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The political economy of SME financing and Japan's regional bank problems ☆

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Abstract

Japan's regional bank problems are accumulating non-performing loans, lack of diversification, and the absence of effective competition. We argue that the problems should be addressed in conjunction with the financing of small and medium enterprises (SMEs) and the political interests of the central and regional governments. The political interests may necessitate funding suboptimal investment projects of regional SMEs or keeping non-performing SMEs alive. In particular, loan repayment guarantees reduce the banks' incentives to screen loan applications, increase the chances that poorer quality projects get funded, and harm competition by deterring entry of other banks. We also offer some policy implications.

JEL classification: G21; G28; R51
Keywords: Japanese regional banks; Small and medium enterprises; Political economy; Loan repayment guarantee

1. Introduction

Over the past years, there has been some progress in rehabilitating Japan's banking sector. The major banks have reduced the stock of their non-performing loans (NPLs) from 8.4% of total

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lending in March 2002 to 4.7% in September 2004 (OECD, 2005).[1] For the first time in many years, the top six banks, excluding Resona, had reported a combined net profit of 944 billion yen for the period of April–September, 2003, thanks to economic recovery and rising stock prices. Despite decreasing NPLs among large city banks, however, regional banks have been slow in disposing of their bad loans, culminating in the nationalization of Ashikaga Bank in November 2003. As of September 2003, regional banks carry 44% of Japan's NPLs, accounting for 4.6% of their total loans. Concerns over the slow progress in restructuring regional banks have been echoed in the comments by, among others, the OECD and the IMF.[2] What are the main problems regional banks are facing? Why have regional banks been slow in reform? What are the obstacles and how can they be addressed? This paper attempts to offer some insight to these questions.

The problem of regional banks is inextricably linked to small and medium enterprises (SMEs) in the region. The survival of regional SMEs is in turn closely related to the political interests of local governments. It is thus imperative to understand the nature of relationships among regional banks, SMEs, and local governments. As of March 31, 2004, there are 64 regional banks in Japan.[3] Unlike large city banks whose customers are relatively large corporations, regional banks focus their business mainly on retail banking and the majority of their loan customers are SMEs in the region. Although the definition of SMEs varies in different countries,[4] SMEs employ roughly a half of the US and two-thirds of the EU workforce. SMEs rely heavily on bank financing. Their share of bank debt to total debt in G10 countries is around double that of large firms and, in some countries, exceeds 60% of all debt. Large part of SMEs' bank debt is from small regional banks (Takats, 2004). In Japan, SMEs account for 99.7% of all enterprises (4.69 million enterprises in 2001), represent 70.2% of all employment (29.96 million people in 2001),[5] and their employees constitute 80% of voters. In return, SMEs account for 70 to 80% of the revenue for Japan's regional banks. Table 1 shows the breakdown of total loans to SMEs from various financial institutions.

How is SME financing different from that of larger corporations? First, there are scale economies in lending: per unit cost of screening and monitoring a loan decreases as the size of loan increases. If firm size is positively related to loan size, then the average cost of serving SMEs is larger than that for larger firms. Second, banks suffer more from acute information asymmetry with SMEs than with larger firms, which again necessitates larger screening and monitoring costs. Information asymmetry is also one of the factors that keep SMEs from using direct financing. To an extent, such costs of information asymmetry can be reduced through relationship banking or collateralized loans. While banks have resorted to such mechanisms in Japan, the government's loan repayment guarantee has been the most influential and controversial in SME financing. We discuss this below.

The close ties between regional banks and local governments play an important role in the relationship between regional banks and local SMEs. Regional banks are the designated financial institutions of local governments, which implies that tax payments, government transfers, public officials' salaries, and other public funds represent stable sources of cash flow into regional banks. Regional banks also assist with the promotion of regions through their activities as underwriters

[1] For the year to March 2004, NPLs have decreased from 5.3% of all loans to 2.9% at Mitsubishi Tokyo Financial Group, from 8.4% to 5.0% at Sumitomo Mitsui Financial Group, and from 6.3% to 4.4% at Mizuho ("Better, not well", The Economist, May 27, 2004).

[2] OECD, 2005; "Regional banks endangering economy", The Japan Times, April 7, 2004.

[3] Since 1989, 65 new regional banks were created from what used to be referred to as 'Sogo Banks'. These secondary regional banks perform more or less the same functions as the original 64 regional banks.

[4] See Schaede (2004), for example.

[5] Source: Small and Medium Enterprise Agency (http://www.chusho.meti.go.jp).