

## **On the Financial Repression in Japan During the High Growth Period (1953-73) (\*)**

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**Abstract:** Japanese financial policies during the so called High Growth Period (HGP-roughly 1953-1973) stand at sharp contrast with the presumptions of the financial liberalization literature. Against the Japanese example, McKinnon (1991) and Horiuchi (1984) have argued, based on relatively high interest rates in Japan during this period compared to developed economies, that the Japanese financial market was not repressed. In this paper, Japanese financial policies during the HGP are examined to show the heavy and distortionary but purposeful government intervention in the financial markets. Moreover evidence is provided against those of McKinnon and Horiuchi to show that major interest rates have been repressed during the HGP. Finally, the reasons that forced the Japanese government to implement financial liberalization after 1973 are discussed. These reasons do not include considerations related to growth and the growth performance have declined after 1973.

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(\*) I thank Mark Mason for comments. The usual disclaimers apply.

# 1. INTRODUCTION

The evolution of the financial industry in Japan has interesting characteristics. The degree of liberalization of the financial sector had fluctuated over the decades. In the first phases of development, liberal practices dominated. Starting with the 1920s, and especially between 1953 and 1973, financial markets were highly regulated. During this period (High Growth Period-HGP), unprecedented growth rates in the real side of the economy were achieved. This was achieved by high investment rates. For example, the ratio of U.S. output of investment goods to that of Japan fell from 7.1 to 2.2 between 1960 and 1974<sup>1</sup>. During the same period, the average rate of growth of capital input in Japan was more than double that in the U.S.<sup>2</sup>

During the HGP, the level of gross capital formation of the private business sector has increased seven fold<sup>3</sup>. This naturally imposed an enormous pressure on the Japanese financial sector which fulfilled its functions successfully.

After 1973, and especially after 1984, a wave of liberalization emerged as a result of a combination of internal and external factors. In this liberalization process, growth considerations played almost no role. Instead, international factors can be attributed an important role in the acceleration of the efforts for liberalization.

The highly regulated financial environment between 1953 and 1973 attracted special attention in the literature. Financial regulations in this period set deposit rate ceilings, suppressed bond and equity markets and effectively isolated the Japanese financial markets from the world financial markets. The banks thus became the single most important financial institution and effectively transferred the personal sector surpluses to the corporate sector which borrowed heavily for its physical investments. Financial liberalization came only after the high growth period was over for reasons not related to growth.

This takes us to an interesting debate. As is well known, it is argued in the financial liberalization literature pioneered by Goldsmith (1969), Cameron (1967), Gurley and Shaw (1960) and more recently revived by McKinnon (1973) and again Shaw (1973) that financial repression leads to low saving and this constraint limits the available funds for physical investments. Liberal financial policies, by raising or totally liberalizing interest rate ceilings, are consequently advocated to increase financial savings. Increased financial savings are presumed to be, subsequently, transferred to capital investments thus increasing the growth rates.

The Japanese experience stands in contrast to these arguments as it is one where high growth rates were achieved in the presence of high government involvement/intervention in financial markets.

Against this paradox McKinnon (1991) and Horiuchi (1984) have argued that Japanese financial markets were not repressed by presenting data on Japanese interest rates during the HGP which were above the rates prevailing in the developed countries.

Such a discussion hinges heavily on the definition of repression. There is a tendency to define financial repression in an operational way and rather narrowly as existence of regulations that fixes interest rates and causes real interest rates to become negative under accelerating inflation. A broader and formally more correct definition that does not also contradict the McKinnon-Shaw view includes however any set of financial regulations that distort the decentralized allocation mechanism in a financial market.

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<sup>1</sup>Nishimizu and Jorgenson (1995).

<sup>2</sup>Nishimizu and Jorgenson (1995).

<sup>3</sup>Goldsmith (1983).

Such a definition of course includes the narrower one mentioned above but not limited to interest rate policies. In other words low interest rates are neither a sufficient nor a necessary condition for a financial market to be “repressed”.

In this paper I take up McKinnon and Horiuchi’s argument that the HGP growth was achieved in a non-repressed market. The more ambitious and different task of investigating the causal relationship between the financial policies and the real growth performance are not pursued here. Instead, the aim here is to pinpoint the fact that Japanese financial markets during the HGP were “repressed” according to the broader definition above. To do this, first the working of the Japanese financial markets is explained with the role of government. Second, data on Japanese interest rates will be provided to show that contrary to what has been argued by McKinnon (1991) and Horiuchi (1984) the level of interest rates also do not lend support to the McKinnon-Horiuchi view. Finally, the reasons that forced the government to implement liberalization after 1973 are discussed.

The organization of the paper is as follows. In the second section the regulatory environment in the financial sector and the structure of interest rates are explained to show the extent of government involvement in the financial sector during the HGP. The third section discusses the main factors that led to the financial liberalization arguing that it was mainly the international factors that pressed for financial liberalization and growth considerations did not play a role in this liberalization. The last section concludes the paper.

## **2. HIGH GROWTH PERIOD AND FINANCIAL REGULATION**

An international comparison of the interest rates prevailing in Japan during the HGP demonstrates that the Japanese interest were at least not lower than the prevailing interest rates in the developed countries<sup>4</sup>. This led McKinnon (1991) and Horiuchi (1984) to present, mistakenly according to our view, Japan during the HGP as having an unrepressed financial market.

Due to what characteristics is a financial market said to be repressed? Is it adequate to consider, comparatively, the nominal or real levels interest rates which is what McKinnon and Horiuchi did? In the literature, a number of different characteristics are taken, implicitly, as indicators of financial repression. Examples are: existence of selective credit policies; suppression of certain markets and certain financial instruments such as bond markets; high reserve requirements, etc. It should therefore be recognized formally that repression is more than an interest rate phenomenon. In a formal approach, financial repression entails the existence of any excessive government intervention in the financial market which might lead to distortions in the price formation mechanism. Moreover, although “repression” is generally taken to have a negative meaning, such government interventions per se might well be based on economic theory and might have welfare improving implications if the financial market is already plagued with imperfections<sup>5</sup>.

Given this broad and formally more correct definition of repression, it is apparent that whether or not a financial market is “repressed” can be measured by two different indicators. The first is the degree and the form of the government’s involvement/intervention in the financial market. In a ‘liberal’ financial environment

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<sup>4</sup>See for example Homer (1977) for a discussion.

<sup>5</sup>See Yulek (1996) for a discussion.

(if there exists one) the government's involvement is thought to be limited to safeguarding the smooth functioning of the financial market and minimizing the possible social costs from asymmetry of information between the agents. The more the government's area of involvement beyond this basic border, the more the market can be said to be "repressed".

The second indicator is the prices in the financial market which is a direct outcome of the first factor above. Here, however, care is needed when inferring conclusions from interest rates about the degree of repression. Prices are indicators of the relative scarcity of a good or factor in a market. In an economy closed to capital movements the scarcity argument applies to the domestic financial market. In such a closed economy, it might be just natural to see a price (here interest rate) go beyond the same price in another economy. If such a situation exists, it is clearly not reasonable to argue that the former economy is not repressed simply because the interest rates are high compared to another country(ies).

In the rest of this section we will examine the HGP period from these two angles separately and try to show the high degree and numerous modes of government involvement in the financial markets and the ensuing 'low' interest rates.

#### *Government Intervention and Regulations in the Financial Markets during the HGP*

Japan has displayed very high growth rates between 1953 and 1972. From the vantage point of this paper the interesting characteristic of the high growth period (HGP) was the celebrated fact that the Japanese financial markets during this period were highly regulated. Moreover, this period of regulation was followed by a more liberal financial environment. Thus the question arises on the role of the regulated financial markets on the Japanese high growth. In this section the financial policies and the channels of government intervention during the HGP will be discussed.

As Teranishi (1988)<sup>6</sup>, we can roughly classify the Japanese financial markets during the HGP for our purposes as follows:

- (a) Indirect finance:
  - private financial system (deposit market and loan market)
  - government financial system (postal savings market and loan market)
  
- (b) Direct finance:
  - securities market ( bond market, stock market, short term money market)

On a more systematic basis, the major categories of financial regulations can be classified under three headings. The first was the regulation of interest rates. Regulation and supervision of the interest rates were conducted by the Bank of Japan and the Ministry of Finance (MOF). A key instrument in this regard was the *Temporary Interest Rate Adjustment Law (TIRAL)*<sup>7</sup>. However, the issue of interest rate regulation and its effectiveness have become one of controversy as explained earlier and will be discussed in more detail in the next subsection.

The second important group of financial regulations involved the entry into financial markets. The bond and equity markets were deliberately suppressed. Entry into the bond market, short term money market and stock exchange were regulated. Corporate bond issuance was limited to companies in the basic industries. This limited

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<sup>6</sup>Teranishi (1988).

<sup>7</sup> Kitagawa and Kurusawa (1994).

the bond supply in the markets. On the other hand, the price of newly issued bonds were kept artificially high, which was another factor that limited the size of the bond market.

The third subgroup of financial regulations limited international capital movements. This effectively isolated Japan from the international financial climate during the HGP.

Financial regulations effectively made banks -especially city banks among them- the most important financial institution category during the HGP as the bond and equity markets were suppressed and international financial access was eliminated.

Once the more difficult part of the task, namely maintaining high intermediation in the presence of fixed -low- interest rates has been somehow achieved, the rest of the story is easier to follow. The triad among the government, large companies and banks effectively managed the transfer of funds originating mainly from the private household sector to investments of the corporate sector (Table 1).

The government's part was, on the one hand, regulating the financial market which enabled the banks to collect funds at low rates. On the other hand it participated directly in the financing process. This was achieved through both BOJ refinancing and government's direct funding of fixed investments (Table 2). The direct government funding was managed under the *Fiscal Investments and Loans Program* (FILP)<sup>8</sup>. Government managed this by developing a constructive fiscal stance during the HGP period in keeping the deficits small or running surpluses. This not only prevented crowding out enabling financial resources of the economy to be allocated almost entirely to private sector but also, as mentioned above, allowed government to actually participate in the financing process by directly lending to private sector under the FILP<sup>9</sup>.

The government regulation aimed at a general reduction of the cost of funds to the business enterprises for investments in physical capital and working capital. The priority sectors of Japanese industrial policy<sup>10</sup> were the major beneficiaries both in terms of lower cost of funds and of availability of credit. BOJ, on its part, followed an accommodating monetary stance in supplying the necessary credits to (city) banks whenever there was need. BOJ's window guidance (*madoguchi no shido*) -in the form of refinancing banks- was used as a carrot to reward investments in priority sectors designated by the Ministry of International Trade and Industry (MITI) and MOF. In this process the Japan Development Bank (JDB) also played an important role<sup>11</sup>.

Government incentives for private fixed investments, combined with low interest rates naturally caused excess demand for funds. The consequence of this for companies was the *overborrowing* situation. This, as stressed by Suzuki (1980), was not necessarily the direct source or consequence of the bank overloan situation, which will be discussed later. Rather, the two were different phenomena with different sources but they were "inextricably entwined" during the Japanese HGP period. The

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<sup>8</sup>Teranishi (1988) stresses the "division of labor between the government and private financial institutions". He presents evidence that government deliberately funded the declining, traditional sector and social overhead provisions.

<sup>9</sup>Government's fiscal stance during HGP was commendable also for the fact that the surpluses/small deficits were achieved under low tax rates.

<sup>10</sup>For a brief discussion of Japanese industrial policy in this context see Somel (1992). See Nester (1991) (especially pages 34, 212-3, 223) for the joint role of BOJ and the Ministry of Japan in the process of financing strategic industries. Finally see Yulek (1996) on a theoretical discussion of why such policies may be welfare improving for the country in the long run.

<sup>11</sup>Nester (1991).

overborrowing of companies had two main reasons. The first was the high ratios of external financing among Japanese firms. The second was the dominance of indirect finance. The natural reason for the external financing requirements was the high corporate sector deficits. This deficit was 65% of gross corporate income in 1956-60, 51% in 1961-65, 34% in 1966-70 and 58% in 1971-74<sup>12</sup>. The second factor derived from the deliberate design of regulations which caused the underdeveloped state of the bond and equity markets and thus the dominance of commercial banks in the financial sector. Even the pension funds and insurance companies preferred direct lending to companies rather than investing in securities<sup>13</sup>.

**TABLE 1: FLOW OF FUNDS BETWEEN HOUSEHOLD CORPORATE AND PUBLIC SECTORS**

YEAR	HOUSEHOLD	CORPORATE	PUBLIC	FOREIGN
1954	6,5	-3,9	-2	-0,5
1955	7,6	-4,4	-2,2	-0,9
1956	7	-7	-0,1	0,1
1957	7,1	-9,8	0,7	2
1958	6,3	-4,5	-0,4	-1,4
1959	9,5	-7,7	-0,9	-1
1960	8,9	-9	0,5	-0,3
1961	8,8	-11,5	0,8	1,8
1962	9	-8	-1,1	0,1
1963	7,7	-7,5	-1,4	1,1
1964	9,3	-7,6	-2,3	0,6
1965	7,9	-4,5	-3,2	-1,1
1966	9,1	-4,8	-4,1	-1,2
1967	9,4	-7,3	-3,1	0,2
1968	9,1	-6,7	-2,8	-0,7
1969	8,7	-6,9	-2,8	-1,3
1970	8,2	-7,2	-1	-1
1971	9,6	-6,3	-1,9	-2,5
1972	11,5	-7,9	-2,7	-2,2
1973	8,8	-7,6	-2,8	0
1974	10,3	-8,5	-3,7	1
1975	10,5	-4,1	-7,3	0,1
1976	11,4	-3,9	-7,6	-0,6
1977	11,2	-2,6	-7,3	-1,5

Source: Cargill and Royama(1992).

Since the Meiji period, the banks had the important role (or the “task”) of focusing the resources of the capital-poor economy: Hence their prominence dated back to the Meiji period:

Under the Meiji Slogan of *shokusan kogyo* ("encouraging industrialization and fostering entrepreneurial spirit"), the accumulation of real physical capital before

<sup>12</sup>Suzuki (1980) pp 27 and table 2.3.

<sup>13</sup>Suzuki Y. (1980).

there were sufficient funds available from the build-up of privately held assets or from bank deposits, required the banks to become aggressive lenders...(Suzuki 1980, p. 22).

During this process of transferring the funds they collected to the firms, the banks had mainly two problems. Firstly, their holdings of corporate bonds were not resalable in the market unless for a loss due to the mentioned artificially high initial pricing of bonds. Secondly, their deposit base was, on the average, of much shorter maturity than their loans. Both of these factors were sources of liquidity problems which was the main reason of the accommodating stance of the BOJ<sup>14</sup>. The BOJ credits to banks took the form of either rediscounting the commercial bills or the repurchase of bonds from banks at preferential prices.

The excess demand for -city- bank funds, and the city banks' eagerness to accommodate this led to overlending by the city banks. The ensuing *overloan* situation refers to the negative reserve position of the banking system; the borrowing of the banking system from the BOJ being bigger in magnitude than the reserves held by the banks at the BOJ<sup>15</sup>. Hence the importance of the BOJ refinancing. Though this was the situation at the aggregate level, not all types of banks overlent during the HGP period. It was the city banks which were having their loans refinanced by the BOJ and by the local banks. This situation is referred to as the *imbalance of the bank liquidity*. This imbalance between the liquidity status of city banks and other financial institutions pushed the call rates to high levels compared to the other rates, which was peculiar to Japan.

**TABLE 2: PERCENTAGE SHARE OF GOVERNMENT FUNDING IN TOTAL FIXED INVESTMENTS BY SECTORS**

	1954-60	1961-67
MINING (COAL MINING)	25.7 (37.2)	39.9 (65.9)
STEEL	4.6	3.6
MACHINE	11.3	9.5
CHEMICAL	8.1	7.1
TEXTILES	14.2	14.7
AGRI. AND FISHERIES	52.9	47.9
ELECTRICITY	32.4	19.7
MARINE TRANSPORTATION	33.9	50.9
LAND TRANSPORTATION	10.4	21.9

Source: Teranishi (1980).

The task of banks in supporting the development process was alleviated by regulatory provisions. Teranishi (1988) suggests the existence of three forms of subsidies to banks. First, the subsidy due to bank borrowings from the BOJ at discount rates which were consistently lower than the call rates. The BOJ thus made two favors to the banks at a time: she provided refinancing when needed and secondly, this provision was made at subsidized rates. Second, subsidies due to implicit taxation from bond holdings. Third, subsidies arising from deposit rate ceilings. Teranishi presents evidence that the third part, subsidies arising from deposit rate ceilings, is by far the major item in the total: 69.7% in 1966-70 and 82.9% in 1971-75.

### *The Level of Interest Rates*

<sup>14</sup>Teranishi (1988).

<sup>15</sup>In other words, the loans extended by the banks exceed the deposits plus the capital base and are therefore partially financed by BOJ credits.

In the previous subsection we briefly explained the degree of involvement and intervention of the government in the financial market at large. We now turn to the issue of interest rates in more detail.

There is no controversy in the literature about the fact that the deposit rates were strictly regulated and that the banks observed the ceilings. As seen in Figure 1, the nominal deposit rates remained at 4% during the HGP. Similarly, there is no controversy on the issue that there were interest rates that were not regulated such as the call money rates, telephone bond rates and Gensaki (repo) rates.

One of the main puzzles about the financial aspects of HGP was the high record of financial savings under binding deposit rate ceilings. Contrary to the -now-orthodox belief that financial repression would lead to financial shallowness, in Japan, the level of financial intermediation stayed at very high levels during HGP (Table 3). This represented considerable financial depth when compared even to industrialized countries<sup>16</sup>. One possible reason for this surprising fact, as proposed by some scholars is the limited range of assets available to savers with non-negative real deposit rates. The underdeveloped state of securities markets, absence of access to international financial markets left the savers with the bank deposits as the only financial asset. This explanation however fails to explain the experiences of other countries which had quite a few similarities in this regard but which had very low financial deepening during the regulation period<sup>17</sup>.

**TABLE 3: INTEREST RATES AND FINANCIAL DEEPENING DURING HGP**

	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973
<b><i>INTEREST RATES</i></b>												
<i>NOMINAL</i>												
DISCOUNT RATE,% (1)		6,6	5,8	6,6	5,5	5,5	5,8	5,8	6,3	6,0	4,8	4,3
AVERAGE DEPOSIT RATE(%)	4,0	4,0	4,0	4,0	4,0	4,0	4,0	4,0	4,0	4,0	3,9	4,0
AVERAGE LENDING RATE(%)	8,2	7,8	7,9	7,8	7,5	7,3	7,5	7,4	7,7	7,6	7,1	7,2
ADJUSTED, 25% (2)		7,4	6,5	7,4	6,0	6,0	6,5	6,5	7,0	6,7	5,0	4,3
ADJUSTED, 40%(2)		8,3	7,1	8,3	6,5	6,5	7,1	7,1	7,8	7,3	5,3	4,4
<i>REAL (EX-POST, WPI)</i>												
DISCOUNT RATE(%)		4,6	5,8	5,6	3,1	3,6	4,9	3,6	2,5	6,9	3,9	-10,0
AVERAGE DEPOSIT RATE (%)		2,1	4,0	3,0	1,7	2,2	3,1	1,8	0,4	4,9	3,0	-10,2
AVERAGE LENDING RATE(%)		5,8	7,9	6,8	5,1	5,4	6,5	5,1	3,9	8,5	6,2	-7,5
ADJUSTED, 25% (1)		5,4	6,5	6,4	3,6	4,1	5,5	4,2	3,3	7,6	4,2	-9,9
ADJUSTED, 40%(1)		6,3	7,1	7,3	4,1	4,6	6,1	4,8	4,0	8,2	4,5	-9,9
<b><i>FINANCIAL DEEPENING</i></b>												
M2/GNP (%)	71,2	74,6	73,0	77,5	77,6	76,4	74,2	74,8	74,1	83,6	90,9	87,3

Source: IMF and author's own calculations.

Notes:

1. Beginning of the year.
2. Adjusted for the effect of compensated balance rates of 25% and 40%.

<sup>16</sup> Especially after mid-1960s, M2/GNP ratios in Japan were consistently higher than those in USA. The gap with Germany, France and the U.K. was much wider. For example, the ratio in 1970 was 74% in Japan, 62% in USA, 49%, in Germany, 43% in France and 35% in the U.K. (data from International Financial Statistics).

<sup>17</sup> A good example for this might be Turkey during 1965-79 period when the financial regulations were very similar to Japanese HGP period. The financial deepening during this period in Turkey was however relatively low though high economic growth rates were attained.

More controversial is the extent of regulation and its effectiveness on the lending rates. Kitagawa and Kurusawa (1994) explain that “short term interest rates at private financial institutions for individual loans under one year in maturity were determined within a band between the maximum interest rate set by the TIRAL and the prime rate set by the Federation of Bankers Association of Japan ... Neither TIRAL nor MOF set explicit limits on long term lending. ... In fact however, the ‘long term prime rate’ charged on high quality corporations such as electric power companies was determined by the parties concerned and the government authorities using implicit rates” (p. 85-86). Although there are other sources of descriptive information about the government’s involvement in the formation of lending rates, below we provide evidence of this fact directly from the data on the lending rates.

Relatively higher interest rates in Japan compared to developed economies have been the basis of McKinnon’s and Horiuchi’s presenting Japan as a case of an unrepressed financial market during the HGP<sup>18</sup>. Figure 1 shows the course of lending rates in Japan, USA and UK<sup>19</sup>. Japanese lending rates have been far higher than the rates in USA and UK until the late 1960s. Though not displayed in the Figure, the same conclusion is true for the comparison of lending rates in Japan and other developed economies.

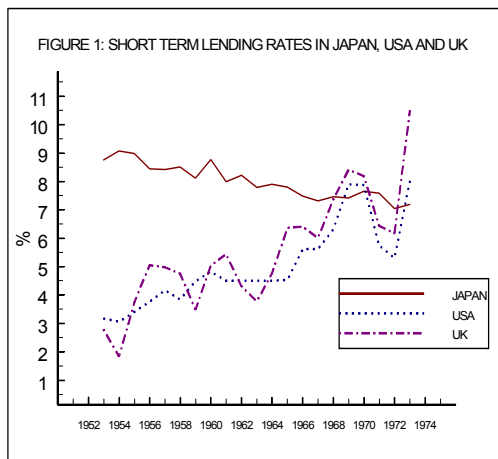
As argued earlier low interest rates are neither a sufficient nor a necessary condition of financial repression. In fact, the mere existence of compensating balances is in itself evidence that the lending rates were subject to binding regulations as otherwise the banks would simply charge, on the borrowers, the rates under the market conditions instead of using the cumbersome method of compensating balances. Furthermore, a direct comparison of the levels of interest rate accross countries as made by McKinnon and Horiuchi may be misleading as the Japanese financial markets were isolated from the international financial markets due to the capital controls during the HGP.

Nevertheless, the views of McKinnon (and Horiuchi) weaken when we compare the various interest rates within Japan. Figure 2a presents the call money rates, bank lending rates, 3-month deposit rates and telephone bond yields. Naturally, these rates are not exactly comparable to each other as they belong to instruments of different maturities (all are annualized rates) and to different financial sub-markets. But again, as in Figure 1, they convey the main idea of my argument.

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<sup>18</sup>See McKinnon(1991).

<sup>19</sup>Because of data availability the rates displayed in Figure 1 are the US prime rate, open market discount rate in UK and the average bank lending in Japan. These interest rates are not precisely comparable to each other but nevertheless their general levels give us a general idea.



Call money rates and telephone bonds yields are two rates that are freely determined<sup>20</sup>. Moreover, they constitute the short and long end of the maturity range. Bank lending rates, as discussed before, are at best mixed in terms of regulation. Finally bank deposit rates were totally regulated. Figure 2a provides us with two sets of important observations. Firstly, it shows that lending rates in Japan are much less volatile than the unregulated call money rates and telephone bond rates. Bank rates are less volatile than interbank or bond rates in other countries as well but clearly the difference in volatility in the Japanese case is striking, suggesting, at least some effective administrative control on the Japanese lending rates. This is clearly seen when compared to the striking co-movement of call rates and prime rates in USA in Figure 2B. Finally, as Figure 1 shows, Japanese lending rates are much less volatile compared to those in the UK and USA.

The second important feature of Figures 2A and 2B is that, generally during the HGP, the call money rates<sup>21</sup> have been above the level of lending rates. Furthermore, the telephone bond yield, representing the longer end of the spectrum of the freely determined interest rates have also been above the lending rates after their start in 1961.

Given these findings around Figure 2A and 2B, our argument is that clearly certain interest rates during the HGP such as the lending rates and definitely the deposit rates have been lower compared to what they would have been, had they been determined freely in the market.

The final piece of evidence about the 'low' Japanese interest rates is depicted in Figures 3 and 4 where real ex-post bank lending rates and real ex-post deposit rates are displayed. In view of the fact that during the HGP inflation rates measured by CPI on the one hand and WPI and GNP deflator on the other diverged considerably, the figures include the real rates deflated by all of these three measures<sup>22</sup>.

The first thing apparent in Figure 3 is that real lending rates deflated by WPI is considerably higher than those deflated by CPI and the GNP deflator. McKinnon (1991) and Horiuchi (1984) uses series deflated by WPI to argue that real rates in Japan were high comparatively. Figure 3 shows that this conclusion changes when

<sup>20</sup>Goldsmith (1983).

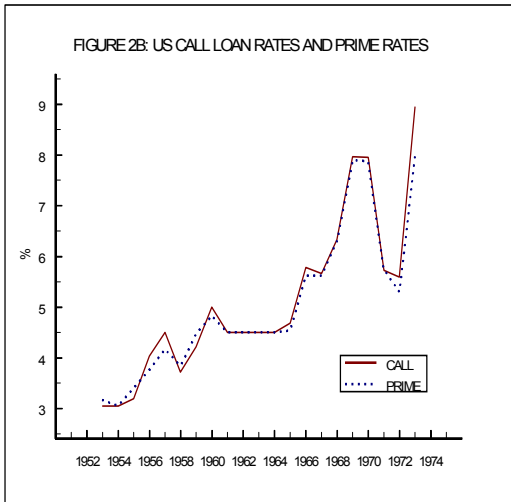
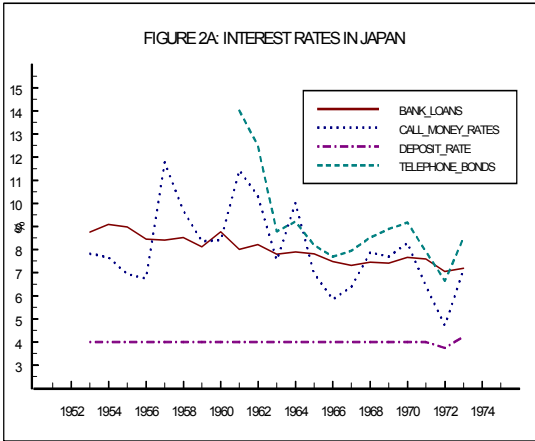
<sup>21</sup>Note that call money rate is of very short maturity.

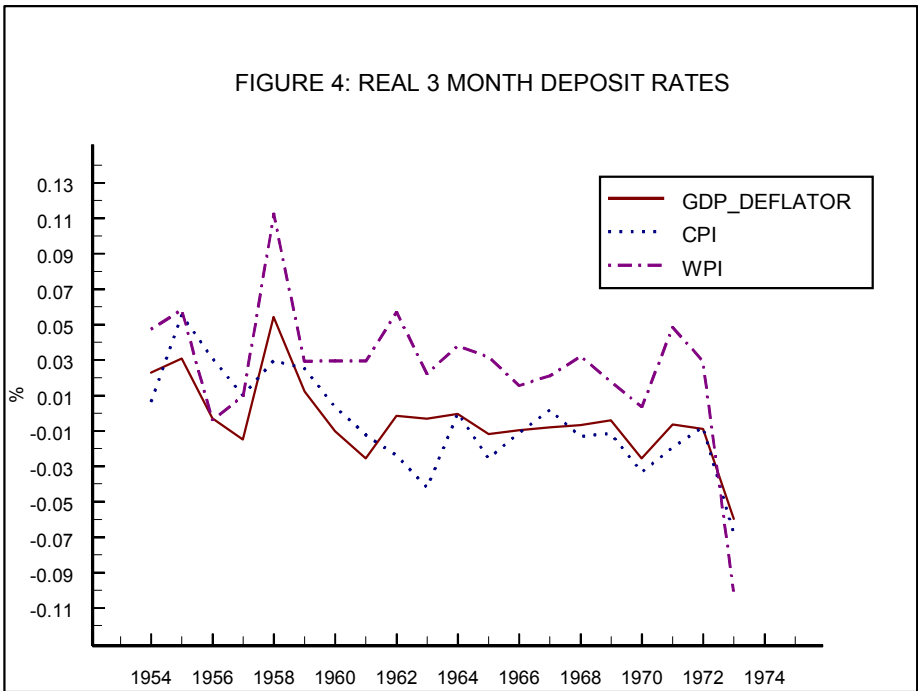
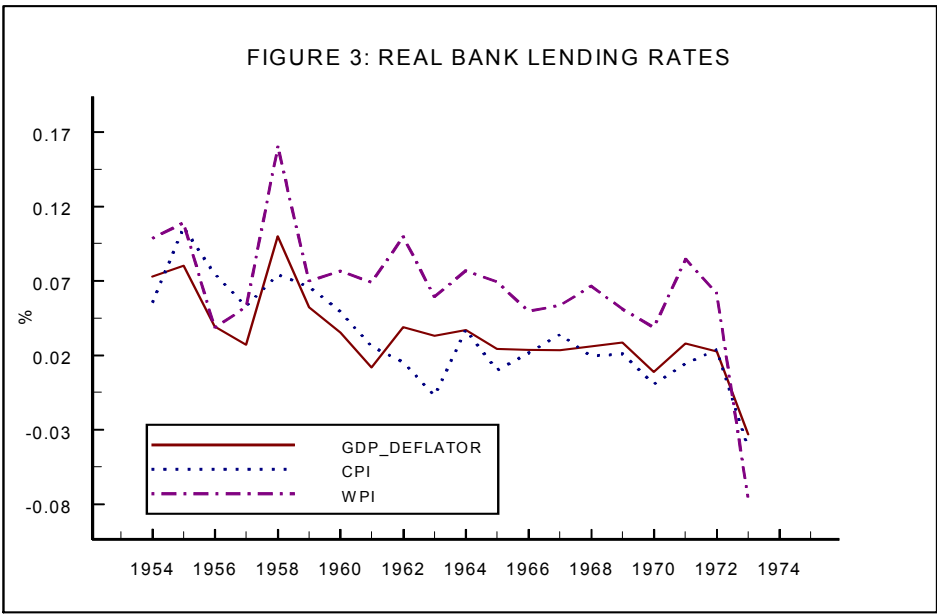
<sup>22</sup>The average annual inflation rates during 1953-1973 were 1.3% in WPI, 4.4% in CPI and 4.2% in GNP deflator.

either CPI or the GNP deflator is used. Real lending rates have been on the average about 3% starting with late 1950s when the deflation is made either by the CPI or the deflator.

Figure 4 displays the real deposit rates. As the three month deposit rates were fixed nominally at 4% and the inflation rates measured by CPI and deflator surpassed this level starting with late 1950s, real rates became negative. When the WPI is used as the GNP deflator, real deposit rates again become higher averaging about 3%. Thus the same divergence in conclusion emerges.

Overall, the evidence in Figures 3 and 4 shows that it is difficult to argue that real interest rates were “high” during the HGP. Against the argument of McKinnon (1991) which states that WPI “represents ... a wide range of tradable goods” and is the relevant alternative to yen-denominated assets, it can well be argued that measuring price inflation by the CPI or the GNP deflator would represent the trade-off between consumption and financial saving better than using the WPI. It is therefore difficult to conclude that discussion and practically the conclusion on real lending rates is at best ambiguous given the different results corresponding to different indices used in deflation.





### 3. LIBERALIZATION IN THE JAPANESE FINANCIAL MARKETS

The financial liberalization process in Japan is generally considered to have started after 1974 and to have continued since then. There have been a number of reasons that triggered the process. The expansionary monetary policy conducted by BOJ in an effort to finance the growth coupled with the effects of the oil crisis led to high inflation reaching 17%<sup>23</sup> in 1973 when it adopted a tight money policy to reverse the process. BOJ's contractionary monetary policy coincided with the first oil shock the same year. As a result of the ensuing disinflationary process, the inflation rate was curbed to 7% in 1975. The GNP growth rates also slowed down after 1973 and investment rates fell.

With lower investments corporate deficits dropped almost by half. Simultaneously however, the general public sector deficits which were kept under control during the HGP started to take over and more than doubled between 1973 and 1975. These asymmetric movements of corporate and public deficits altered the pattern of flow of funds that prevailed during the HGP.

As the domestic factors were reshaping the flow of funds within Japan, on the international front, with the high growth rates attained in the previous 20 years the country had already become an important world economy; an economy that could no more be ignored by the rest of the world. In addition to the internal factors, there were also growing international pressures that now started to exert influence on the domestic policies.

#### *Domestic Factors*

Cargill and Royama (1992) explain why all the major domestic players supported liberalization of the financial markets. The government faced resistance from the banks and the securities companies in absorbing the increasing government debt after 1975. In contrast, before 1975, at low levels of outstanding government debt, both the banks and the securities companies had been willing to absorb those securities. Throughout the HGP there was the implicit promise of the BOJ to repurchase government bonds from banks with a premium after one year. The banks thus anticipated that they would be able to resell the government securities to the BOJ with a capital gain. The securities companies were willing to absorb the debt since they could use them in the -then- unofficial *Gensaki* (repurchase) market.

The growth of government debt increased the size of the *Gensaki* market considerably. The growing *Gensaki* market in turn provided an unregulated short term investment market especially to the corporate sector which started to shift their bank deposits to the new market. With the increasing pressure from the banks that tended to lose funding sources, the authorities allowed the issuance of CDs in May 1979 which is considered as a major step towards the liberalization of interest rates.

Banks were supporting liberalization as they considered it to be an opportunity to regain their share in the financial markets. The declining corporate physical investments and consequently lower corporate deficits had reduced the dependence of the corporate sector on banks. The corporate sector on the other hand was also supporting liberalization. They faced increasing liquidity and their dependence on the banks had declined. Liberalization was seen to offer them better utilization of their extra liquidity. They had already started to use the unofficial *Gensaki* market heavily to utilize their excess liquidity in short term investments. Moreover, with reduced

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<sup>23</sup> WPI.

dependence on bank credits, they did not have to hold large deposits in banks in the form of compensating balances.

The household sector was also for liberalization as that would widen the available menu of financial assets. On the one hand, they simply expected higher returns on their investments. On the other, the reduced growth rates effectively reduced the growth of their income and increased their reliance on their investments. Finally, the aging population had increased the emphasis on personal investments. Liberalization was simply seen as a means of achieving higher returns on their savings.

### *International Factors*

While the liberalization policies before 1984 can mainly be attributed mainly to the aforementioned domestic factors those after 1984 were driven by international factors and in particular by the efforts of USA. These factors increased the pace of liberalization that started in the second half of the seventies.

US pressure stemmed from the deterioration of its external balance. In the face of mounting current account deficits against Japan, USA was concerned about the effects of a weak yen. The American side located the reason of the appreciation of dollar vis-à-vis yen in the isolation of Japanese financial markets and pressed for the internationalization of the yen as a measure to support it against dollar. In the bilateral talks between the Japanese Finance minister and the US Treasury Secretary in 1983, the Japanese side agreed upon three measures: to promote the internationalization of the yen, to deregulate Japanese capital and financial markets, and to help strengthen the yen. The establishment of a *Yen/Dollar Committee* was also agreed upon with the aim of following up the joint undertakings and investigating the possibility of additional measures.

The findings of this committee was announced in 1984 and became the basis of the *US-Japan Accord* the same year. The new measures reduced restrictions on international bond issues (Euroyen activities) including Japanese resident borrowing, and bond issues by Japanese residents and foreigners. The limits on forward foreign exchange transactions and swap limit rules on Japanese banks were abolished. The access of foreign financial institutions to Japanese markets were eased and the limits on the purchase of foreign securities by Japanese non-bank institutional investors were lifted<sup>24</sup>.

## **4. CONCLUSIONS**

Though the literature still leaves much to be investigated on the causal relationship between finance and development, financial structure obviously has important implications on the growth process as it determines the transfer of savings into physical investments. The issue of finance is naturally critical for countries that have not completed their development process. The current orthodox view proposes liberalization of financial markets to achieve high growth rates. This view suggests that financial liberalization will trigger higher savings and thus higher physical investments in the developing countries. In almost all of the financial liberalization

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<sup>24</sup>For a more detailed but still brief account of the liberalization after 1973 see Somel (1992). Comprehensive discussion on the same issue can be found in Osagi (1990), note 18, Suzuki, Y.(1986) and Takeda and Turner (1992).

experiences so far, growth performance have not confirmed the expectations of this view.

The examination of the regulations and the interest rates show that the Japanese example stands in stark contrast with the financial liberalization recipes that have been prepared for the developing countries starting with 1973 and which have been adopted by an increasing number of developing countries. During the Japanese high growth period the financial markets were highly regulated. It is far too ambitious to try to prove that these regulations were the major factor that caused the rapid growth and is beyond the scope of this paper. Clearly however, Japanese financial policy was a consistent and integral part of the Japanese industrial policy during the HGP. The liberalization started mainly because of external factors as explained.

The question of how low the “artificially low” interest rates in Japan were, has been the subject of other studies and not taken up here. But mthis study has shown that the government has been involved deeply in the functioning of the financial market during the HGP. McKinnon-Horiuchi’s approach represents an easy way out of the apperant paradox. The Japanese experience seems to be much more complicated one than they understand and promises to shed, through future research, an interesting light on the finance-growth nexus.

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