A Strategic Shift from International to Multinational Banking: A "Macro-Developmental" Paradigm of Japanese Banks *qua* Multinationals

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1. A Stage-theoretic Macro-developmental Approach

The macro-developmental approach for explaining cross-border investment, which originated with John H. Dunning's "investment development cycle" model (1981), is gaining currency as more elaborate, differentiated, or new models have been introduced in recent years.[1] Yet the focus has so far been placed on cross-border investment activities mainly in the manufacturing (*real* sector) industries that are interpreted as a structural – and ownership-asset-based – phenomenon reflective of the stages of economic development; no corresponding stage-theoretic approach has been explicitly applied to financial (*money* sector) activities across borders. The banking industry, in particular, is a key infrastructural industry that is *strategically* crucial – hence, policy-sensitive – for economic development, particularly in late-comer countries which strive to catch up with the advanced countries.

The purpose of this paper is to explain the sudden rise of Japanese banks qua multinationals in global finance from the mid-

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[1] See, for example, Dunning, 1988, 1991, and 1992; Cantwell and Tolentino, 1990; Tolentino, 1992; Kojima and Ozawa, 1984 and 1985; Kojima 1990; Ozawa, 1991 and 1992.

1970s onward – and particularly throughout the 1980s – within a macro-developmental stage-theoretic framework. The basic idea is that Japan's banking sector was almost totally isolated from the rest of the world and closely controlled by the Bank of Japan (which was in turn supervised by the Ministry of Finance) for the purpose of building a *trade-supported* economy (or *Boeki-rikkoku*) up until the end of the 1960s; a catch-up development strategy that resulted in what is known as the "era of high growth" when the Japanese economy grew at the average rate of about 10% a year. *International banking* (trade finance and debt capital borrowing to be transacted basically from home through correspondent banks and through a limited minimum number of overseas outposts set up by compatriot banks to supplement correspondent banking) was basically sufficient for the national purposes in that era.[2]

But, as examined below, a host of internal as well as external events that occurred towards the end of the 1960s and in the early 1970s forced Japan to alter its development course from high growth to low growth orientation; and the resultant structural changes in the Japanese economy made it both *possible* and *strategically necessary* for Japanese banks to suddenly go multinational. It was the policy/institutional rearrangements at the macro-structural economy level, not so much the accumulation of ownership advantages at the individual bank level, that triggered the overseas advances of Japanese banks *qua* multinationals. This strategic switch from international to

[2] Any open economy requires the services of cross-border banking. For the sake of analysis we are differentiating *international* from *multinational* banking in terms of the banking sector's departure from the trade-supportive function for the home country to the foreign direct investment (FDI)-supportive orientation and offshore (not home-bound) banking. In our definition, the mere existence of overseas branches alone does not signify multinational banking so long as those branches operate merely to support and promote the home-based, trade-oriented production of their home country. Correspondent banking ("arm's-length" banking) across borders, which is basically used to settle trade accounts, is a form of international banking, but certainly not that of multinational banking. Some branches are often set up simply to supplement or substitute for such correspondent banking, because correspondent banking services are not adequately provided or are unavailable.

By multinational banking we mean the cross-border banking activities that are parallel to, and supportive of, the FDI activities of both the home and the host countries and also that are offshore and globally oriented in transactions.

In making the above distinction, we owe to Professor Mira Wilkins of Florida International University for a stimulating exchange of views on this subject, although she may not agree with our conceptual differentiation.

multinational operations on the part of banks also occurred in unison with the strategic switch of Japan's real sector corporations from trade primacy to a rising dependency on overseas investment. Both sectors' concurrent strategic shifts initiated by changes in Japan's macrostructural characteristics led to the emergence of Japan as an overseas-investment-supported economy (popularly called *toshi-rikkoku*) that evolved from a trade-supported economy.[3]

2. Peculiarities of Japanese Banks *qua* Multinationals

The sudden growth of Japan's financial power and its dominance in global banking that occurred in the latter half of the 1980s caught the world by surprise. All of a sudden, the list of the world's ten largest banks ranked in terms of assets began to be monopolized by Japanese banks. At the start of the 1960s, not a single Japanese bank was counted in the world's top fifty; in 1980, one Japanese bank (Dai-Ichi Kangyo Bank or DKB) slipped into the top ten list, and by 1989 nine Japanese banks came to rank among the top ten, thirteen Japanese banks in the top twenty, and as many as twenty-three Japanese banks among the top fifty.[4] This development naturally alarmed overseas competitors. It was even interpreted as the latest attack of Japan's juggernaut intent on destroying and taking over another key industry – banking this time around, just as the Japanese had previously done to the automobile and electronic-goods industries in the West.

Then, suddenly again, the story began to change (particularly after the collapse of Japan's stock and real estate markets in 1989). Japan's share of total international bank assets started to decline somewhat, as shown in Table 1. Given Japan's current banking crisis, this trend is expected to continue for sometime to come, and their phenomenal expansion of the 1980s may be a thing of the past.

[3] An indicator of this shift in strategic orientation is the FDI/GNP ratio relative to the export/GNP ratio. The former rose from 0.005 in 1979 to 0.016 in 1988, while the latter declined to 0.08 in 1988 from its high of 0.135 in 1984. See Economic Planning Agency, 1990, p. 33.

[4] Various issues of *Euromoney*.

Nevertheless, Japanese multinational banks are definitely here to stay as the world's leading banks.

In addition to (a) the rapidity with which Japanese banks advanced into overseas markets, their multinationalization has also been characterized by a peculiar (rather unique) combination of (b) their dominant asset position or low equity/asset ratios (which made them rank among the world's largest banks in assets),[5] and (c) low overseas profit margins.[6] So, how can we explain these major features of Japanese-style multinational banking? what are the circumstances that have made it possible for them to emerge so "successfully" as multinational banks – at least in asset size if not in performance? Judged from the low overseas profit margins, do they really possess significant firm-specific – and rent-yielding – advantages as compared to the Western banks? what are the determinants of these unique features of Japan's multinational banking?

As detailed below, the factors underlying the sudden growth of Japanese banks *qua* multinationals lie not so much at the individual firm (micro) level but more fundamentally at the economic-institutional/macro-structural policy level. Japan's multinational banking, with all its peculiarities, is an institutional phenomenon associated with the catch-up process of Japan's postwar economy in which banks were once assigned a special strategic role as a development catalyst, especially during the period from the mid-1950s to the beginning of the 1970s when the Japanese economy grew at a phenomenal pace.

[5] At the end of March 1986, for instance, the average equity-to-asset ratio for the thirteen Japanese city banks was 2.19% compared with 5 to 6% for U.S. banks. And these relatively low equity-to-assets ratios enabled the Japanese banks to offer cheap loans very competitively in the global markets (Viner, 1988, p. 202).

[6] "Overall, on a return-to-assets basis, Japanese banks have relatively low profits, both in the short run and in the long run. For example, while U.S. and West German banks' average returns on total assets (ROAs) have been close to 1% in most recent years, Japanese banks have averaged only 50 to 60% of that figure ... the Japanese tend to operate with substantially lower ratios of book value capital to total assets (ranging between 3 and 3.5%) than U.S. banks (whose book value capital generally averages between 6 and 7% of bank assets). Accordingly, Japanese banks' rates of return on equity capital (ROE) are high, especially compared to the United States. Japanese banks averaged a rate of return on owners' equity of 15 to 16% during the 1980s, compared to average equity returns of about 13% for U.S. banks during the same period" (Rose, 1991, pp. 55-56). The lower capital-to-asset ratios of Japanese banks were said to have contributed to the establishment of the 8% capital-asset ratio by the Bank for International Settlements in 1987.

TABLE 1

INTERNATIONAL BANK ASSETS BY NATIONALITY OF BANK
(Percentage share of total assets at end of period)

	1983	1986	1989*	1989**	1990	1991
Japan	21.1	32.4	38.0	36.5	33.9	31.4
United States	28.0	17.3	14.1	13.5	11.4	10.6
France	8.8	8.4	8.4	8.0	8.8	9.5
Germany	6.7	7.8	8.4	8.1	9.7	10.4
United Kingdom	8.3	6.1	4.8	4.6	4.4	4.6

* Old series ** New series

Note: The gradual widening of statistical coverage means that the figures shown above are not strictly comparable; with the exception of end-1989, however, the changes were small.

Source: Bank for International Settlements, *International Banking and Financial Market Developments* (August 1992 and earlier issues), as presented in Masahiko Takeda and Philip Turner, 1992, p. 82.

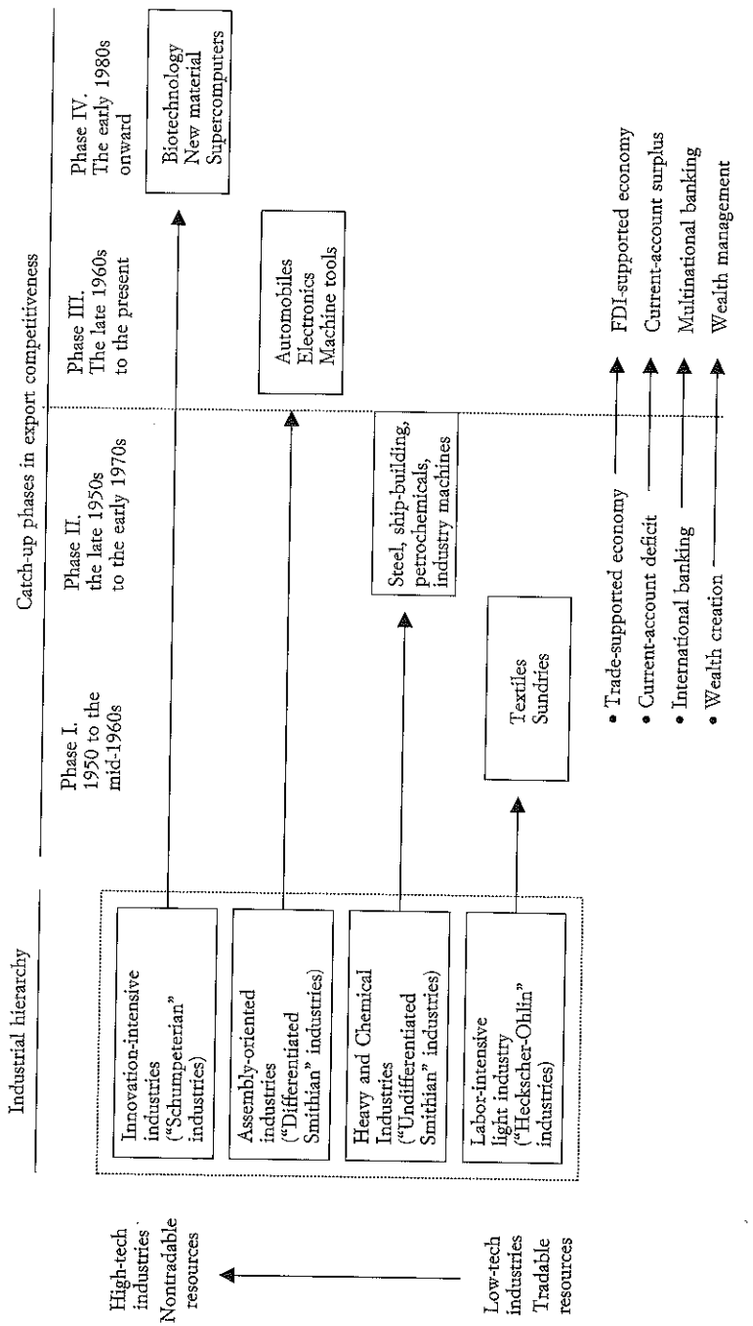
3. Bank-loan Capitalism during Japan's High Growth Era

To better understand how Japan's multinational banking reflects Japan's macroeconomic institutional phenomenon, it is necessary to go back to the era of what may be called "bank-loan capitalism" in Japan's postwar economic reconstruction and expansion period. This high growth era witnessed the highly capital-intensive industries, mainly heavy and chemical industries (notably steel, shipbuilding, heavy machinery, and petrochemicals), being modernized and further expanded, resulting in investment-driven growth.

As shown in Figure 1, the period of heavy and chemical industrialization actually constituted the second phase (from the late 1950s to the early 1970s) after the phase of labor-driven industrialization (1950s to the mid-1960s). In the prewar period, Japan had succeeded in building both the labor-intensive light industry and the basic heavy and chemical industries. But once Japan regained autonomy in 1950, it had to modernize the prewar-built industrial facilities, as it had been left behind in the rapid technological progress that previously occurred in the Western world during the Second World War and the immediate postwar period.

FIGURE 1

CATCH-UP DEVELOPMENT AND EXTERNAL BANKING NEEDS: JAPAN'S STRATEGIC SHIFT FROM INTERNATIONAL TO MULTINATIONAL BANK



Japan's strategy was to move up the ladder of industrial sophistication by starting out with labor-intensive light industries ("Heckscher-Ohlin" industries such as textiles, light machinery, and sundries as primary exports in order to earn precious foreign exchange) and swiftly climbing to heavy and chemical industries ("undifferentiated Smithian" industries – "Smithian" because of economies of scale and learning), and then to higher-productivity, assembly-oriented industries ("differentiated Smithian" industries), and finally to innovation-intensive industries ("Schumpeterian" industries) (Ozawa, 1991).

It was relatively easy for Japan to repeat its labor-driven development in the early postwar period by concentrating on standardized labor-intensive manufacturing, as it had plenty of labor, both unemployed and underemployed, who were eager to work at low wages in the aftermath of defeat. But how did Japan raise the necessary capital to finance the next phase of highly capital-intensive heavy and chemical industries over a short span of time?

Instead of borrowing from overseas, Japan employed a self-reliant method of financing economic development through domestic bank loans. Actually this financing strategy had been previously pursued with success in Japan's effort for industrialization during the Meiji period (1868-1912), as well as in the pre-World-War-II period (1912-1942) and during the war itself (1942-1945).

Indeed, the banking industry was among the very first industry to be protected and promoted by the Meiji government under the National Banking Act patterned on the American model and expanded very quickly after the adoption of the gold convertibility of bank notes in 1876, providing funds and contributing to "the wide spread development of many industries" in a manner "essential to industrial development".[7]

Given the relatively low level of income – hence, the equally low level of national saving at the beginning of Japan's modernization –, the only way for Japan to create loanable funds without borrowings from foreign countries was thus to make the most of the banks' credit-creating capacity with the help of Japan's central bank. In this scheme, the *zaibatsu*-related large banks were favorably treated as the financiers of Japan's effort to pursue heavy and chemical industrializ-

[7] See Nakamura, 1983, p. 60.

ation (designed to build up military strength). And this financial strategy continued up to the Second World War. For example, during the 1932-44 period, more than two-thirds of the funds of Japanese industry (excluding banks) were raised from the external sources, and more than half of the total of external capital came from banks.[8]

In the postwar period, the reconstruction and modernization of Japan's heavy and chemical industries required a huge sum of capital, and the large city banks, once again regrouped under the new system of *keiretsu* at the end of the Allies' occupation, played a pivotal role in capital financing. This is clearly evident in the ever-declining equity-to-total-capital ratio throughout Japan's high-growth era; for all industries it declined from 26.9% in 1950 down to 16.1% in 1970, and for manufacturing it decreased from 31.4% to 19.9% over the same period.[9]

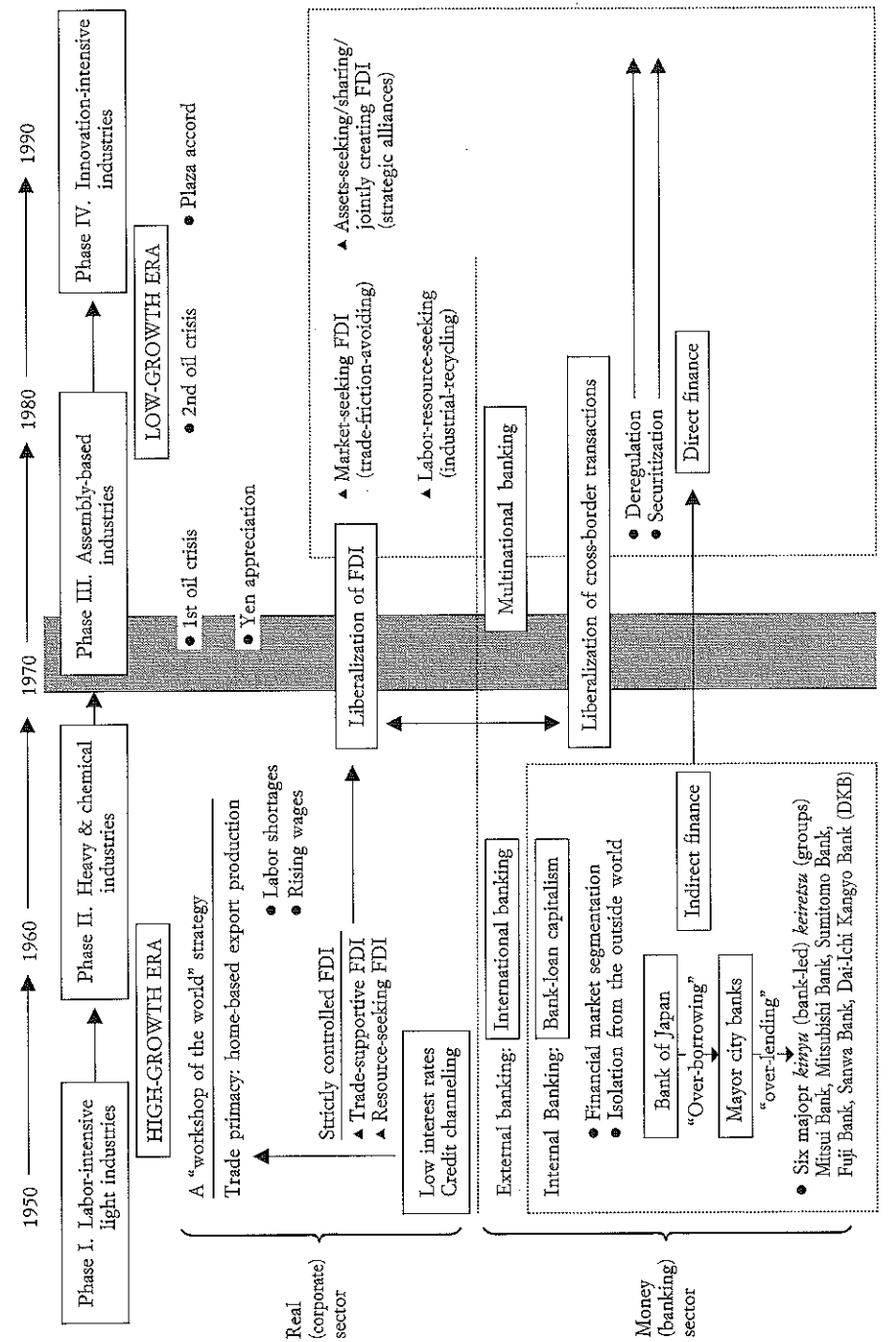
And this rising leverage also meant a decline in what little dependence Japan had on foreign capital. For example, Japan's foreign debts accounted for merely 4.5% of its total funds (and this ratio declined ever since) during the post-Korean war economic expansion of 1954-57 when Japan was most dependent on borrowings from outside.[10] As will be explained below, an end to the increasing leverage came as a slow growth era arrived in the early 1970s and as businesses improved their self-financing capability *pari passu* with the improvement in their export competitiveness, hence in Japan's balance of trade.

As illustrated in Figure 2, the Bank of Japan pumped funds into Japan's major city banks which in turn extended industrial loans to their own groups of closely affiliated corporations, the groups known as the bank-led *kinyu* (or *financial*) keiretsu. There were six such major *financial keiretsu* which competed vigorously in arranging a complete set of heavy and chemical industries (such as steel-mills, petrochemical complexes, heavy machinery shops, and shipyards); a system popularly described as a "one-set principle".[11] Observing the close inter-corporate linkages in cross-share-holding and directorship not only between the lead *keiretsu* banks and their affiliated corporations but also among the nonbank firms, Gerlach (1992) nicknamed the Japanese brand of capitalism "alliance capitalism".

[8] The data are from Goldsmith, 1983, p. 127.
[9] Caves and Uekusa, 1976, p. 479.
[10] Hamada and Horiuchi, 1987, p. 233.
[11] Miyazaki, 1980, pp. 53-75. The six *kinyu keiretsu* were led by the Mitsubishi Bank, the Mitsui Bank, the Fuji Bank, the Sumitomo Bank, the Sanwa Bank, and the Dai-Ichi Kangyo Bank (DKB).

FIGURE 2

A DUAL SWITCH OF JAPANESE INDUSTRY FROM DOMESTIC (EXPORT-CENTERED) TO MULTINATIONAL (FDI-DEPENDENT) ORIENTATION



The end result was the two peculiar monetary phenomena in Japan; *over-borrowing* on the part of the corporate sector and *over-lending* on the part of banks supported by the Bank of Japan. Over-borrowing describes a situation in which corporations rely on borrowing from banks to an unusually high degree, and over-lending means a condition in the private banking sector in which banks extend more loans than the funds they receive from deposits or own capital, with the gap filled primarily by borrowings from the Bank of Japan (Suzuki, 1987, pp. 23-24). Both over-borrowing and over-lending are the distinct features of bank loan capitalism.

Japan's banking institutions were also *compartmentalized* into specialized activities and markets (*e.g.*, separation of the lending business from underwriting and trading in securities and the trust business; separation of short- and long-term finance; separation of markets by size of customer) in order to channel funds into specific areas, and *isolated* under protection from the outside world in order to maintain an independent monetary policy and control. During the first and second phases of postwar industrialization, that is, *largely up until 1970, international banking alone was considered largely sufficient for the interest of economic development at home and only a limited form of cross-border banking was allowed* (initially, only the Bank of Tokyo was given the role of a foreign exchange bank to facilitate Japan's international trade as was the case with its predecessor, the Yokohama Specie Bank, during the Meiji period of industrialization).[12]

This money-sector strategy was fully consistent – and so designed – with Japan's real-sector strategy for trade-based industrialization. Its overseas investment in the nonbanking sector was initially controlled and subject to case-by-case screening and approval by the Ministry of Finance, which made decisions in close consultation with other government agencies, especially the Ministry of International Trade and Industry. Although no requirements for approval were officially announced, it was generally understood that foreign direct investment (FDI) must either promote exports from Japan or lead to the overseas development of natural resources vital to Japanese industry and that overseas production must not jeopardize the competitive position of other Japanese firms at home. These implicit

[12] For Japan's multinational banking in the prewar period, see Tamaki, 1990, and Wilkins, 1990a, 1990b.

requirements clearly meant that Japan's development strategy was intended to develop export-competitive home-based manufacturing by importing whatever necessary raw materials and fuels (*i.e.* a "workshop of the world" strategy) and that overseas investment was permitted only when it was capable of either promoting "exports from Japan" or developing the importable "overseas resources vital to Japanese industry" (Ozawa, 1979). In other words, like the money sector, the real sector too was totally devoted to Japan's trade primacy effort, and FDI was assigned merely a supportive role. In short, Japan initially protected *both* the money (banking) and real (non-bank industrial) sectors simultaneously from outside competitors in order to build trade-competitive industries at home.

As might be well expected, bank-loan capitalism during Japan's high growth era was closely controlled and fully supported by the Japanese government. Banks were able to extend industrial loans by simply borrowing from the Bank of Japan. No wonder, then, that their *equity-asset ratio* was kept at unusually low levels. Beside, there was no possibility of bank failure, as far as major *keiretsu* banks were concerned; they were strategically too significant to fail. The government would always come to the rescue if something ever went wrong to threaten the banks' financial health. The result was that banks' operations became extremely *asset-expansive*.

Moreover, Japan's major banks held the shares of their closely affiliated corporations within the framework of *kinyu keiretsu*, usually in the neighborhood of several percents as a symbol of long-term trust relationships. And the banks' shares were in turn owned by their major corporate customers. This cross-holding of stock served to reduce the transaction costs associated with asymmetric information and opportunism, further deepening the inter-sectoral affiliation between banking and nonbank industries.[13]

To the extent that corporations were highly *market-share-oriented*, rather than profits-oriented, particularly during the high growth period of scale-dependent heavy and chemical industrializ-

[13] Wallich and Wallich (1976) observed: "The arm's-length, competitive principles of Anglo-Saxon-style banking did not mesh with the habits of Japan's clannish, cooperative business society. Before World War II the style of the major *zaibatsu* called for banks that were closely associated with them and were capable of supporting the complicated manoeuvres of holding-company operations. After the war the largest banks replaced the *zaibatsu* holding companies in their function as leaders of "groups", a role that also called for a variety of capabilities not ordinarily associated with the concept of commercial banking" (p. 279).

ation, their closely accommodating bankers too strived to expand their market shares by extending loans, thereby becoming asset dominant in their operations.[14]

The very success of bank-loan capitalism, however, inevitably undermined the privileged position of banks. As corporations became successful and profitable, with their own internal funds rapidly piling up, they began to "depart" from banks. Especially when Japanese industry successfully moved to the phase of assembly-based industrialization in which higher value-added and more consumer oriented industries such as autos and consumer electronics came to dominate the Japanese economy as the new growth industries, the manufacturing sector became increasingly independent financially. For example, Toyota Motor Co. came to be known as "Toyota Bank" because of its huge accumulation of internal funds in the 1980s. In the meantime, banks began to wean themselves from the Bank of Japan as their major source of funds, as the phase of capital-intensive heavy and chemical industrialization came to an end and as the Japanese households began to save more and more out of their rapidly rising incomes.[15]

Moreover, the Japanese economy was forced to shift gears, from high growth to low growth under pressures from both external and internal developments. Externally, the sharp appreciation of the yen in 1971 (the shift to floating rates), and the first oil crisis of 1973 jolted Japan as a workshop of the world. Internally, Japan as a resource-poor and geographically small island nation, hit the limit of heavy and chemical industrialization which had caused serious environmental problems at home (as the heavy and chemical industries were pollution-prone) and trade frictions in securing overseas resources (as they were highly resourse-intensive). Japan had to move up the ladder of industrialization to the next phase of more environmentally compatible, higher value-added "differentiated Smithian industries" such as automobiles and electronics.

[14] Given the financial environment strongly protected by the government, no wonder the banking industry understandably came to develop a false sense of security that misdirected them in the recent past leading to the current financial crisis at home.

[15] In 1965, Japan's household savings as a percentage of disposable income was 17.5% compared to 15.9% in West Germany, 11.1% in France, 6.0% in the United States, and 6.1% in the United Kingdom. Japan's ratio rose to 21.0% in 1972 compared to 15.1%, 12.1%, 7.2%, and 5.0% in those respective countries (Wallich and Wallich, 1976, p. 257).

This new era brought about dramatic *structural* changes in the early 1970s (1973-74), which practically overnight rendered the heavily regulated financial system of the high growth era outmoded and unfit for the next phase of structural upgrading. "Corporations reacted to low growth with austerity, that is, with caution about investment, employment, and borrowing, while households reacted to the decline in the growth of income by paying hitherto unknown levels of attention to the formation and management of savings" (Suzuki, 1987, p. 4).

Another significant concurrent development was the emergence of the government sector as a deficit unit because of its expansionary financial policy pursued in the post-oil-crisis period. Thus, Japan's financial market experienced dramatic structural changes as the corporate sector declined in importance as the major deficit sector, and the households continued to save while growing more sensitive to yields on their assets. And for the first time in the postwar period, Japan's underdeveloped (caused by governmental restrictions) securities market began to develop because of the necessity to finance government deficits, an ironical turn of events that made Japan's financial industry yield-sensitive, that is, more market-oriented than regulation-constrained.

Moreover, the government's reliance on the bond market contributed to restructuring the mechanism of financial flows away from *indirect* finance and more toward *direct* channels, and this change put the banks in a bind. Since interest rates at banks were strictly controlled, they were not able to respond to the increased preference for high-yielding assets on the part of corporations and individuals (Suzuki, 1987, p. 31). The households were later also attracted by the 1980 new provisions in the state-run postal savings program that allowed the issuance of ten-year, high-yielding, fixed-interest deposits that could be withdrawn after only six months without penalties. Consequently, banks themselves had to introduce financial assets in order to survive the competition stemming from both the securities companies and the postal savings system.

4. Direct Finance and Deregulation Asymmetry across Borders

The abrupt end to banks' privileged position as the citadel of bank-loan capitalism during the high growth period thus entailed miseries, especially aggravated by the uneven process of deregulation and the opening of Japan's financial market for foreign competitors that began in a piecemeal fashion during the late 1960s and 1970s. Above all, Article 65 of the Securities and Exchange Law (modeled on the Glass-Steagall Act of the United States) that prohibits banks from underwriting and dealing in securities other than public bonds became the banks' major obstacle to prosperity in the newly arrived era of direct finance. As one observer put it,

> From the standpoint of Japanese bankers ... the most consequential trend, unquestionably, is that *both* Japanese banks and foreign banking institutions that compete with them are experiencing a declining share of total fund flows through both the Japanese financial system and the international financial system, as securities markets and nonbank financial service firms become more important. *This adverse trend for Japanese bankers has given powerful impetus to them to expand overseas particularly into the United States, and to seek favorable regulatory concessions at home* (emphases added; Rose, 1991, p. 51).

In a similar vein, other studies also interpreted deregulation, along with other global trends in financial services, as the primary cause of Japanese banks' overseas expansion. Duser (1991) presented the following analysis:

> ... the deregulation of the respective areas of the Japanese financial system parallel with the 'securitization' trend in financial markets resulted in such a risky domestic business situation that the banks' top managements were easily persuaded to *expand into overseas banking and securities markets*. Conflicts of scope between the different groups of financial institutions which became deregulated also intensified. After the implementation of the postwar financial system in Japan, direct competition between different groups of financial institutions had not existed for twenty years and even among institutions of the same group it was severely restricted by the strength of corporate relationships and strict price (*i.e.* interest rate) regulations. And the worldwide trend towards 'securitization' widened the price differentials between banks' loans and marketable debt instruments to such an extent that the large corporate customers in Japan increasingly looked to finance themselves with bonds and equities. This tendency to find direct means of finance, in combination with the borrowers scaling down their fund demand as a result of the slow-down in economic growth, at the same time meant that banks were losing considerable shares of their core business corporate lending to the capital markets because they were (and still are in principle) barred from corporate bond underwriting in Japan ...
> ... Their answer was a strategic shift of which *the expansion of their international operations was not the only but a major element.* This shift aimed at improving competitiveness versus old and new rivals, maintaining relationships with increasingly demanding customers and improving the bank's profitability (emphases added; pp. 75-76).

Thus, as a micro-level strategic action Japanese banks were clearly motivated to expand overseas in search of less regulated and more profitable market environments. In this regard, furthermore, Duser viewed the Japanese phenomenon not as something peculiar to Japan but as part of the global trends that had been developing in the industrialized world.

In addition, the process of deregulation in Japan had a unique twist; the foreign operations of financial institutions were liberalized more rapidly than their domestic counterparts. For example, the interbank market was still regulated at home, while Japanese banks were allowed to operate freely in the overseas interbank markets, especially in the Eurodollar market. This asymmetric reform as a factor for offshore banking was stressed by Takeda and Turner (1992, p. 86).

> A significant proportion of interbank transactions was driven by various restrictions in the domestic market. The existence of interest rate controls in the domestic market combined with progressive deregulation of the financial system (which allowed banks greater freedom to undertake international business) gave rise to profitable arbitrage opportunities between the domestic and international yen markets. In this sense, it was the – somewhat inconsistent – maintenance of controls in one area (interest rates) and their relaxation in another (capital flows) that led what was essentially domestic business to be exported abroad.

This type of cross-border operations designed to take advantage of inconsistencies in regulations or laws is, indeed, typical of multinational corporations' behavior in all industries, and is known as

the "institutional arbitrage" (Kogut, 1983). For example, transfer pricing is a well-known mechanism used by multinationals in all industries to benefit from differential tax rates; environment-sensitive investments likewise capitalize on differences in environmental regulations.

Equally interesting are two other observations made in Takeda and Turner (1992). The first is that Japan's interbank market thus transnationalized served to channel foreign-currency denominated long-term loans back to Japanese nonbank residents who, relieved from exchange rate risk, eagerly purchased foreign bonds – as well as to the overseas affiliates closely connected with Japan's nonbank industries (namely, Japan's FDI). The second is that Japan's overseas banks raised short-term liabilities (*i.e.*, borrowed short) and acquired long-term assets (*i.e.*, lent long) through financing FDI by Japan's nonbank corporate customers, particularly during the latter half of the 1980s.

Hinted here is a close linkage between Japan's banking and its nonbank corporate sector in overseas investment activities, a theme on which our conceptual framework of analysis can shed supplementary light in terms of Japan's experience of bank-loan capitalism and the macro-level strategic shift away from trade primacy and toward greater FDI orientation.

5. Real- and Money-sector Linkages: Concomitant Shifts from the Trade Mode to the Multinational Operation Mode as a Structural Necessity

Our additional – and supplementary – explanation is based on the banking sector's more fundamental link with the corporate sector: "For most domestic banks their first experience in transactions external to their country of operation came through their dealings in foreign exchange, and in the financing of trade for their domestic customers. That is, the base from which most multinational banking operations developed was their own customers' foreign exchange and trade requirements in other countries" (Weston, 1980, p. 285) This tandem form of banks' overseas operations is well conceptualized in the "follow (or lead)-the-customer" theory of multinational banking (Grubel, 1977).

This money-and-real-sector linkup was, however, more deeply developed and more distinctly pronounced in Japan because of its bank-financed development experience during the high growth era than in any other country. In contrast, American – and for that matter, British – banks are, on the whole, more arm's-length oriented in their relationship with their corporate customers because nonfinancial business enterprises themselves have traditionally been averse to being dependent on external sources of funds, especially bank loans.[16]

And most importantly in our analysis, Japan's intersectoral nexus *itself* became multinationalized simultaneously as Japan metamorphosed from the trade-based economy to a more FDI-oriented economy, when Japan's postwar economic development progressed through Phase II structural upgrading (*i.e.*, heavy and chemical industrialization) and on to the next stage (Phase III) of assembly-based industrialization, as emphasized earlier.

Our evolutionary macro-developmental perspective, as schematically illustrated in Figure 2, can be summarized as follows:

a) A huge success in building export competitiveness (derived initially from Phase I/Phase II structural upgrading – and soon from Phase III) created opportunities for trade finance and trade-related dealings in foreign exchange. For that era of trade primacy (1950-1970), international banking alone was mostly sufficient for Japan's trade-focused developmental purposes, and the establishment of overseas banking outposts was permitted to only a limited number of selective banks (initially, only the Bank of Tokyo as Japan's sole foreign exchange bank and later a small number of big *keiretsu* banks). Their overseas business activities were restricted mainly for the purpose of assisting Japanese industry in developing home-based trade-competitiveness.

b) Yet the era of home-based manufacturing and exporting soon ended in the early 1970s. For both internal and external reasons (that included labor shortages, rising wages at home, the rapidly appreciating home currency, and trade frictions abroad), the corporate

[16] For example, "The early American entrepreneurs developed a fetish about self-financing. Even when, pressing on all fronts to expand, they were hamstrung by shortages of capital, they resisted any form of outside financing, seeing it as a dilution of their personal control. Henry Ford was the extreme example: he never sold. The firm's entire expansion was financed without public sale of equity and without bank loans" (Piore and Sabel, 1984, p. 70).

(*i.e.* real) sector rapidly went multinational mostly in order to replace (substitute for) exports via local assembly/manufacturing operations in the advanced countries and to seek low-cost labor in the developing countries.

The end of Phase II industrialization also meant an end to bank-loan capitalism and Japan's high-growth period, and Japanese banks suddenly lost their privileged position at home. *Asset dominance* (banks' high asset-capital position) was the ineluctable feature of Japan's bank-loan capitalism in which banks were accustomed to the "over-lending/over-borrowing" banking practices.

They were even confronted with the unprecedented competition emanating from the deregulation and internationalization (liberalization) of Japan's financial industry. This development also coincided with the global trends toward the homogenization of the financial industry and the rise in securitization.

At the same time, however, the corporate sector's shift toward multinational operations created new opportunities for their closely affiliated banks to follow and manage FDI-related finance and banking. As shown in Table 2, city banks, especially *keiretsu* banks, vied with each other in setting up overseas subsidiaries, branches, and representative offices. Throughout the 1960s only 43 overseas outposts were approved and established. But once the high growth era of trade primacy ended, the number climbed sharply. It added a total of 326 more outposts in the 1970s and a total of 730 more outposts in the 1980s.

Indeed, the Japanese banks were so eager to establish overseas operations that the Ministry of Finance had to guide their overseas advances lest the gradual deregulation and opening of Japan's financial market be jeopardized by the clamor for reciprocity from other countries.[17] The rapid growth of foreign banks' operations in Japan (measured in terms of the number of their banking facilities as shown in Table 2) occurred in close parallel to the overseas advance of Japanese banks subsequent upon the onset of the low growth era.

[17] Even now, for instance, each spring or fall those Japanese banks that are planning to open overseas offices, branches, and subsidiaries must apply for permission from the Ministry of Finance.

TABLE 2

ESTABLISHMENT OF JAPANESE BANKS' OUTPOSTS ABROAD AND FOREIGN BANKS' OUTPOSTS IN JAPAN

	1960-64	1965-69	1970-74	1975-79	1980-84	1985-89	Total*
Japanese banks abroad							
Branch[1]	15	11	45	28	51	99	275
Subsidiary[2]	1	1	36	25	60	145	269
Rep. office	9	6	92	100	178	197	441
Sub-total	25	18	173	153	289	441	985
Foreign banks in Japan							
Branch[1]	4	5	38	18	26	27	121
Subsidiary[2]	0	0	0	0	0	9	9
Rep. office	7	25	64	35	53	58	131
Sub-total	11	30	102	53	79	94	261

* Total of existing outposts at the end of 1989. Annual figures may not add up to a total of existing numbers due to mergers and cessation of operations.

[1] Recorded on the basis of opening.

[2] Subsidiary means more-than-50%-owned ventures.

Source: Compiled from Ministry of Finance, *Kokusai Kinyukyoku Nenpo* (Annual Report of the International Finance Bureau), various issues, as presented in Economic Planning Agency, *Gurobaruka suru Kinyu Shisutemu* (The Financial System under Globalization), Tokyo, 1990, p. 133.

c) Japanese corporations' FDI soared phenomenally, especially after the Plaza accord of 1985 that triggered a sharp appreciation of the yen. The upsurge of FDI in the 1986-89 period amounted to $170,246 million compared to the previous upsurge of $49,220 million in the 1978-84 period.[18]

Included in Japanese statistics on FDI are, however, the long-term intra-company loans (debt with maturities exceeding one year) extended from the Japanese companies to their overseas subsidiaries and joint ventures. And in many cases direct loans are much larger than equity capital transferred, especially when short-

[18] The 1986-89 upsurge actually represented the third wave of Japan's foreign direct investment in the postwar period. The first upsurge of $8,259 million occurred in the 1969-73 period. Ministry of Finance, *Zaisei Kinyu Tokei Geppo* (Fiscal and Monetary Statistics Monthly), various issues, as compiled and reported in JETRO, 1991, p. 16.

term intra-company loans (working capital) are included.[19] This is usually the case with Japanese FDI in the developing countries. For example, it is said that in Thailand only one-third of Japan's FDI is equity and that debt (loans) comes from their parent companies and from the local banks, inclusive of Japanese affiliates – and often under the guarantees provided by Japanese bank affiliates in third-countries such as Hong Kong.[20]

An official survey (made at the end of March 1990) of Japanese multinationals' activities abroad revealed that 47% of long-term intra-company loans were raised locally, and that as much as 60% of those locally financed loans came from the local affiliates of Japanese banks.[21]

This very high debt/equity ratio of Japanese FDI is reminescent of – and in fact, reflective of – the financial practice of Japanese industry during the high growth era of bank loan capitalism. And it also indicates how closely Japanese banks are working with their nonbank corporations in financing the latter's overseas investments and operations.

d) But as a legacy of bank-loan capitalism during the high growth era, Japan's major banks competed vigorously with each other in assisting the overseas expansion of their corporate customers. Market share expansion under fierce inter-*keiretsu* rivalry resulted in *low profit margins*. One estimate says that Japanese overseas branches earned only 2% on equity; "pathetic returns ... well below what it cost to fund the assets offshore".[22]

On an individual bank basis, they had little ownership-specific strengths *qua* financial institutions other than their intimate ties with corporate customers and the cheap money they were able to draw

[19] The rule of thumb is that these overseas intra-company loans are about 3 to 5 times their corresponding equity capital invested. In 1992, for example, the Ministry of International Trade and Industry which administers the overseas investment insurance program extended its coverage to intra-company loans for Japanese investments in the Commonwealth of Independent States (former Soviet Union) within the limit of $1.8 billion, including the coverage of equity capital. *Nippon Keizai Shimbun*, May 9, 1992, p. 7.

[20] Tokunaga, 1992, p. 153.

[21] MITI, 1991.

[22] "Japanese banks: America cracks down", *The Economist*, January 18, 1992, pp. 80-82.

upon at home (until the Tokyo stockmarket collapsed in 1989).[23] In fact, Japanese banks are not really the leading innovators of financial services and risk-management techniques, although they are quick to learn from overseas competitors and adopt new financial services.[24] (In this regard, the conventional corporate-asset-based – micro-theoretic – models of multinational banking[25] seem rather helpless in the face of the growth peculiarities of Japanese multinational banks.)

e) In short, the growth peculiarities of Japan's multinational banking (the rapidity of overseas expansion, the asset dominance or the low equity-asset position, and the low profit margins for overseas operations) all have been reflected in the *legacies* of – the persistent behaviors molded out of – the era of Japan's bank-loan capitalism that had lasted largely until the end of the 1960s. And the "habits" of Japanese banks in financing corporate investment have been duplicated in the simultaneous overseas expansions of both the banking (money) sector and the industrial (real) sector ever since Japan began to move away from trade primacy and more towards the FDI-dependent economic structure.

[23] One study estimates that over the period of 1982-1991 the "cost of equity" (the required return on equity) in Japan was 5.06% on average compared to 7.81 in the United States: "In Japan, higher household savings made for lower equity costs. In addition, smoother growth in Japan, resulting in part from successful macroeconomic policy, meant lower risk in profits, and lower risk in profits meant lower costs of equity" (McCauley and Zimmer, 1991, p. 17 and p. 19). Another study shows that the "average real long-term interest rate" (nominal yield less past three years' inflation) was 4.2% in Japan over the 1983-90 period compared to 5.0% in Germany, 5.1% in France, 5.1% in the U.K. and 5.4% in the U.S., although the real short-term interest rate was lower on average in the United States than in Japan during the latter half of the 1980s (Howe and Pigott, 1991-92). During the 1980s when Japan's multinational banking recorded an explosive growth in terms of either share of international bank assets or number of overseas outposts, Japanese banks were thus basically enjoying a relatively low cost of long-term funds, one of the home-location-specific advantages they were able to draw on, although Japanese overseas banks did borrow short in a lower-cost short-term money market abroad.

[24] A recent survey on the performance of foreign financial institutions in Japan reveals that foreign banks have developed lucrative niche businesses in derivative products, such as swaps and options, while foreign brokerage houses in stock futures options. "Foreign banks, brokers press into niche markets", *The Nikke Weekly*, February 22, 1993, p. 17. This development partly provides evidence that foreign institutions possess superior technical skills in introducing new financial products.

[25] For an excellent study of the firm-specific advantages of banks in different strategic forms and manifestations, see Smith and Walter, 1990.

6. Conclusions

The preceding analysis provides an underlying, encompassing, and basic framework that can capture the Japanese phenomenon of multinational banking as an intertemporal evolutionary/institutional process, a concomitant of Japan's economic development which in its early stages (in the 1950s and 1960s) required only international banking – but in step with its structural upgrading, full-scale multinational banking has emerged as an *organic structural* necessity.

Throughout the postwar period of two and a half decades, Japan concentrated on building trade-competitive industries at home by making the best use of large-scale city banks as providers of loanable funds for their affiliated *keiretsu* enterprises. A need for capital was keenly felt during the second phase of postwar reconstruction and expansion aimed at building up heavy and chemical industries, highly physical capital intensive sectors. Japan's banking industry was secluded under protection and heavily controlled by the government as an instrument to finance economic development at home. Trade-supportive international banking alone was permitted during the high growth era.

Yet the arrival of the low growth era in the early 1970s, coinciding with the third phase of industrialization centered on consumer-oriented, parts/components-intensive industries such as automobiles and electronic goods, brought about a departure from indirect finance and a move toward direct finance in corporate capital formation. Simultaneously, the non-bank corporate (real) sector's need for FDI rose in its effort to retain and expand its overseas markets initially captured through exports, and the banking (money) sector led or followed its customers with whom the latter had cultivated close affiliative relationships during the high growth era of bank-financed development at home. Bank credit capitalism was transformed into bank credit multinationalism.

The distinctive features of Japan's multionational banking, namely, the sudden and swift rise in overseas banking after the high growth era, the low capital/asset ratios, and the low overseas profit margins – *and* the key role in heavily leveraging Japan's FDI, can only be understood within the stage-theoretic macro-developmental (historical perspective) framework introduced above.

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