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Evidence from the Deregulation of  
Financial Services in Japan**

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**The Legislative Dynamic:  
Evidence from the Deregulation of Financial Services in Japan**

by Yoshiro Miwa and J. Mark Ramseyer\*

Abstract: In many ways, the current financial distress in Japan traces itself to the limited range of non-bank financial intermediaries available. That limited availability is itself a creature of regulation. By examining the recent deregulation of commercial paper issues by financial intermediaries, we explore the dynamics of the regulatory process that originally contributed to -- if not caused -- the current distress.

We also use this case study to explore the dynamics of the Japanese legislative and regulatory process more generally. We characterize deregulation as a bargain between banks and the newer non-bank intermediaries: the banks acquiesced to commercial paper issues by non-banks, while the non-banks agreed to the regulatory jurisdiction of the Ministry of Finance. The non-banks obtained a cost-effective way to raise additional funds; the banks brought their new competitors within their regulatorily enforced cartel. At a specific level, the dynamics illustrate the classic Stiglerian theory of regulation; at a more general level, they illustrate the trans-national economic logic to the Japanese legislative and regulatory process.

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“Persons pretending to forecast the future,” the New York state criminal code once declared, “shall be considered disorderly and liable to a fine of \$250 and/or six months in prison.”<sup>1</sup>

A decade into the worst recession since the war, for Japanese firms no one seems willing to forecast anything other than more of the same. Most everyone looks to banks for the blame. A decade since asset prices fell, banks still hold debt for which their collateral gives scant recourse. They seem unsure whom to try to blame, but no one forecasts much of a quick recovery for them either. And try as they might to disguise it, many among the banks, the firms, the press and the public continue to fear a financial collapse.

Similar in scope to their Japanese peers, U.S. banks and firms suffered far less severe a recession and pose little risk of collapse. Much of this contrast traces itself to structural differences in the financial services industry. More specifically, it traces itself to differences in the range of non-bank financial institutions that investors and firms can tap. As Merton Miller put it:<sup>2</sup>

Banking is not only basically 19th-century technology, but it is disaster-prone technology. And in the summer of 1997 a banking-driven disaster struck in East Asia . . . . That the U.S. economy did not freeze up into depression in 1989-90, as it had in 1931 and so often before that, can be credited, I believe, to the rich variety of non-bank financial markets and institutions available to American firms and households.

Why the different range of institutions and markets? If the U.S. economy could avoid disaster by having non-bank financial institutions, why did Japanese authorities not permit the same? Institutionally, they readily could have done so; economically, they surely understood the issues involved. Before 1940, Japanese firms did raise most of their funds through stock and bond markets, and relied on banks only secondarily.<sup>3</sup> In the intervening half century, what changed? Why did the Japanese government pursue such ill-advised policies?

We place the blame for the lack of diversification in Japan on the regulatory framework, and explore the political economy behind it. More specifically, we examine the way the Ministry of Finance (MoF) stymied the development of a commercial paper market for non-bank financial intermediaries. Justifying its role with an idiosyncratic interpretation of Section 2(c) of the 1954 Capital Funding Act,<sup>4</sup> the MoF blocked non-bank intermediaries from using commercial paper to raise funds. More generally, it cited the Act to prevent those non-bank intermediaries from circumventing the regulatory framework by which it coddled the banks and securities firms. In this chapter, we ask why the regime changed in the late 1980s and 1990s, why it had not changed earlier, and why the non-bank intermediaries deferred to the MoF’s only dubiously based instructions.

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<sup>1</sup> N.Y. Code Crim. Proc. Sec. 889 (since repealed), as quoted in Robert S. Pyndyck & Daniel L. Rubinfeld, *Econometric Models and Economic Forecasts* (New York: McGraw Hill, 4th ed., 1997).

<sup>2</sup> Merton H. Miller, *Financial Markets and Economic Growth*, *Journal of Applied Corporate Finance*, Fall 1998.

<sup>3</sup> See Yoshiro Miwa & J. Mark Ramseyer, *Banks and Economic Growth: Implications from Japanese History*, 45 *J. Law & Econ.* \_\_ (forthcoming 2002).

<sup>4</sup> *Shusshi no ukeire, azukarikin oyobi kinri to no torishimari to ni kansuru horitsu* [An Act Regarding the Regulation of the Receipt of Investment Capital, Deposits, and Interest Rates], Law No. 195 of 1954.

This exercise in historical reconstruction raises broader issues in the Japanese legislative process. First, it illustrates the political dynamics behind regulation and legislation. Although many specialists claim that Japan operates by its own political logic, we find the logic consistent with that which governs regulation and legislation in most advanced capitalist democracies. More specifically, the logic illustrates George Stigler's classic observations that (a) most regulation represents an attempt to enforce the terms of a cartel against its internal prisoners' dilemma, and (b) as such is a commodity for which there is both a supply and a demand.<sup>5</sup>

Second, the chapter shows how the Japanese government induced firms to comply with its informal regulation. Most specialists assert that Japanese firms comply either because cultural norms dictate compliance or because bureaucrats wield unspecified but unreviewable power. We find that those firms which did comply complied for more tractable and straightforward reasons.

Last, the chapter illustrates the congenital inability of government to improve outcomes by manipulating the market. In designing and implementing financial policy, the Japanese government failed catastrophically. Given that failure, we have little reason to think it could have manipulated markets to facilitate growth in earlier decades either.<sup>6</sup>

As part of a survey volume on Japanese law, this chapter comprises two distinct parts. In the first, we outline the institutional structure of the Japanese legislative process, and summarize the academic debate over it (Section I). In the second part of the chapter, we use the deregulation of the market for non-bank commercial paper as a case study in the dynamics of the regulatory and legislative process (Section II).

## I. The Puzzle of Legislative Process

### A. The Form of the Process:

1. Constitutional structure. -- Formally, the Japanese legislative process is easy enough to describe: to become law, a bill must pass both houses of the democratically elected bicameral parliament (the Diet; Const., Art. 59)<sup>7</sup>. The principal details add some length to the description, but not much: members of the upper house serve for six years, and those of the lower serve four (unless the house is earlier dissolved; Arts. 45-46); if the lower house is dissolved, new elections must be called within 40 days (Art. 54); if the upper house rejects a bill passed by the lower house, it still becomes law if passed again with a two-thirds vote of the lower house (Art. 59).

As befits a parliamentary democracy, the executive answers to the legislature. Thus, the lower house elects the Prime Minister (Art. 67), and can fire him through a no-confidence vote (Art. 69). In practice, the head of the majority party (provided there is one) in the lower house becomes Prime Minister. He then picks the Cabinet (Art. 68), and the Cabinet runs the

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<sup>5</sup> See generally George J. Stigler, *The Theory of Economic Regulation*, 2 *Bell J. Econ. & Mgmt. Sci.* 3 (1970); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 *J. Law & Econ.* 211 (1976). On the political economy of the Japanese financial services industry, see Yoshiro Miwa, *Kin'yu gyosei kaikaku* [Financial Administration Reform] (Tokyo: Nihon keizai shimbun, 1993); Frances McCall Rosenbluth, *Financial Politics in Contemporary Japan* (Ithaca: Cornell University Press, 1989).

<sup>6</sup> A point we explore in more detail in Yoshiro Miwa & J. Mark Ramseyer, *Nihon keizai ron no gokai: (2) yuko na "sangyo seisaku"* [Misunderstandings in the Theory of the Japanese Economy: (2) Effective "Industrial Policy"] (Tokyo: Toyo keizai shimpo sha, forthcoming 2003).

<sup>7</sup> *Nihon koku kempo* [Constitution of Japan], effective 1947.

bureaucracy. The Cabinet passes the orders necessary to enforce statutes (Art. 73), and the orders are enforceable if consistent with the constitution and statutes (Art. 41).<sup>8</sup>

2. Electoral rules. -- For most of the post-war period, voters elected lower house legislators from multi-member districts through a single non-transferable vote. This required the majority party in many districts to split its supporters among several candidates. Primarily, it did this through candidate-specific support groups. For reasons discussed elsewhere, it cultivated these groups by routing incumbents cash which they then used to provide private goods with which to tie voters to specific support groups.<sup>9</sup>

In 1994, the Diet changed the electoral rules radically. Henceforth, voters would elect a majority of lower house legislators from single-member districts. Apparently, the majority party leaders reasoned that they could safely capture most of the single-member districts. By retaining multi-member districts for a substantial minority of legislators, however, they could also ensure that the other parties not coalesce into a single, more threatening opposition.<sup>10</sup>

3. Politics. -- The Liberal Democratic Party (LDP) kept a majority in the lower house from its founding in 1955 until 1993. That year, intra-party brinkmanship tied to quarrels over the electoral reforms caused many LDP members to defect. Two opposition governments followed, but the LDP resumed power in 1996. As of mid-2002, it continues to control the Cabinet.

4. Judicial review. -- Japanese courts review both the constitutionality of legislation and the legality of orders and regulations (Art. 81). They also interpret and apply the constitution, laws, orders, and regulations as necessary. They retain full jurisdiction over private disputes, criminal disputes, and disputes involving the government. They hold the government subject both to injunctions and to damage claims.<sup>11</sup>

The Cabinet appoints the judges. Those on the Supreme Court serve until mandatory retirement at 70. Those on the District and High Courts serve 10-year terms, but virtually all are reappointed.<sup>12</sup>

## B. The Substance of the Process:

1. Introduction. -- If the formal legislative structure is straightforward, its import is not. As with so much in western Japan-oriented scholarship, the scholarly divide turns on the extent to which economic theory explains Japanese phenomena. By standard theory, structure matters crucially: structure determines which players have a role in making policy, what endowments they bring to the process, and what deals they can cut.

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<sup>8</sup> See generally J. Mark Ramseyer & Minoru Nakazato, *Japanese Law: An Economic approach* ch. 8 (Chicago: University of Chicago Press, 1999).

<sup>9</sup> See generally J. Mark Ramseyer & Frances McCall Rosenbluth, *Japan's Political Marketplace* ch. 2 (Cambridge: Harvard University Press, rev. ed., 1997).

<sup>10</sup> See generally "Preface, 1997," in Ramseyer & Rosenbluth, *supra* note.

<sup>11</sup> See Ramseyer & Nakazato, *supra* note, at 147-50.

<sup>12</sup> We leave for other fora questions about how independent judges are in what sorts of cases. See generally J. Mark Ramseyer & Eric B. Rasmusen, *Measuring Judicial Independence: The Political Economy of Judging in Japan* (Chicago: The University of Chicago Press, forthcoming 2003).

By contrast, Japan specialists traditionally claimed that formal structure mattered little: notwithstanding the structure, bureaucrats dominated politicians; notwithstanding the unenforceability of bureaucratic preferences, citizens dutifully did as they were told; notwithstanding the failure of bureaucratic planning elsewhere, Japanese bureaucrats masterminded growth with aplomb. These “facts,” they then claimed, were explicable only in cultural (or at least idiosyncratically Japanese) terms.

More recently, scholars have looked harder both at economic theory and at the “facts” the theory supposedly fails to explain. On doing so, they find that the dominant patterns of government-firm interaction do embody social-scientifically predictable responses to institutional structures. That earlier scholars failed to notice this sometimes reflected their failure to think hard enough about the theory. Other times it reflected their failure to look critically enough at the “facts.”<sup>13</sup>

2. The Japan-specific story. -- a. The dominant bureaucracy. For decades, area-specialists claimed Japanese bureaucrats dictated policy independently of politicians. Kiyooki Tsuji had already made the point a staple within Japan by 1952.<sup>14</sup> T.J. Pempel helped bring the claim to the U.S., and Chalmers Johnson transformed it into the orthodoxy.<sup>15</sup> Indeed, he made it central to his master-claim that Japanese bureaucrats master-minded Japanese economic growth. In potentially the most oft-quoted line by an American scholar on Japanese political structure, he forthrightly declared that:<sup>16</sup>

the elite bureaucracy of Japan makes most major decisions, drafts virtually all legislation, controls the national budget, and is the source of all major policy innovations in the system.

The claim persists. To be sure, observers today routinely report a decline in bureaucratic power. Yet as a benchmark from which to measure decline, they posit a bureaucratically hegemonic past. “The declining role of industrial policy as an engine of growth is much discussed and well-documented,” explained Ronald Dore.<sup>17</sup> What observers document, though, are the current bureaucratic failings -- easy enough to do. They do not document the decline. Instead, they simply posit a past Valhalla of bureaucratic hegemony. Bureaucrats do not currently enjoy much power. According to these accounts, however, they lack it because they lost it -- not because they never had it.

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<sup>13</sup> For an amusing if idiosyncratic take on the debate in political science, see John C. Campbell, *Hedgehogs and Foxes: The Divisive Rational Choice Debate in the Study of Japanese Politics*, 8 *Social Science Japan* 36 (1997). For evidence that similar failings plague the literature on the Japanese economy, see Yoshiro Miwa & J. Mark Ramseyer, *Nihon keizai ron no gokai: (1) “Keiretsu” no jubaku kara no kaiho [Misunderstandings in the Theory of the Japanese Economy: (1) Liberation from the Spell of the “Keiretsu”]* (Tokyo: Toyo keizai shimpo sha, 2001); Yoshiro Miwa & J. Mark Ramseyer, *The Fable of the Keiretsu*, 11 *J. Econ. & Mgmt. Strategy* 169 (2002); Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 *Law & Soc. Inquiry* 401 (2002); Yoshiro Miwa & J. Mark Ramseyer, “Keiretsu no kenkyu” no keiretsu no kenkyu [Research on the Keiretsu in “Research on the Keiretsu”], 67-2 *Keizaigaku ronshu* 36 (2001), 67-3 *Keizaigaku ronshu* 68 (2001).

<sup>14</sup> See Kiyooki Tsuji, *Nihon kanryosei no kenkyu [New Edition: A Study of the Japanese Bureaucratic System]* (Tokyo: Kobundo, 1952).

<sup>15</sup> See T.J. Pempel, *The Bureaucratization of Policymaking in Postwar Japan*, 18 *Am. J. Pol. Sci.* 647 (1974); Chalmers Johnson, *MITI and the Japanese Miracle* (Stanford: Stanford University Press, 1982).

<sup>16</sup> Johnson, *supra* note, at 20-21.

<sup>17</sup> Ronald Dore, *Stock Market Capitalism: Welfare Capitalism* 157 (Oxford: Oxford University Press, 2000); see also, e.g., Curtis J. Milhaupt & Mark D. West, *Law’s Dominion and the Market for Legal Elites in Japan* (unpublished, 2002).

b. The informal bureaucracy. Japanese bureaucrats obtain their control through voluntary compliance. According to the Japan-specific accounts, Japanese bureaucrats rule informally in such a way that regulatory practice remains both unreviewable and unenforceable. Nonetheless, firms and individuals comply voluntarily.

Conventionally, all this went by the phrase “administrative guidance.” Joseph Sanders, for example, wrote that “MITI’s core activity is administrative guidance -- advice or direction by government officials carried out voluntarily by the recipient.”<sup>18</sup> Karel van Wolferen claimed that courts have “almost totally insulat[ed] bureaucratic activity from judicial review.”<sup>19</sup> And Ulrike Schaede asserted that “there is effectively no legal recourse” for firms that would contest the administrative guidance.<sup>20</sup>

Why firms comply, in these Japan-specific circles remains something of a puzzle. Some attribute the compliance to raw, unreviewable power. Schaede, for instance, described what she saw as a “carrot-and-stick” logic. Ministries can approve or deny approvals and licenses “on entirely discretionary grounds,” she explained. For the denied firms, no “administrative or legal appeal [is] available.”<sup>21</sup> Henry Rosovsky wrote that “no Japanese would dare ask” a MITI bureaucrat what legal authority he had for the administrative guidance.<sup>22</sup>

Others turn to Japanese culture. “The more familiar you become with Japanese customs,” wrote James Fallows, “the more you are impressed with the virtue of doing the expected thing.”<sup>23</sup> Culturalist if ever there was one, Wolfgang Pape declared that the “extremely effective” practice of administrative guidance:<sup>24</sup>

has deep roots in the sociocultural foundations of Japanese society. ... The recipient of administrative guidance is conscious of the necessity of understanding and harmony with government agencies that can override interests held in common with peers that possibly contravene it.

Indeed, explained Dore, “an almost universal assumption” in Japan has been the notion that “government should, and in the proper hands could, be a repository of virtuous and benevolent leadership.”<sup>25</sup>

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<sup>18</sup> Joseph Sanders, Courts and Law in Japan, in Herbert Jacob, et al., eds., Courts, Law, and Politics in Comparative Perspective 315, 367 (New Haven: Yale University Press, 1996). See also, e.g., Ulrike Schaede, The “Old Boy” Network and Government-Business Relationships in Japan, 21 J. Japanese Stud. 293, 301 (1995) (“Effectively, there is no legal recourse to regulation in the form of administrative guidance, because compliance is ‘voluntary.’”)

<sup>19</sup> Karel van Wolferen, The Enigma of Japanese Power: People and Politics in a Stateless Nation 215 (New York: Vantage Books, 1989).

<sup>20</sup> Ulrike Schaede, Understanding Corporate Governance in Japan: Do Classical Concepts Apply, 3 Indus. & Corp. Change 285, 289 (1994).

<sup>21</sup> Schaede, supra note, at 290. Cryptically,

<sup>22</sup> Rosovsky, supra note, at 244.

<sup>23</sup> Fallows, supra note, at 218 (ital. in orig.)

<sup>24</sup> Wolfgang Pape, Gyosei shido and the Antimonopoly Act, 15 Law in Japan 12, 12, 13, 14-15 (1982).

<sup>25</sup> Dore, supra note, at 156.

c. The guiding bureaucracy. Having posited informal yet omnipotent bureaucrats, the Japan myth proceeds to a virtuous climax: through this informal power, bureaucrats masterminded, indeed created, Japan's "miraculous growth" and triumphant transformation. Sector by successful sector, their role was to Fallows "familiar and obvious."<sup>26</sup> By economic logic they should never have succeeded, or even tried. Yet to Fallows as to so many in Japanese studies, Japan is the case that proves universalistic economic theory wrong. To Fallows the journalist, Japan operates by a "noncapitalistic market economy."<sup>27</sup> To Johnson the political scientist, the U.S. economy operates by a "market rational" logic while Japan runs by a radically contrasting "plan-rational" one. To Dore the sociologist, the U.S. is a "Goldilocks economy," while Japan keeps a "sense of belonging to a national community which sustains cooperation within industries, and makes possible inclusive, and redistributive, educational and social welfare systems."<sup>28</sup>

Romeo comes in many guises, of course, and Stalinism by any other name would smell as sweet. Traditional economists did not just repeat this legend; some helped create it. Back in 1972, Henry Rosovsky declared Japan to "be the only capitalist country in the world in which the Government decides how many firms should be in a given industry, and sets about to arrange the desired number."<sup>29</sup> Twenty years later, Paul Krugman could claim that there was "no question" that "before the early 1970s the Japanese system was heavily directed from the top, with the MITI and the Ministry of Finance influencing the allocation of credit and foreign exchange."<sup>30</sup>

Japanese economists have been no less enamored of the government-grew-the-economy hypothesis. According to University of Tokyo economists Tetsuji Okazaki and Masahiro Okuno-Fujiwara, through its "industrial policy" the Japanese government uses "administrative guidance and other discretionary measures to achieve 'development' and establish 'order' in the industry." In the process, it covers three steps:<sup>31</sup>

First comes the "discovery" of an industry for development, using forecasts of future trends in technology or demand. ... At the second stage, industries selected for development and sectors earmarked for growth have to be nurtured and given support. ... The third stage requires co-ordination of the allocation of funds and other resources between industries through inductive means. The allocation of the necessary facilities, and the selection and co-ordination of firms is carried out through discretionary administrative guidance against a backdrop of regulatory and financial measures.

The result of this is that all firms in the sector have access to the same information on new business opportunities, and have a strong incentive to get ahead of others and quickly establish a foothold in the new business. This leads to excess competition,

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<sup>26</sup> James Fallows, *Looking at the Sun: The Rise of the New East Asian Economic and Political System* 58 (New York: Pantheon, 1994).

<sup>27</sup> Fallows, *supra* note, at 207 (approvingly quoting Eisuke Sakakibara).

<sup>28</sup> Dore, *supra* note, at 17, 219-20.

<sup>29</sup> Henry Rosovsky, *What Are the Lessons of Japanese Economic History?*, in A.J. Youngson, ed., *Economic Development in the Long-Run* 229, 244 (London: Allen & Unwin, 1972).

<sup>30</sup> Paul Krugman, *The Age of Diminishing Expectations: U.S. Economic Policy in the 1990s* 142 (Cambridge: MIT Press).

<sup>31</sup> Tetsuji Okazaki & Masahiro Okuno-Fujiwara, *Japan's Present-Day Economic System and Its Historical Origins*, in Tetsuji Okazaki & Masahiro Okuno-Fujiwara, eds., *The Japanese Economic System and Its Historical Origins* 1, 11-12 (Oxford: Oxford University Press, Susan Herbert, trans., 1999).



circumstances where investment and facilities are expanded beyond the individual firm's means, and to business plans that target market share rather than profits.

To prevent the resulting "systemic risk," the government in Okazaki and Okuno-Fujiwara's account then coordinates cartels and subsidies.

3. The alternative story. -- a. The dominant bureaucracy. By economic theory, none of this should be true. Given the Japanese institutional framework, politicians should control bureaucrats. If administrative guidance is truly unenforceable, recalcitrant firms should not comply. And given the incentives and informational problems they face, bureaucrats should not improve on market outcomes. Consider each in turn.

Most basically, institutions should matter. As explained earlier, they will matter because they determine who the players in the game will be, what relative endowments they will bring, and what enforceable bargains they will make. Suppose, for example, that bureaucrats hold information not available to politicians, set the agenda by which legislators can act, and face no risk of retaliation from politicians. Suppose further that they choose to pursue goals they know majority politicians do not support. In some cases, politicians will lack the information necessary to stop them. Even where politicians know of their ploy, they will not be able to place reform on the agenda. When bureaucrats flout their political preferences, they will have no way to punish the miscreant bureaucrats.<sup>32</sup>

Suppose, however, that those conditions do not hold. The possibility is crucial, because in Japan they emphatically do not hold. In Japan, most bureaucratic action involves little technical expertise, and when it does the politicians can independently acquire (by hiring staff) the necessary information with ease. In Japan, politicians control the legislative agenda, and can readily repeal regulations by statute. And in Japan, politicians can easily derail bureaucratic careers.

Under such circumstances, in equilibrium we still would rarely see political intervention. We would rarely see it because, as several prominent political scientists explained, "the process of policy administration by autonomous agencies is observationally equivalent to that under strict [legislative] control."<sup>33</sup> The observational equivalence reflects the fact that in neither the bureaucratic-dominant nor in the politician-dominant world will legislators intervene. To be sure, if bureaucrats are independent, they will do as they please, and legislators will leave them alone. Yet if legislators strictly control bureaucrats they will still leave the bureaucrats alone. They will leave them alone because: (a) bureaucrats will know that legislators could potentially intervene, both to change policy and to ruin their careers; (b) bureaucrats will know that legislators will indeed intervene if they do flout legislative preferences; and (c) rational bureaucrats will avoid that outcome by giving legislators what they want from the start.

Indeed, in equilibrium bureaucrats will want what legislators want anyway. Reasoning that administering policies they do not like is no fun, potential bureaucrats who do not share the political preferences of the legislative majority will self-select out of bureaucratic careers. In the end, those who choose to become bureaucrats will disproportionately include those who want what majority legislators want.

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<sup>32</sup> See Mathew D. McCubbins & Gregory W. Noble, *The Appearance of Power: Legislators, Bureaucrats, and the Budget Process in the United States and Japan*, in Peter F. Cowhey & Mathew D. McCubbins, eds., *Structure and Policy in Japan and the United States* 56 (Cambridge: Cambridge University Press, 1995);

<sup>33</sup> Randall L. Calvert, Mark J. Moran & Barry R. Weingast, *Congressional Influence over Policy Making: The Case of the FTC*, in Mathew D. McCubbins & Terry Sullivan, eds., *Congress: Structure and Policy* 493, 501 (Cambridge: Cambridge University Press, 1987) (orig. in ital.).

b. The informal bureaucracy. -- By standard theory, rational bureaucrats will also act informally whenever possible. They will do so because informality is cheaper than formality. An agency that must formalize its action both incurs costs itself and imposes costs on the regulated firms -- costs that both could otherwise avoid. In splitting the gains that accrue to informality, they potentially both gain.

Perhaps the analogy to litigation would help. Whether in Japan or anywhere else, disputants do not litigate most quarrels. Instead, they settle them out of court. In doing so, however, they do not render the law irrelevant. Instead, they settle by reference to the expected litigated outcome. Given that they would both incur substantial litigation fees if they took the dispute to court, both parties gain by negotiating an out-of-court settlement that reflects the expected litigated outcome.<sup>34</sup>

Crucially, however, even when bureaucrats act informally, they will obtain compliance only if they can credibly threaten to formalize their instructions. In litigation, defendants will pay plaintiffs large sums out-of-court only when plaintiffs can credibly threaten to sue. In regulation, reluctant firms will comply with informal instructions only when they know bureaucrats could formalize those instructions and force them to comply if they did anything else. Absent an agency's power to formalize its instructions, firms that object to the instructions will not comply.

c. The guiding bureaucracy. -- More than to anyone else, the modern theory of policy-making owes its genesis to George J. Stigler. According to Stigler, "as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit."<sup>35</sup> Disproportionately, regulation will occur when firms demand it strongly, and they will demand it when they need the government to keep prices high.

As prisoners' dilemmas, cartels are necessarily unstable. Consequently, as Fred S. McChesney put it, "as a long-run source of rents" they "are notoriously unreliable." Potentially, regulation solves this problem. "With its ability to legalize price fixing, to police cartelizing agreements with taxpayer funds, and especially to restrict entry into markets," continued McChesney, "regulation can often perform rent-creating functions more efficaciously than private parties themselves can."<sup>36</sup>

Even when regulation does not transfer wealth to all firms in the industry, it will usually transfer wealth to some. Most commonly, it will prevent a competitive fringe in an industry from competing away the profits of all. Again, in McChesney's words:<sup>37</sup>

[A]n entire industry of producers does not seek regulation to benefit itself at the expense of purchasers. Instead, some relatively homogeneous subgroup of producers lobbies for and obtains regulation that benefits itself at the expense of another subgroup of producers.

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<sup>34</sup> The classic references are William M. Landes, *An Economic Analysis of the Courts*, 14 *J. Law & Econ.* 61 (1971); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 *J. Legal Stud.* 399 (1973).

<sup>35</sup> See generally George J. Stigler, *The Theory of Economic Regulation*, 2 *Bell J. Econ. & Mgmt. Sci.* 3, 3 (1971); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 *J. Law & Econ.* 211 (1976); George J. Stigler, *A Theory of Oligopoly*, in *The Organization of Industry* ch. 5 (Chicago: University of Chicago Press, 1968).

<sup>36</sup> Fred S. McChesney, *Money for Nothing: Politicians, Rent Extraction, and Political Extortion* 11 (Cambridge: Harvard University Press, 1997).

<sup>37</sup> McChesney, *supra* note, at 14.

What politicians and bureaucrats will not do, by this theory, is promote growth by manipulating the market. They will not do so, both because they gain little from doing so, and because they would not know how. They lack the incentives because growth is a “public good.” Benefiting the public at large, few firms or voters have reason to lobby or campaign actively for it. By contrast, cartels are a “private good.” Because they benefit small groups intensely, those groups will often have reason to demand them vociferously. As a result, firms and voters that use their votes and cash to bid for private goods (like cartel-enforcement) will generally outbid those that bid for public goods (like growth).

Politicians and bureaucrats lack the information to promote growth by manipulating the market because market outcomes already embody the collective judgment of the investing community. Investors have a simple reason to buy into firms they think present the best growth potential: if right, they get rich. Given that incentive, they devote enormous resources to acquiring the information they need to identify the right projects. Bureaucrats and politicians could promote growth by manipulating the market only with better information still -- better information than the investing community about the relative prospects of various products, services, and technologies. Absent a reason to think sinecured generalists on the government payroll can routinely outguess investors with millions of their own at stake, theory gives us no reason to think either politicians or bureaucrats will out-guess the market.

d. The Japan-specific claims. -- And in truth, most of the Japan-specific “facts” at issue are dead wrong. Bureaucrats do not, for example, work independently of their political masters. Instead, they generally pursue (and since 1955 have consistently pursued) goals that further the electoral interests of the ruling LDP. Controversial to be sure, some evidence shows that political considerations do indeed shape the careers of senior government employees, and other evidence suggests policy outcomes reflect even the factional composition of the LDP itself.<sup>38</sup>

Similarly, administrative guidance has always been reviewable. Suppose a regulator “interprets” a statute in a way that bans firm A from taking a given action. If A wants to contest the interpretation, it need simply ignore it. By so doing, it forces the regulator to formalize its interpretation and sue. When it does, the court will face a justiciable controversy. From time to time Japanese firms have indeed done just that. From time to time -- particularly when facing actions taken by opposition-dominated local governments -- courts have indeed declared administrative guidance invalid.<sup>39</sup>

Neither does the administrative guidance necessarily induce firms to comply. Even when government power and ideological pressure was the strongest -- at the height of the Second World War -- the Japanese government could not obtain the compliance it wanted.<sup>40</sup> The post-war MoF has done little better. Already in the 1950s, the MoF had adopted a policy of requiring city banks to divest their trust businesses. The Daiwa Bank refused. After a decade’s worth of Daiwa intransigence, in 1965 MoF publicly told the bank to divest. Desperate to induce compliance, it even offered the bank regulatory favors if it did. The bank still refused -- with banking industry

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<sup>38</sup> See generally Ramseyer & Rosenbluth, *supra* note, at chs. 6-7; Ramseyer & Rasmusen, *supra* note; McCubbins & Noble, *supra* note; Mathew D. McCubbins & Michael F. Thies, *As a Matter of Factions: The Budgetary Implications of Shifting Factional Control in Japan’s LDP*, 22 *Legislative Studies Quarterly* 293 (1997).

<sup>39</sup> See J. Mark Ramseyer, *Rethinking Administrative Guidance*, in Masahiko Aoki & Gary R. Saxonhouse, eds., *Finance, Governance, and Competitiveness in Japan 199* (Oxford: Oxford University Press, 2000).

<sup>40</sup> See Yoshiro Miwa, *Seifu no noryoku* [The Competence of the State] (Tokyo: Yuhikaku, 1998).

representatives publicly noting to the press MoF's lack of a statutory basis for its instructions -- and has kept its trust business to this day.<sup>41</sup>

MoF was not powerless. Rather, it had the power the legislators and courts chose to allocate it. This power stemmed precisely from the fact that its regulatory action was reviewable. Precisely because it could formalize its informal policy, when a court would enforce its formalized regulation firms would comply with the informal analogues independently. Concomitantly, however, when a court would not enforce MoF's formalized version, neither would firms necessarily comply informally. Instead, as the Daiwa Bank showed, they could choose to stay intransigent to the end.

Japanese bureaucratic action has never been about promoting economic growth anyway, much less about "plan-rational" guidance. Again as Stigler explained, usually it has reflected the economic self-interest of the firms at stake. Usually, it has involved simply the use of state power to enforce cartels.<sup>42</sup>

## II. The Commercial Paper Dispute

### A. Introduction:

To explore the Japanese legislative and regulatory process in more detail, turn to a case study: the opening of the commercial paper market to non-bank financial intermediaries. We first summarize the history of the liberalization (Section B.), then note the limitations to the case study (Sec. C.) and clarify the legal basis on which the government claimed to rely (Sec. D.). We conclude by explaining the political economy of the deregulation: the bargain involved in the opening of the market, and why the opening happened when it did (Sec. E.).

### B. The Story in Brief:

1. Commercial paper. -- Established U.S. firms often raise a large portion of their funds through commercial paper. The paper, as several prominent scholars described it:<sup>43</sup>

is a short-term, unsecured obligation of the corporation, issued for a fixed amount and bearing a fixed rate of interest. Commercial paper occupies a middle ground between stocks and bonds, on the one hand, and commercial loans on the other; it is sold in a market like stocks and bonds, rather than being individually negotiated like commercial loans, but the sales generally occur by private placement, rather than through public offerings.

In a world (like post-war Japan and the U.S.) of bifurcated commercial and investing lending, this put commercial paper in a legislative free-fire zone. Because it was short-term, it was

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<sup>41</sup> Yoshiro Miwa, "Kin'yu seido kaikaku" to shintaku ginko ["Financial System Reform" and the Trust Banks], in Keimei Kaizuka and Kazuo Ueda, eds., *Henkaku ki no kin'yu shisutemu* [The Financial System in a Time of Change] 173 (Tokyo: Tokyo University Press, 1994); Okura sho wa ikisugi [MoF Going Too Far], *Nihon keizai shimbun*, Feb. 23, 1965.

<sup>42</sup> For other evidence that the Japanese government did not mastermind growth, see Yoshiro Miwa, *Firms and Industrial Organization in Japan Part III* (Houndmills: Macmillan, 1996); Yoshiro Miwa, *supra* note (Competence); Miwa & Ramseyer, *supra* note (book 2); Yoshiro Miwa & J. Mark Ramseyer, *Directed Credit? The Loan Market in High-Growth Japan*, \_\_ *J. Econ. & Mgmt Strategy* \_\_ (forthcoming 2003); Yoshiro Miwa & J. Mark Ramseyer, *Seisaku kin'yu to keizai hatten: Senzenki Nihon kogyo ginko no keesu* [Policy Finance and Economic Growth: The Case of the Pre-War Industrial Bank of Japan], 66-3 *Keizaigaku ronshu* 2 (2000).

<sup>43</sup> David G. Litt, Jonathan R. Macey, Geoffrey P. Miller & Edward L. Rubin, *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 *U. Pa. L. Rev.* 369, 375 (1990) (hereinafter LMMR).

relatively safe and could cost-effectively substitute for direct bank loans. Because it was readily tradable, it could also substitute for stocks and bonds. Effectively, it thus threatened both commercial banks and securities firms. What it effectively threatened, of course, it also potentially promised. Precisely because it substituted for loans and securities, it potentially offered entrepreneurial banks and brokers a means to steal clients.

2. The bureaucratic role. -- In Japan, MoF regulates both banks and securities firms. Whether it would regulate commercial paper, however, was unclear. If the paper were a security, the Japanese analogue to Glass-Steagall would have placed it out-of-bounds to the banks and in-bounds for the securities firms.<sup>44</sup> Yet it was not clearly a security; MoF had no formal regulatory jurisdiction over non-bank, non-securities-firm intermediaries; and in the abstract MoF had no power to decide what commercial paper was anyway. Yet who could issue and trade in the paper depended crucially on what the paper was.

Tax law only complicated matters. Under the post-war tax regime, traders in securities paid a transactions tax. The rate depended on the transferor and the type of security. Yet as of the early 1980s, a private investor who sold a bond paid a tax of .045 percent of the aggregate sales price (not net profits, and payable with every turnover).<sup>45</sup> By contrast, makers of promissory notes (but not later transferors) paid a less burdensome stamp tax.<sup>46</sup> For a market realistically to develop, qualifying as a promissory note for tax purposes was crucial.

Importantly, MoF not only regulated banks and brokers, it also helped enforce the tax code. Not only did it make preliminary decisions (subject to judicial review, of course) about what businesses banks and securities firms could undertake legally.<sup>47</sup> It also had administrative responsibility over the taxes they and other firms owed.<sup>48</sup>

3. The deregulation. -- By the mid-1980s, MoF decided to create the market (table for the moment its authority and incentives to do so) for commercial paper. In the process, however, it decided to ban direct paper (commercial paper sold directly to investors), but to allow dealer paper

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<sup>44</sup> Shoken torihiki ho [Securities Exchange Act], Law No. 25 of 1948, Sec. 65 (as in effect; hereinafter SEA). The U.S. Supreme Court found commercial paper to be a security in *Securities Indus. Assn v. Board of Governors*, 468 U.S. 137 (1984).

As if to confuse matters, foreign commercial paper (the market for which was liberalized earlier than for domestic commercial paper) was treated as a security for purposes of the Foreign Exchange & Foreign Trade Control Act, but not for purposes of the Securities Exchange Act. See Takeo Kosugi & Steven M. Dickinson, *The Creation of a Domestic Commercial Paper Market in Japan*, 27 *Colum. J. Transnational L.* 91, 100-05 (1988). According to a joint statement by two staff members of MoF's banking and securities bureaus, it would have been "inappropriate" to treat commercial paper the same as securities, given its short-term character and the fact that it is placed with professional investors. Moreover, they claimed, this was consistent with the practice in other countries. See Motoyasu Yoshikawa & Hiroshi Harada, *Kokunai CP shijo sosetsu no kei to sono gaiyo* [A Summary and the Particulars of the Establishment of a Domestic Commercial Paper Market], 1172 *Kin'yu homu jijo* 7, 10 n.4 (1987).

<sup>45</sup> Yuka shoken torihiki ze ho [Securities Transaction Tax Act], Law No. 102 of 1953, Secs. 2, 10.

<sup>46</sup> A note of 1 million yen, for example, incurred a tax of 200 yen (.02 percent); a note of 10 million incurred a 2,000 yen tax; and a note of 100 million yen incurred a 20,000 yen tax. See *Inshi ze ho* [Stamp Tax Act], Law No. 23 of 1967, Tab. 1(c). The stamp tax applied to bonds as well.

<sup>47</sup> SEA, *supra* note, at Sec. 28 (requiring MoF permit to carry on securities business); *Ginko ho* [Banking Act], Law No. 59 of 1981, Sec. 4 (same for banking business; current as of 1994).

<sup>48</sup> Hiroshi Kaneko, *Sozei ho* [Tax Law] 102 (Tokyo: Kobundo, 5th ed., 1995).

(paper underwritten by a bank or securities firm).<sup>49</sup> It would tax qualifying paper as a promissory note subject to a stamp tax of only 5,000 yen, but stop non-bank financial institutions from using the paper to raise funds.<sup>50</sup> Subject to a variety of constraints, it created this commercial paper market in November 1987.

The market flourished. From its start in November 1987, the commercial paper market grew rapidly: 13.07 trillion yen's worth outstanding in 1989, to 15.76 trillion by 1990 when MoF lowered the stamp tax on the paper further.<sup>51</sup> That year it also opened the market to issues by securities firms. Central to this case study, in 1993 it opened the market to issues by non-bank intermediaries.<sup>52</sup>

To justify its role in controlling access to the new market by the non-bank intermediaries, MoF had first to argue that the intermediaries could not have issued the paper on their own. For MoF, this claim involved two steps. First, it treated the firms as members of the lending industry for purposes of Section 2(c) of the Capital Funding Act (see Section II.D., below). Second, it called commercial paper a bond. Because the Act banned lending companies from using bond proceeds in their loans, it could then argue that the firms could not have issued the paper without its approval. Relatedly, it could also justify letting them issue paper on the pretext that they not route the proceeds to their loans.

As the leasing firms expanded the market, they continued to push for further deregulation. With due deliberation to be sure, the government responded positively. It relaxed the limits on the amounts of funds the firms could raise. It allowed dealer paper. And by the end of 1998, it repealed Section 2(c) outright.<sup>53</sup> Thereafter, licensed (but only licensed) non-bank intermediaries could use commercial paper proceeds for their loans. Including major leasing firms like ORIX, by early 2002 over sixty such firms had received a license.<sup>54</sup>

### C. The Scope of the Project:

1. The literature. -- On the deregulation of the Japanese commercial paper market, the fullest study in English remains the 1990 essay by David G. Litt, Jonathan R. Macey, Geoffrey P.

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<sup>49</sup> Yoshikawa & Harada, *supra* note, at 8; Shuichi Sonoda?, *Shoken gaisha ni yoru kokunai CP no toriatsukai ni tsuite* [Regarding the Handling of Domestic Commercial Paper by Securities Firms], 1172 *Kin'yu homu jijo* 11, 12 (1987). By the early 1990s, the rule was embodied in *Komaasharu peepaa to no toriatsukai ni tsuite* [Regarding the Handling of Commercial Paper, Etc.], MoF Banking Bureau Communication 610 of 1993, Sec. I.1.(5) (as in effect; hereinafter *Circ. 610*).

After the repeal of *Circ. 610* and Capital Funding Act Sec. 2(c), along with the amendment of the relevant tax provisions, the dealer-paper requirement effectively disappeared. By March 2000, the ORIX group (including ORIX Securities) was issuing a majority of its commercial paper (over 1 trillion yen total) as direct paper. Private correspondence with the firm.

<sup>50</sup> *Sozei tokubetsu sochi ho* [Special Tax Measures Act], Law No. 26 of 1957, Sec. 91-2(a) (STMA; as in effect at the time). By the terms of the section, the lower tax rate did not apply to direct paper.

<sup>51</sup> Gordon de Brouwer, *Deregulation and the Structure of the Money Market*, in Paul Sheard, ed., *Japanese Firms, Finance and Markets 274* (Melbourne: Addison-Wesley, 1996); LMMR, *supra* note, at 427 n.196.

<sup>52</sup> On the commercial paper issues by securities firms, see *Shoken kyoku nempo* [Securities Bureau Annual] 59 (1990); Miwa, *supra* note (1992), at 323.

<sup>53</sup> *Kin'yu gyo sha no kashitsuke gyomu no tameno shasai hakko to ni kansuru horitsu* [Law Regarding the Issuance of Bonds, Etc. by Members of the Financial Industry for the Lending Business], Law No. xx of 1998. It also repealed the dealer paper requirement for the lower tax rate. See STMA, Sec. 91-2.

<sup>54</sup> CFA, Sec. 3, as revised. Data obtained through inquiry by the authors.

Miller and Edward R. Rubin (LMMR).<sup>55</sup> Focusing on the conflict between the banks and securities firms, LMMR called the process a “political battle” between “powerful and well-organized special interest groups.”<sup>56</sup> The dynamics through which the government let banks enter the commercial paper market in the U.S. and Japan were “remarkably similar,” they wrote. In both countries the banks fought it to protect their “core banking business of extending short term credit to large business firms.”

Despite that similarity, LMMR claimed that the participants in the “political battle” adopted different strategies in the two countries. In Japan, they explained, the participants showed a predisposition toward “preclearance,” a tendency to negotiate potential regulatory conflict in advance.<sup>57</sup> In the U.S., they did nothing of the sort. “Open conflict is anathema” to the Japanese, they reasoned. In Japan “public displays of disaffection are assiduously avoided.”<sup>58</sup>

As carefully as they analyzed the process, LMMR unwittingly raised several issues. First, do we need these cultural characterizations to explain the dynamics in Japan? That the liberalization of commercial paper pitted banks against securities firms we do not contest. That it reflected a peculiarly Japanese antipathy to open conflict we do.

Second -- and relatedly -- by positing a cultural proclivity not to cross MoF, LMMR glossed over the financial dynamics of doing so. Why did the banks and securities firms not create the market on their own? MoF bureaucrats may not have wanted them to create the market, but no statute clearly banned one. Why did they care what the bureaucrats wanted? LMMR would apparently have us believe that the banks and securities forsook substantial profits from a commercial paper market simply to avoid a public clash. Yet what financial incentives did the parties actually face?<sup>59</sup>

Third -- and centrally for this paper -- what of the non-bank financial intermediaries?<sup>60</sup> Banks and securities firms were not the only firms interested in the commercial paper market. In the U.S. neither dominates the market. Instead, the non-bank financial intermediaries do.<sup>61</sup> Why

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<sup>55</sup> LMMR, *supra* note. For a detailed chronology of the liberalization from a more bureaucracy-centric perspective, see Ulrike Schaede, *The Introduction of Commercial Paper -- A Case Study in the Liberalization of the Japanese Financial Markets*, 2 *Japan Forum* 5 (1990).

<sup>56</sup> LMMR, *supra* note, at 371.

<sup>57</sup> Tracking the distinction between “ex ante monitoring” and “ex post monitoring” in Hideki Kanda, *Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan*, 12 *U. Pa. Int'l Bus. L.* 569 (1991).

<sup>58</sup> LMMR, *supra* note, at 435, 440.

<sup>59</sup> If pushed, perhaps LMMR would have argued that MoF would have surreptitiously punished a bank or securities firm that ignored its preferences. The argument is common enough among observers who claim Japanese bureaucratic omnipotence. Schaede, *supra* note, at 301, for example, claims that “[c]orporations know that by following ‘advice’ they may reap rewards later. On the other hand, if the ministries find a noncompliance with administrative guidance, they have numerous options to obstruct future business of the party concerned.” The myth that Japanese bureaucrats can free-handedly punish non-compliant firms is fostered by references to Frank K. Upham, *The Man Who Would Import: A Cautionary Tale about Bucking the System in Japan*, 17 *J. Japanese Studies* 323 (1991). Unfortunately, the references are severely misleading -- the account in that article concerned petroleum-refining, where MITI’s involvement had a statutory basis.

<sup>60</sup> Although not directly concerned with the commercial paper market, a similarly misleading focus on the banking and securities firms to the exclusion of non-bank financial intermediaries occurs in Curtis J. Milhaupt & Geoffrey P. Miller, *Cooperation, Conflict, and Convergence in Japanese Finance: Evidence from the “Jusen” Problem*, 29 *L. & Pol’y in Int'l Bus.* 1 (1997).

<sup>61</sup> On the use of commercial paper by non-banks in the U.S., see LMMR, *supra* note, at 425.

did the Japanese non-banks not create the commercial paper market on their own? Would LMMR have us attribute this to a Japanese proclivity for “preclearance” too? LMMR wrote that a “number of the people we interviewed stated that it would simply be inconceivable for a bank to begin issuing commercial paper without regulatory approval.”<sup>62</sup> Yet if ever there were a non-answer that is surely one.

In claiming that financial institutions could not flout MoF preferences, LMMR were not alone. From time to time, scholars “explaining” Japanese bureaucratic power posit a peculiarly Japanese “customary ‘rule’”: in University of Tokyo law professor Hideki Kanda’s words, “the non-existence of an ‘explicit’ legal rule endorsing a certain activity under explicit regulatory conditions is understood to mean that such activity is prohibited.”<sup>63</sup> His senior colleague Akio Takeuchi did not call it a rule, but apparently did see it as a custom: the executives involved were simply -- customarily -- spineless. Commercial paper was legal, MoF preferences or no. If the executives wanted to sell the paper, declared Takeuchi, they should simply do it.<sup>64</sup>

The Kanda-Takeuchi comments raise an obvious question, of course. Absent legal enforceability, why would firms follow such a “customary rule”; given their aggression in the market itself, why would they defer so placidly to bureaucrats. The comments raise more basic questions besides. Do the firms follow such a custom in fact? Do they spinelessly defer in fact?

2. A caveat. -- Our case study lets us explore these issues in the context of financial regulation. When, for example, do firms defer to the government, and why? When does the government regulate informally, and why? And why does regulation take the shape that it does? Yet we note one obvious limitation. Most prominently, our case study does not address the relative power of politicians and bureaucrats. We do not address it, because it does not arise. It does not arise, because on the issues at stake the politicians and bureaucrats held largely congruent preferences.

#### D. The Capital Funding Act:

1. The puzzle. -- To begin to ask why the non-bank intermediaries acquiesced to MoF’s preferences for so long, consider the explanation given by one of intermediaries itself. Part of the puzzle is why banks and securities firms acquiesced, but another concerns these non-banks. At least the banks and securities firms were under the general regulatory jurisdiction of the MoF. The non-banks were not, yet refrained from starting a commercial paper market before 1993 anyway. Even after 1993, they refused to expand their role beyond that authorized by MoF. Why were they so docile?

By the 1990s, the Deregulation Subcommittee of the Administrative Reform Committee began to explore the prospect of deregulating the field. By statute, the committee reported to the Prime Minister, and he in turn was required to weigh its conclusions heavily. As part of the work of producing that report, in November 1995 one of us (Miwa) asked a representative from the ORIX leasing firm (Hironao Fukushima) why they were so docile.<sup>65</sup> The colloquy -- which

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<sup>62</sup> LMMR, *supra* note, at 447.

<sup>63</sup> Kanda, *supra* note, at 582.

<sup>64</sup> Takeuchi, *supra* note, at 11.

<sup>65</sup> The committee had begun deliberations in December of 1994, and met for three years. The committee was established by the Gyosei kaikaku iinkai setchi ho [Act to Establish the Administrative Reform Committee] Law No. 96 of 1994; see Secs. 1-3.



occurred at a public hearing with a MoF representative present -- concerned the rules by which MoF had decided to let non-bank intermediaries like ORIX issue commercial paper:

Miwa: Currently, leasing companies too can issue commercial paper, right?

Fukushima: Restrictions aside, we've been able to issue commercial paper since June 1993. There are lots of those restrictions, though: limits on what we can do with the funds, reporting requirements, rules about putting part of the funds in capital surplus, rules about organizing and retaining documents, demands that we keep special accounts, limits on how much we can raise through commercial paper, and so on. What we're asking today is that these restrictions be reconsidered and abolished.

Miwa: Do you issue a substantial amount?

Fukushima: In July 1993, right after the ban on domestic commercial paper was repealed, we at ORIX issued 350 billion yen. By October of 1995 we were issuing 500 billion yen, and by August 1996 1 trillion. That's a substantial amount. Still, relative to the total funds we raise, it's trivial. In March 1996, the 21 major leasing companies had total debt of 19.26 trillion yen. Of that amount, though, they raised no more than 3 percent through marketable bonds, commercial paper, and notes (what we call "direct finance").

Miwa: The rules about what you can do with the funds you raise, and about allocating amounts to capital surplus are ineffective? A waste?

Fukushima: Neither rule has any substantive effect. This is just regulation for the sake of regulation. Money can't be traced. So what if you demand reports to ensure that the firms don't use the funds for loan capital? So what if you make them maintain special bank accounts for the funds? So what if you limit the use they can make of the funds? Substantively, none of that makes a bit of difference.

Miwa: It sounds like you've got quite a few complaints: that leasing companies face restrictions on what they can do with the funds they raise through commercial paper, that the reasons for the restrictions are inappropriate, that the basis for them is unclear and inappropriate.

If you're so unhappy with this, why don't you just violate it? All you're complaining about is an interpretation of Section 2(c) of the Capital Funding Act [discussed below], after all. And that interpretation is just an "administrative communication" from a MoF section chief. Right? It's not even a circular.

I don't know if these administrative communications are called "administrative guidance," but why should a communication like that bind a leasing company on such an important issue? Suppose ORIX, as a representative firm, ignored it. What would happen? It's not as if MoF could sue for "violations of an administrative communication." Are there sanctions? Why is commercial paper a "bond" within Section 2(c)? Why is ORIX a "corporation having as its principal business the lending of money" within Section 2(c)?

If commercial paper isn't a bond, then none of this matters, right? And if ORIX isn't a "corporation having as its principal business the lending of money," then Section 2(a) doesn't apply, right? You have a section chief's "administrative communication" about MoF's "interpretation," and you're complying with it? Quietly? Without even trying to contest it?

Fukushima: Well, we could ignore it. But commercial paper is dealer paper. If we ignored it, banks and securities firms wouldn't handle our paper. And if they didn't handle it, that'd be their own choice. Suppose we sued 'em. It'd be a private civil dispute, we'd

probably lose, and even if we did win the decision wouldn't govern the meaning of Section 2(c). Even if MoF's preferences were behind it all, we'd never be able to prove it.

Miwa: Why don't you place the commercial paper directly? Does it have to be dealer paper?

Fukushima: ...

Miwa: What if you tried?

Fukushima: It's hard to say. But if it got harder to issue dealer paper, the costs would be huge. If the securities firms and banks will line up behind MoF, we can't experiment very easily. We don't want to jeopardize large dealer-paper issues with a small direct-placement issue.

Miwa: Then there's the stamp-tax question. Commercial paper is treated as a promissory note, right? What're the implications of all this?

Fukushima: Under an amendment to the Special Tax Measures Act, commercial paper is subject to a flat 5,000 yen per note stamp tax, provided it meets certain conditions. If it doesn't meet them, it incurs a tax that varies by the amount of funds raised -- and the offering's not going to be attractive. MoF's tax office administers the Special Tax Measures Act. So if the commercial paper isn't dealer paper, it's not going to qualify for this tax preference.

Miwa: So you comply because of the stamp tax, and because banks and securities firms do what MoF wants?

Fukushima: That's right.

If ever Japanese bureaucratic power were over-determined, it was over-determined here. MoF regulates banks and securities companies. Through the National Tax Office it collects taxes. And whatever the limits to MoF's regulatory discretion and interpretive authority (crucially, neither is boundless), banks and securities firms had a collective self-interest in keeping commercial paper inaccessible to the non-bank financial intermediaries anyway. As a result, MoF did not need the power to force an entire industry to comply against interest. It needed only to prevent renegade banks and securities firms from cheating on the industry cartel. That much power it apparently had.

2. The statute. -- As the colloquy suggests, the only statute on which MoF based its claim that it could ban non-bank financial intermediaries from issuing commercial paper was the 1954 Capital Funding Act. Had the Act's drafters designed it to transfer monopoly rents to banks, they could not have done so more baldly. The Act banned firms not licensed as banks from taking deposits as a business (Section 2(a)). Crucially for non-banks that hoped to issue commercial paper, Section 2(c) provided:

A corporation having as its principal business the lending of money . . . which borrows money from a large, unspecified number of people through the issuance of bonds will be treated as a firm taking deposits as a business.

Section 8 then imposed fines and prison time on those who violated Sections 2.

3. Its genesis. -- (a) The early consumer credit industry. If the design of the Capital Funding Act suggests legislators hoped to transfer rents to banks, its drafters justified it as an anti-fraud statute.<sup>66</sup> In the chaotic early post-war years, entrepreneurs concocted a bewildering array of

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<sup>66</sup> See generally Minoru Tsuda, *Shusshi no ukeire, azukarikin oyobi kinri to no torishimari to ni kansuru horitsu* [An Act Regarding the Regulation of the Receipt of Investment Capital, Deposits, and Interest Rates], 7 *Hoso*

ways to induce savers to entrust their money with them. By some estimates, they formed tens of thousands of firms to collect and lend such savings. Many of these firms were straightforward savings associations. Others are hard to decipher a half century after the fact, but probably functioned more like pyramid schemes.

As eventually enacted, the Capital Funding Act targeted one of the less-than-respectable finance forms: the joint-stock mutual finance firm. Critics accused the operators of these firms of collecting savings by promising investors distributions larger than what the firms could plausibly pay. They proposed either to police the marketing claims or to ban the firms outright.

Some critics hoped initially to control the joint-stock mutuals through the Securities Exchange Act. When that proposal proved problematic, they turned to the Capital Funding Act. The drafters of the Capital Funding Act had not originally envisioned it as a way to regulate joint-stock mutuals, and had seen no reason to treat bond issues as “deposits” within the Act’s Section 2(a) ban. The mutuals’ critics, however, pointed out that unless they did so the mutuals would be able to evade the Act by switching from stock finance to bonds. To stop that ploy, they induced the drafters to include bond finance within Section 2(c).<sup>67</sup>

This eleventh-hour switch left technically inclined observers unhappy. Although the Capital Funding Act fell under the joint jurisdiction of the Ministries of both Justice and Finance, it pleased bureaucrats at neither. “On a variety of details, the bill leaves theoretical issues unresolved,” complained one official from the Justice Ministry.<sup>68</sup> “You can’t say the language is crystal clear,” agreed a MoF bureau chief. “I talked about it with the Justice Ministry and studied how to write it. In the end, though, we just couldn’t come up with anything better.”<sup>69</sup>

(b) Other statutes. Other than the Capital Funding Act, few post-war statutes regulated non-bank intermediaries. In 1983, the Diet did pass a Finance Industry Act that mandated licenses, imposed disclosure requirements, and banned what Americans call predatory lending.<sup>70</sup> Until then, however, the non-banks had faced only minimal restrictions. The Interest Regulation Act and the Temporary Interest Adjustment Act capped interest rates at the 15-20 percent range, but the caps were easy to evade and carried no criminal penalties anyway.<sup>71</sup>

Even the Capital Funding Act did very little. It imposed criminal sanctions for usury, but only if a lender charged over 109.5 percent a year.<sup>72</sup> It did stop the intermediaries from either taking deposits or selling bonds, but not from borrowing at a bank. Other than ban interest charges

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jiho 767, 767-68 (1954); Hideo Kanbayashi, *Kashikingyo to no torishimari ni kansuru horitsu kaisetsu* [Commentary on the Act to Regulate the Money-Lending Industry, Etc.], *Zaisei keizai koho*, June 10, 1949, at 1; Shigeo Tamiya, *Rishoku kikan no torishimari ho* [The Statute on the Control of Profit-making Institutions], *Kin’yu homu jijo*, Mar. 25, 1954, at 4.

<sup>67</sup> Tamiya, *supra* note, at 8-9.

<sup>68</sup> Tamiya, *supra* note, at 9.

<sup>69</sup> Comments of Michikazu Kono, *Dai 19-kai Kokkai shugiin Okura iinkai giroku*, vol. 51 (May 7, 1954).

<sup>70</sup> *Kashikin gyo no kisei ni kansuru horitsu* [Law Regarding the Regulation of the Money-Lending Industry], Law No. 32 of 1983.

<sup>71</sup> *Risoku seigen ho* [Interest Limitation Act], Law No. 100, of 1954, Sec. 1; *Rinji kinri chousei ho* [Temporary Act for the Adjustment of Interest Rates], law No. 181 of 1947, and accompanying regulations. See generally Miwa & Ramseyer, *supra* note (Directed Credit); Toshio Tsubaki & Shin’ichi Nishio, *Kin’yu torihiki no horitsu sodan* [Legal Consultation on Financial Transactions] 54-55 (Tokyo: Yuhikaku, 1987).

<sup>72</sup> Capital Funding Act, Sec. 5.

over 109 percent, in short, it did almost nothing to regulate how the firms lent money. It merely limited how they raised the money they lent. Even in recent years, the application of the Act has primarily involved fraudulent investment schemes.<sup>73</sup>

4. Its application to commercial paper. -- Come mid-1993, MoF announced that non-bank intermediaries could raise funds through commercial paper. It is not as though the Diet amended a statute or repealed a ban. It is not as though the Diet passed anything at all. It is not even as though MoF had general regulatory authority over non-bank intermediaries in the first place. Instead, MoF merely amended its internal circular “Regarding the Handling of Commercial Paper,” added an accompanying set of explanations and conditions, and thereby apparently settled the matter.<sup>74</sup>

Circulars are not “law.” As the Supreme Court put it, a “circular is an instruction to a subordinate administrative unit regarding the exercise of administrative power. It is not law that binds the citizens.”<sup>75</sup> Consequently, circulars do not bind the parties with whom the agency deals - - though to the extent they reflect what an agency is likely to do, they obviously affect such parties. Neither do they bind courts -- though to the extent judges want either to minimize effort or to defer to specialists, they obviously affect judicial outcomes.

In its amended 1993 circular, MoF announced the conditions under which non-banks could issue the paper. They could issue only dealer paper, only in denominations of at least 100 million yen, and only with maturities of under a year. They would need to maintain special bank accounts to handle the funds raised through the commercial paper, to use the funds only for restricted purposes, and to certify that they did not use the funds as loan capital.

MoF said nothing in the circular or the attachments about its statutory authority for doing this: why non-banks could not legally issue commercial paper before, and why they could now. Given that no statute or regulation had changed, logically the legal status of commercial paper should not have changed either. If non-banks could not legally issue it before, they could not legally issue it now. If they could legally issue it now, they could legally have done so before.

Presumably, if pressed MOF would have claimed that commercial paper was a “bond” within the scope of Section 2(c), and that the non-banks had as their “principal business the lending of money.” If so, then Section 2(c) prevented them from issuing that paper before, and subjected them to criminal sanctions if they did so now. Although the Act fell within the joint jurisdiction of the Ministries of Justice and Finance, Finance had the initial regulatory authority. Presumably, MoF could claim that the circular lowered the risk (though hardly to 0, given the instability in the Cabinet) that it would recommend the prosecution of a non-bank that issued commercial paper.

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<sup>73</sup> E.g., [No names given], 832 Hanrei taimuzu 227 (Kyoto D. Ct. Sept. 20, 1993); Iwano v. Goto, 657 Hanrei taimuzu 141 (Sendai High Ct. May 27, 1987).

<sup>74</sup> Circ. 610, as amended June 30, 1993; Okurasho ginko kyoku, Jimu renraku [Administrative Communication], June 30, 1993. Note, however, that in 1993, MoF did promulgate an order, Okura sho rei 14 of Mar.3, 1993, Sec. 1, that unambiguously placed commercial paper within the ambit of the catch-all definition given in Sec. 2(a)(viii) of the SEA.

<sup>75</sup> Nakagawa v. Nagasaki zeimu sho cho, 10 Somu geppo 381 (Sup. Ct. Dec. 24, 1963); see Hiroshi Kaneko, Sozeiho [Tax Law] 105 (Tokyo: Kobundo, 5th ed., 1995); Jiro Tanaka, Gyosei ho, jo [Administrative Law: I] 164 (Tokyo: Kobundo, new ed. 1984).

The question, however, is whether MoF was right. As of 1987, one securities law treatise could declare that there was no statutory ban on commercial paper in Japan.<sup>76</sup> The senior University of Tokyo corporate law scholar could flatly announce that “if an firm wants to issue commercial paper, under current law it should be able freely to do so.”<sup>77</sup> Was commercial paper a bond? On the one hand, it was a debt, and so was a bond; it was transferable, and so was a bond. On the other, the paper came in much larger denominations; was offered only to large institutional investors; and bore a much shorter term.

And did a leasing company have as its “principal business the lending of money”? Was a lease a loan? Formally, no. The parties negotiated contractual terms that coupled a transfer of the right to use equipment with a promise to pay periodic fees for that right. Formally, that made it a different contract from one that coupled the transfer of funds with a promise to pay fees for the right to use those funds to buy the equipment. Substantively, however, the leasing firm might as well be lending money. In substance, the firm and the lessee could negotiate contractual terms that accomplished the same result as if the lessor had lent the money, and the lessee then used that money to buy the equipment from the manufacturer.<sup>78</sup>

Arguably MoF just allowed firms to issue the paper under conditions that insured that a court would treat it as a promissory note rather than a bond. Yet if so, the parties hardly needed MoF’s help. They knew the market, and they could read the law. If they wanted to issue notes rather than bonds, they did not need MoF to tell them how to do so. Indeed, MoF’s requirements were not economically binding anyway. In the mid-1990s, when MoF demanded maturities of under a year for the paper, ORIX issued most of its paper with 3-month terms; when MoF demanded face amounts of 100 million yen, ORIX typically issued it at face amounts of 5 to 30 billion yen.<sup>79</sup>

#### E. The Bargain:

1. The deal. -- At the same time that it announced that non-bank intermediaries could issue commercial paper, MoF also asserted regulatory jurisdiction over the intermediaries. That it coupled the two matters captures the bargain: in exchange for access to the commercial paper market, the non-bank intermediaries agreed to submit to MoF’s regulatory jurisdiction. In the process, they also agreed to abide by the terms of the cartel in the banking industry.

For the essence of MoF regulation lay in the cartel. Since the war, MoF had regulated the banks in classic Stiglerian fashion: against firms that would try to cheat on the terms of the industry cartel, it enforced the cartel’s terms. Given the fungibility of money and the alternative ways to raise it, the cartel had never generated large rents.<sup>80</sup> Of the major threats to the cartel, the

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<sup>76</sup> Ichiro Kawamoto & Yasunami Otake, *Shoken torihiki ho* [Securities Exchange Act] 113 (Tokyo: Nihon keizai shimbun, 1987).

<sup>77</sup> Akio Takeuchi, *Shasai hakko shijo no arikata* [The Proper Bond Issue Market], 1100 *Shoji homu* 4, 11 (1987). See also the discussion in note 6, *supra*.

<sup>78</sup> Note, however, that Japanese courts have not been inclined to recharacterize leases as loans. E.g., *Jinshi marin K.K. v. Nishi*, 1048 *Hanrei jiho* 107 (Tokyo High Ct. Apr. 27, 1982); *Fuyo sogo riisu K.K. v. Iryo hojin shadan Tokyo shakai byoin*, 1185 *Hanrei jiho* 104 (Tokyo High Ct. Jan. 29, 1986).

<sup>79</sup> Private correspondence with the firm.

<sup>80</sup> Alternatives we discuss in Miwa & Ramseyer, *supra* note (LSI), and Miwa & Ramseyer, *supra* note (Directed Credit).

non-bank financial intermediaries simply represented the most recent. By bringing them within its jurisdiction as well, MoF mitigated their corrosive potential.

2. The banking cartel. -- a. Bonds. The post-war history of the bond market illustrates the way banks had earlier fought to preserve their cartel. If for industrial firms an active bond market represented a financing opportunity, for banks it represented a threat. Precisely because it gave their best customers a way to raise debt capital without them, it was an institution banks worked to cripple.

Primarily, banks reduced threat the bond market posed by imposing a toll charge on those who would use it. They charged the toll by requiring most issuers to post collateral.<sup>81</sup> They imposed the requirement through a “bond issue committee,” which they in turn dominated. Because by law only banks could manage the collateral,<sup>82</sup> the collateralization rule routed fees to the banking industry even when firms turned elsewhere.<sup>83</sup> In exchange for letting a few firms raise their debt on the bond market, in other words, it used the collateralization requirement to route banks a toll charge when they did.

By the 1980s, things changed. Foreign exchange controls loosened, and technological change eased communication and trade.<sup>84</sup> In the process, many of the larger manufacturing firms discovered increased access to the far less regulated European financial market. In 1980, Japanese firms raised only 680 billion yen through overseas bonds. By 1984, they were raising 2.8 trillion yen, and by 1989 11.1 trillion.<sup>85</sup>

As Euro-issues grew, the domestic market languished. From 1981 to 1985, the amount that manufacturing firms raised through domestic straight bond issues fell from 1,269 billion yen to 944 billion. By 1989 it had fallen to 729 billion. Even these numbers exaggerate domestic issues, for most were utility company issues: 73.4, 59.1, and 95.1 percent of all private-sector domestic straight bond issues by non-financial firms in 1981, 1985, and 1989, respectively. Other than NTT and KDD (the telephone companies), non-financial firms simply did not issue domestic straight bonds.<sup>86</sup>

b. Commercial paper. And similarly the commercial paper market. It too represented a threat to the banking cartel, and it too the banks sought to stifle. To be sure, the two alternatives

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<sup>81</sup> These dynamics are explored in Yoshiro Miwa, *Kin'yu gyosei kaikaku: “yakusho banare” no susume* [Reform of Finance Industry Policy: Toward a “Distancing of Government”] 71-74 (Tokyo: Nihon keizai shimbun, 1993); Miwa, *supra* note (1992), at 324-27; J. Mark Ramseyer, *Explicit Reasons for Implicit Contracts: The Legal Logic to the Japanese Main Bank System*, in Masahiko Aoki & Hugh Patrick, eds., *The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies* 230, 237-39 (Oxford: Oxford University Press, 1994).

<sup>82</sup> *Nihon Ginko, Waga kuni no kin'yu seido* [Our Country's Financial System] 195 (Tokyo: Nihon Ginko, 1986).

<sup>83</sup> The restrictions are detailed in, e.g., Shin Nihon shoken chosa sentaa, ed., *Shoken hando bukku* [Securities Handbook] Part 3 (Tokyo: Toyo keizai shimpo sha, 3d ed., 1989).

<sup>84</sup> On foreign exchange liberalization, see Yukio Yanagida, et al., eds., *Law and Investment in Japan* ch. 6 (Cambridge: East Asian Legal Studies, Harvard Law School, 2d ed., 2000).

<sup>85</sup> Ramseyer, *supra* note, at 240 tab. 7.2. ORIX had already started issuing bonds on the foreign market in 1973, with a \$10 million straight bond issue.

<sup>86</sup> For these and other details of the scope of the domestic bond issues, see Miwa, *supra* note (1992), at 312-13 tab. 12-1.

threatened different sectors of the banking industry. As long-term debt, bonds threatened the profitability of the banks specializing in longer term loans -- disproportionately banks like the Industrial Bank of Japan and the trust banks. As short-term debt, commercial paper threatened those specializing in shorter term loans, disproportionately the large money-center banks.<sup>87</sup> Because the non-bank intermediaries borrowed heavily from the latter (they also borrowed from the trust banks), extending the paper market to them only exacerbated the problem.

Lest there be any doubt, note that the earlier ban on commercial paper had nothing to do with “investor protection.” Several years before it allowed a market for domestically issued commercial paper, the MoF had already allowed domestic trading in overseas issues.<sup>88</sup> Fundamentally, it was the issuing of the paper by Japanese firms that concerned the government, not the purchase of the instruments by Japanese investors. Where it had allowed domestic investors to trade in the paper of foreign firms by 1984, it did not allow them to trade the paper of foreign affiliates of Japanese firms until later.

By the mid-1990s, deregulation hit both the bond and the commercial paper markets. After two decades of gradual liberalization, the bond market was completely deregulated by 1996.<sup>89</sup> With the repeal of the Capital Funding Act in 1998, the final restrictions on commercial paper issues by the non-banks disappeared as well.

c. The waning cartel. Never secure in the first place, by the close of the 1980s the banking cartel had atrophied badly. Internationally, the few preeminent institutions like the Mizuho (Daiichi Kangyo) Bank and Nomura Securities obscure the highly competitive character of the Japanese financial services industry in Japan. As of the early 1990s, Japanese firms chose from among 140-plus banks.<sup>90</sup> To be sure, traditionally only three could issue debentures and primarily only trust banks managed client trusts. Otherwise, however, the market was for banks a free-for-all.<sup>91</sup>

In this competitive market, banks loaned funds at rates that reflected borrower risk.<sup>92</sup> Throughout the post-war period, the government and industry purported to regulate the interest rates banks could charge their lenders. As we explain elsewhere, the rates did not bind. Firms that needed funds, after all, not only had access to the highly competitive banking world, but a wide variety of sources other than banks besides. The large Japanese trading firms routinely provided

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<sup>87</sup> E.g., Seiichiro Saito, *Zeminaaru gendai kin'yu nyumon* [Seminar: Introductory Modern Finance] 282-83 (Tokyo: Nihon keizai shimbun sha, 3d ed., 1995).

<sup>88</sup> LMMR, *supra* note, at 411-12.

<sup>89</sup> See Hoshi & Kashyap, *supra* note, at 230.

<sup>90</sup> As of March 1993, there were 11 “city” (money-center) banks, 64 regional banks, 66 “type-2” regional banks, 3 long-term credit banks, and 7 trust banks. There were no legal distinctions among the first three of these categories. In addition, there were a wide variety of other financial institutions. See generally Hiroshi Kusumoto, ed., *Nihon no kin'yu gyosei, kancho, kin'yu kikan*, [Japanese Financial Administration, Bureaucracy, and institutions] (Tokyo: Toyo keizai shimpo sha, 1994).

<sup>91</sup> This is not how the English-language literature characterizes it, of course. Reflecting that literature, for example, Milhaupt & Miller characterize it as involving as “extreme compartmentalization.” Milhaupt & Miller, *supra* note, at 6 (1997). Regional banks may have “specialize[d] in local lending to small business” (*id.*, at 7), but (other than the effects of the ministry’s approval process for branches), this specialization was not regulatorily driven.

<sup>92</sup> Miwa & Ramseyer, *supra* note (Directed Credit).

capital. The agricultural cooperatives lent funds,<sup>93</sup> and (as the discussion above indicates) as technological change lowered the costs of tapping sources overseas so did foreign institutions.<sup>94</sup>

Although the government regulated the rates banks could pay depositors, banks were not the only place investors could park their money. Instead, they could choose from among a variety of investments, including trusts, life insurance contracts, and a securities funds.<sup>95</sup> Given this competition, insiders would necessarily have earned few rents.

Low to begin with, come international competition the rents to cartelization fell even further. As they fell, so did the support Japanese banks -- especially the more efficient banks -- were willing to offer it. Increasingly, they eyed the gains to be had from dismantling the status quo. Increasingly, the other banks found it harder to maintain the financial order unchanged.

d. The rising non-bank intermediaries. Although deregulation followed, the non-bank financial intermediaries were among the last to reap its benefits. Several reasons account for this. First, ostensibly, the key to access lay in Section 2(c) repeal. Yet facially Section 2(c) merely prevented money-lending firms from lending bond proceeds, and until the 1980s the banks had kept the bond market crippled anyway. Absent much of a bond market, Section 2(c) would have seemed a non-issue. Second, to issue commercial paper cost-effectively, the non-banks also had to convince MoF to levy only a low tax on the paper. Until it did, Section 2(c) made little difference.

Third, before the 1990s, the non-bank intermediaries had neither the ability nor the incentive to lobby for either Section 2(c) repeal or the prerequisite tax change. They lacked the ability because they lacked political substance. ORIX was the largest of the leasing firms, but as of 1980 even it had only 506 employees. Only by 1990 did it grow to 2000 employees. By the year 2000 it had grown to over 3000. Only with such scope did the industry obtain the political influence it needed. Before the 1990s, the non-bank intermediaries also lacked the incentive to lobby. They lacked the incentive because they lacked economic substance. Because commercial paper is unsecured, even in the U.S. only the biggest and safest firms can use it to raise funds.<sup>96</sup> Until they acquired that stability, the Japanese leasing firms simply could not have issued paper -- until then, legal license was a non-issue.

3. The bargain, respecified. -- Eventually, the bargain did come to pass: MoF agreed to let the non-bank intermediaries issue commercial paper, and the intermediaries agreed to submit to its regulatory jurisdiction. A committee report from MoF in 1991 hinted at what would become the bargain. The ministry should consider letting non-banks issue commercial paper, it declared, only “if the place of the non-bank financial intermediaries were clarified within the financial system, and if an appropriate supervisory and regulatory system were established.” Maybe the non-bank intermediaries could some day issue the paper, but only if they first agreed to be regulated.

As of the early 1990s, MoF (and the banks whose interests it largely represented) and the non-bank intermediaries had not yet made the bargain. Already, however, the government was starting to try to pull them within MoF’s regulatory orb. In December 1990, the Financial Issues Research Committee of the LDP reported that “the non-bank intermediaries were channeling

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<sup>93</sup> Nihon ginko, *supra* note, at 336-42.

<sup>94</sup> See also Miwa & Ramseyer, *supra* note (Directed Credit).

<sup>95</sup> E.g., Sanwa, *supra* note, at 98-202.

<sup>96</sup> Meir Kohn, *Money, Banking, and Financial Markets* 213 (Chicago: Dryden Press, 1991).



massive loans into real estate.” They must, it cautioned, “conduct their loan business in an appropriate and healthy manner.” Notwithstanding, a subcommittee concluded a few months later, the government still “was not able to supervise investments in a way that would let it address the current real-estate loan problems.”<sup>97</sup>

Soon the government did begin to assert that regulatory jurisdiction. In 1991 and again in 1992, it did pass legislation imposing on the non-bank financial intermediaries reporting requirements for real estate loans.<sup>98</sup> What it had not yet done was to subject the non-banks to general regulatory jurisdiction. Obviously, the banks could have tried to induce the government to do so by legislative fiat -- and the non-banks might or might not have successfully blocked them. Just as obviously, the non-banks might have tried to obtain the legislation necessary cost-effectively to issue commercial paper (including the lower tax rates and a general authorization for direct paper) -- and the banks might or might not have successfully blocked them. And the banks and non-banks might have combined to lobby for a legislative package that did both.

Instead, the banks and non-bank negotiated through administrative fora. The MoF had organized a “Non-Bank Study Committee.” After a series of meetings, the committee in April 1991 detailed the potential deal to be made. On the one hand, banks and non-banks competed, and banks were regulated while the non-bank intermediaries were not. On the other, non-banks could not issue commercial paper. Couple the issues, and make the deal: give non-banks the right to issue the paper, and “clarify the role of non-bank intermediaries in the financial world and institute the appropriate supervisory and instructive system.”

A year later, another MoF committee repeated the potential deal. “Given the current circumstances of the non-banks,” it noted, it would be good if “the administrative offices had a better grasp of the general situation and a better ability to monitor.” While the non-bank intermediaries ought to be able to “issue commercial paper for raising capital other than loan funds,” they should be able to do so only if “there were in place an institutional apparatus for guiding and directing the non-banks.”

The pretext for the deal lay in the Capital Funding Act requirement that lenders segregate bond proceeds from loan capital. Never mind that money is fungible, and that intra-firm segregation rarely accomplishes anything. By equating leasing firms with money lenders and commercial paper with bonds, the banks and non-banks could use the Capital Funding Act requirement to justify coupling commercial-paper access with regulatory jurisdiction. As the MoF committee above noted in its 1992 report, the group needed to insure that non-banks did not loan out the commercial paper proceeds. MoF should allow non-banks into the commercial paper market -- but only if “measures could be put in place to insure that the commercial paper proceeds not be used to fund loans.”

### III. Conclusions

Much of the current financial distress in Japan traces itself to the limited range of non-bank financial intermediaries that investors and firms can tap. That limited range, in turn, is a creature of regulation. If the regulation seems bad policy, it was. Yet as an means to the public good, the post-war regulatory regime in the financial services industry never made sense anyway. The regime crippled the market for bonds. It squelched the market for commercial paper. It stifled

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<sup>97</sup> Kin'yu zaisei jijo, March 11, 1991, at 30.

<sup>98</sup> Law No. 74 of 1991, and Law No. xx of 1992. Both were amendments to the Kashikin gyo no kisei to ni kansuru horitsu [Law Regarding the Regulation, Etc., of the Money Lending Business], Law No. 32 of 1982.

firms that might threaten the banks. It capped interest rates. It stopped most new branches. For several years (think “Robot Protection Act”) it even shut down ATMs over evenings and weekends.

Yet while the details differ, the more fundamental point is hardly specific to Japan. As a means to the public good, regulation seldom makes sense anywhere. As Ronald Coase put it in 1964: “What the regulatory commissions are trying to do is difficult to discover; what effect these commissions actually have is, to a larger extent, unknown; when it can be discovered, it is often absurd.”<sup>99</sup> The U.S. financial services industry had its Glass-Steagall, its bans on branch banks, its interest rate caps. Other industries had their own equivalents.

At root, regulation is not about the public good, and never has been -- not in the West, and not in Japan. It has been about redistribution. Sometimes the redistribution is explicit: think dairy cows in the American Midwest, silk worms in central Japan. And sometimes the redistribution takes the form of cartel enforcement. Because they are so unstable, as a long-term source of rents cartels can be notoriously unreliable. Sometimes, the government can help the industry preserve those rents by preserving that stability.

In the Japanese financial sector, the government helped preserve cartel stability by stifling competition. For years, that entailed crippling non-bank intermediaries and the markets for corporate bonds and commercial paper. By the late 1980s, it entailed liberalizing the commercial paper market, but only by simultaneously bringing the non-banks within its cartel-enforcing regulatory jurisdiction.

All this is a story one could tell about most any democracy. For such is the nature of social scientific theory: it applies across nations, across cultures, across time. We do not claim the vicissitudes of non-bank intermediaries and commercial paper issues in Japan proves that universality. No case study ever could. We do claim it illustrates the dynamic involved: both the dynamics of the Japanese legislative and regulatory process, and the dynamics of political economy more generally.

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<sup>99</sup> Ronald Coase, Discussion, \_\_ Am. Econ. Rev. \_\_, 194 (1964).