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# Micro-aspects of monetary policy: Lender of Last Resort and selection of banks in pre-war Japan

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**Abstract**

This paper explores how the Bank of Japan (BOJ) dealt with the trade-off between stability of the financial system and the moral hazard of banks in pre-war Japan. The BOJ concentrated Lender of Last Resort (LLR) loans with those banks that had an established transaction relationship with the BOJ. At the same time, the BOJ carefully selected its transaction counterparts, and did not hesitate to end the relationship if the performance of a counterpart declined. Further, the BOJ was selective in providing LLR loans. Through this policy, the BOJ could avoid the moral hazard that the LLR policy might otherwise have incurred.
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## 1. Introduction

Since Bagehot (1873), the central banks of many countries have come to adopt the role of Lender of Last Resort (LLR), and we have a rich store of theoretical and empirical literature on LLR (Goodhart, 1985; Miron, 1986; Bordo, 1990; Goodhart and Huang, 2005 , among others). According to the "classical view" of the LLR, the Central Bank should

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prevent illiquid but solvent banks from failing by lending money at a penalty rate (Bordo, 1990, p. 19). That LLR lending has been effective in preventing bank panics is well established (Bordo, 1990; Butkiewicz, 1995; Miron, 1986). However, as Goodhart (1985) argues, it is difficult for central banks to distinguish between solvent and insolvent banks. Therefore, the bank as the LLR is faced with a trade-off between the stability of the financial system and moral hazard (Cordella and Yayati, 2003).

Drawing on the experience of the United States and Europe, Bordo (1990, p. 9) states that "[a]ssistance to insolvent banks was the exception rather than the rule until the 1970s... [t]he monetary authority in earlier times erred on the side of deficiency rather than excess." However, not so much is known about how the central banks have dealt with the trade-off. In this paper, we address this issue focusing on the Bank of Japan (BOJ) in the period before the Second World War. The Japanese financial system became unstable in the 1920s and the BOJ actively played the role of LLR. We explore how the BOJ selected the banks to be bailed out and what implications the BOJ's policy had.

In the literature on Japanese financial history, Ehiro (1920) and Ito (2003) review the role of the BOJ as the LLR during this period. As they point out, the LLR loan by the BOJ was a major policy tool for stabilizing the financial system of the 1920s. In another strand of the literature, Yabushita and Inoue (1993) found that the probability of bank closure during the financial crisis of 1927 was negatively correlated with the profitability and the ratio of risky assets of a bank. Okazaki (2002) and Okazaki et al. (2005) confirmed this result using data regarding a wider range of bank exits. Yabushita and Inoue concluded that bank closures during the financial crisis of 1927 were not contagious.[1] In the context of this paper, this interpretation suggests that the LLR loans by the BOJ successfully prevented financial crises from becoming contagious. Further, the negative correlation between bank performance and bank closure suggests that the LLR loans did not impair the selection mechanism of the market, by bailing out insolvent banks. In other words, it seems that the BOJ could deal with the above trade-off reasonably well.

In order to understand how this occurred, it should be noted that the BOJ was selective in its provision of LLR loans, and that LLR loans were crucial for banks (Ishii, 1980). Ishii (1980) indicated that those banks which already had transaction relationships with the BOJ were the main recipients of LLR loans, and that those banks, for the most part, were large-sized ones.[2] Referring to this fact, this paper will examine how the BOJ selected its transaction counterparts, using internal documents from the BOJ and bank-level quantitative data.

The BOJ archives hold the original documents on the individual openings and closings of transaction relationships with private banks in the pre-war period. I look at how the BOJ evaluated banks that applied to open a transaction relationship, and how it made the decision to approve or reject such applications. *Nihon Ginko Enkakushi* (*The History of the BOJ*) also contains comprehensive records of the individual transaction relationships between the BOJ and private banks.[3] Based on these materials, a database of the

[1] Korenaga et al. (2001) reexamined their proposition by discriminating between two waves of bank closures in 1927 and found that while the second wave was contagious, the first was not. It is important to explore how the LLR loans from the BOJ affected these attributes of the bank closures.

[2] Following Ishii (1980), Shiratori (2003) argues that the BOJ's selective stance was based on its policy of maintaining the value of the currency in preparation for the return to the gold standard.

[3] *Nippon Ginko Enkakushi* is an unpublished series of volumes on the BOJ's history, as edited by the BOJ.

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