firms -- expeditiously go out of business. In the early 1970s, with its 40-year history the venerable Hanasaki firm was one of the largest Japanese manufacturers of women's clothing. When it tried to expand in 1976, it found itself with enormous unsold inventory: 1.6 to 1.7 billion yen on annual sales of 18.5 billion.

"We begged it several times to come up with a consolidated rationalization plan, and a plan to rebuild," recalled one Sumitomo Bank representative (Apareru, 1978: 81). "But it wouldn't comply." So, when in October it saw Hanasaki's winter clothes moving slowly, the bank offset 200 million yen's worth of Hanasaki liabilities against Hanasaki's deposits. Early the next year it announced that "there are limits to a bank's assistance," and declared an end to all further loans. Hanasaki promptly went out of business.

<u>Hayashi.</u> Sometimes a rescue succeeds, but only after creditors manipulate the bankruptcy process to oust the incumbents. The Hayashi firm had been one of the largest wool spinning firms in Japan. When business fell in the 1977, the founder-president resigned. As his family had earlier pledged their stock in Hayashi Spinning to the Tokai Bank in exchange for its aid, they now sued to retrieve that stock.

Soon, rumors began to circulate that the family would liquidate the firm at the February shareholder's meeting. Apparently, they planned to use their equity stake to demand concessions from their creditors. Afraid of losing control, the Tokai Bank promptly filed for reorganization under the bankruptcy laws. Through the bankruptcy proceeding, it cut the incumbent shareholders' interests to less than 10 percent of the firm's stock. It then reorganized and revamped the firm. The factories continued to operate with the labor force uncut -- but now under bank control.

Mitsumi. And sometimes if banks try to intervene, the firms reject the banks and restructure on their own. Electrical parts maker Mitsumi had fallen on hard times in 1970 after issuing bearer securities in Germany the previous year. In 1971 the Mitsui Bank sent in one of its men as Mitsumi vice president and another as director -- this in addition to the Mitsui banker already on the 10-member board. As of early 1970, the Mitsui bank as Mitsumi's fourth-largest creditor had lent Mitsumi 340 million yen. By 1972 it was its largest creditor and had 635 million outstanding.

Within a year the Mitsui officers had largely disappeared. The vice president had become an ordinary director, and the other directors had vanished. Apparently, the incumbent managers -- still under the control of an autocratic CEO -- had fought the bankers and pushed them out. Where Mitsumi had had 3528 employees in January 1971, three years later it was down to 2002 employees. It survived, but for several years only on a much reduced scale.

3. The evidence. -- If the "main bank system" ever functioned, the anecdotes in Section 2 suggest it functioned haphazardly at best. Banks missed problems. Firms failed. Banks jettisoned them when they did. Broader empirical evidence, however, suggests the system never functioned at all. Indeed, the evidence suggests it never existed. Consider the approximately 1000 firms listed on Section 1 (the largest firms) of the TSE in the 1980s and early 90s, and define the main bank as the bank that lends the most to a given firm.[29]

a. Governance by main banks. Main banks seldom used board appointments to dominate firms. During 1980, 1985, 1990, and 1995, 92 to 96 percent of the firms had no directors with appointments at the firm's main bank. At root, observers seem to confuse bankers with retired bankers. The distinction matters critically. If a bank hoped to use a board slot to monitor a firm, it would not name someone who had retired from the bank, could not return to the bank, and relied on that firm for his income. Notions of "Confucian loyalty" do not reach that far, and the banks themselves never located future jobs for their officers once they left. Instead, the bank would send a relatively young executive on the bank payroll who forfeited his career if he showed himself disloyal.

Yet when Japanese firms do appoint bankers to their board they name retired bankers, and even of those they appoint very few. During our four years, where only 4-8 percent of the firms had a director holding a bank position concurrently, 53 to 56 percent of the firms did have a retired banker on their board. They did not have many, though. The mean firm had only 0.2 to 0.3 directors with a concurrent bank position, and 1.1 retired bank officers.

b. Delegated monitoring. Main-bank theorists do not just claim that the main bank monitored its debtors. After all, good banks everywhere monitor their debtors. Rather, they claim that the main bank monitored on behalf of all other banks. Rather than

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[29] We take the empirical evidence from Miwa & Ramseyer (2003a).

waste their resources duplicating each other's efforts, the banks collectively delegated monitoring to the firm's main bank.

The hypothesis has an obvious testable implication: if Japanese banks monitor through board appointments and delegate that monitoring to a firm's main bank, then virtually all banker-directors should come from the main bank. By contrast, if banks do not delegate, then banker-directors should come from a variety a banks. Given that the firm will have closer ties to its main bank than to others (after all, by definition it has borrowed the most from that bank), it may appoint more directors from the main bank than elsewhere. If but only if banks delegate their monitoring to the main bank, however, will all banker-directors come from the main bank.

Banker-directors do not come only from the main bank. Instead, they come from a variety of banks. As of 1985, of their retired banker-directors firms appointed 57 percent from their main bank. They appointed 1.1 mean retired banker-directors in total. They appointed a mean 0.6 from their main bank.

c. Main bank rescues. Main-bank stability. -- According to most accounts, Japanese banks implicitly agreed to rescue those distressed clients for which they acted as main bank. Effectively, the accounts claim that main banks offered implicit insurance policies against financial or economic distress. The claim suggests several testable propositions.

First, if firms purchase implicit insurance from their main bank, then firms should switch main banks seldom and those closest to insolvency should switch never. After all, the firm (by hypothesis) has paid the premiums on its policy for years. It will not -- at the very point when it can expect to start collecting on the policy -- try to switch carriers.

In fact, main bank relations were anything but stable -- either among the profitable or the unprofitable. During each half-decade from 1980 to 1994, over a fifth of the firms found a new main bank. Just as the more profitable firms switched, so too did the less (the differences are not statistically significant): during 1980-85 28 percent of the firms in the least profitable quartile switched main banks, while 30 percent of the others did, during 1986-90 23 percent of the least profitable switched while only 20 percent of the others did, and during 1990-94 27 percent of the least profitable shifted while 28 percent of the others did.

Main-bank dependence. Second, if main banks offered implicit insurance against financial distress, the firms most likely to have "collected" on the policies would have been those closest to insolvency. If so, then on average the nearly insolvent firms should have owed a larger fraction of their loans to their lead bank than the other firms owed.

The phenomenon does not occur: main banks had not loaned a larger share of a firm's debt to the least profitable firms than to the others (none of the differences are statistically significant). During 1980-85, the least profitable quartile of firms borrowed from their main bank 27.8 percent of their loans while the others borrowed 30.6 percent. During 1986-90 the least profitable quartile borrowed 32.0 percent from their main bank while the other firms borrowed 33.9 percent. During 1990-94, the least profitable quartile borrowed 34.4 percent, while the others borrowed 33.8.

Change in main-bank dependence. If the main bank implicitly agreed to shoulder a disproportionate amount of the additional loans troubled firms needed, then as firms entered financial distress they should also have increased the fraction of the debt they borrowed from their main bank. On average, a main bank would have lent additional funds to healthy firms roughly proportional to its share in the firm's existing debt. To the financially distressed firm, however, it should have increased that share.

This did not happen: the least profitable firms did not increase the fraction they borrowed from their lead bank. Again, partition the TSE firms by profitability quartile in 1980-85, 1986-90, and 1990-94. Then compare (a) the mean increase in the fraction of its debt a firm borrowed from its main bank at the least profitable quartile against (b) the mean increase at the others. According to the standard accounts, the increase should have been larger among the distressed firms than among the others. It was not. During 1980-85 and 1986-90, the main bank increased its share of a firm's debt more at the top three quartiles than at the bottom. During 1990-94, it cut its debt share less drastically at the top three quartiles than at the bottom. Again, none of the differences are statistically significant. The point, however, is clear: main banks did not try to help unprofitable firms.

Expertise. Last, main-bank theorists typically claim banks helped troubled firms by dispatching experienced officers to the firm. As the anecdotes above relate, sometimes banks did indeed send their officers to troubled firms. Yet seldom did those officers “rescue” the firms -- for fundamentally they did not know how. Bankers may be smart, but they needed more than smarts to run an industrial firm. They needed experience, and that they did not have. Some of them had successfully run financial intermediaries, but none had built cars or sold detergents. “The biggest problem with having a bank control management,” complained one businessman, “is that bankers can’t stop thinking like bankers. Sure, they can cut personnel and inventory. But they don’t seem to realize that even in the middle of all the cut-backs, you’ve got to plan for the future and invest in the right facilities” (Ginko kanri, 1978: 87). As Mansaku Takeda (1978: 41), senior consultant to the Daiichi Kangyo Bank, put it, “banks are places to oversee loans. There’s no reason think a banker has any talent for running a firm, and there’re precious few examples of firms that did better because a banker came to run them. ... Sure, bankers may be smart. But whether they have any managerial talent is another issue.”

IV. Conclusions:

Has Japan changed its ways? Has it dismantled its developmentalist regulations?"

Have you, dear reader, stopped beating your spouse?

The Japanese government has not dismantled its developmentalist (or any other heavily interventionist) regulatory regime, for (except in a very few sectors) it had no such regime to dismantle. At least since the 1960s, regulators controlled few means by which to induce firms to comply. Firms and banks have not dismantled their keiretsu corporate groups, for they had no such groups to dismantle. Even in their purported heyday of the 1960s, the groups never constituted anything more than the feverish figment of an over-active Marxist imagination. Firms and banks have not dismantled their main bank arrangements, for they had no such arrangements to dismantle. Banks never dominated firm governance, secondary banks never delegated monitoring to a firm's main bank, and banks never agreed (even implicitly) to rescue firms in distress.

The economy in post-war Japan was a competitive market economy rather than a controlled one -- and it grew rapidly for just that reason. The government did not heavily regulate markets, large groups of firms did not stifle competition, and banks did not control firms. Instead, firms bought and sold, borrowed and lent, and thrived or failed -- on highly competitive markets.

It is one thing (and apparently a popular thing in the academy) to speculate about the effect of institutional change on market behavior. It is another thing entirely (and in the Japanese context apparently an abandoned art) to study the institutional arrangements actually in place. Until we know what institutions actually exist, however, we cannot expect to know the effect that any change in those institutions might have on the market choices economic actors make. Know thy data, Zvi Grilliches told generations of budding Harvard econometricians. Office-chair theorists would do well to learn a little data too.

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