

How Japan leveraged commercial banks for high economic growth

Privatising banks is no panacea. Instead, India would do well to learn from Japan's 'window-guidance' system that first identified which sectors are most likely to achieve national macroeconomic objectives and thereafter ensure that these sectors receive credit cheaply and to the extent required

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Representative image

- Profit maximization by banks at the micro-level will not automatically achieve high rates of macroeconomic growth - Instead, Japan chose a system of 'window guidance' where they identified sectors most likely to achieve national objectives and ensured that cheap credit went to them-They directed credit to industries that could quickly grow in size and competitiveness

- Propelled by this strategy, Japan entered a phase of strong growth in the 1950s

In an exclusive interview with [Moneycontrol](#), former Reserve Bank of India (RBI) Governor Duvvuri Subbarao clearly articulated how India adopted a mixed banking sector, with the private sector focusing almost entirely on profit maximisation while public sector banks pursued social objectives, compromising on profits.

Between these two extremes, Japan leveraged commercial banking by using a strategy called 'window guidance' wherein the government induced its central bank, the Bank of Japan (BoJ), to ensure that credit reaches identified sectors or even specific companies to achieve its economic objective of rapid growth, rather than purposes 'social' in nature, as for instance, financial inclusion and lending to microenterprises. The latter objectives fall under the ambit of priority sector lending (PSL) in India, aimed at providing credit to weaker sections of society, which could not have been served by private sector banks motivated by profit maximisation.

To appreciate why governments may want to leverage commercial banking to achieve these objectives – be it economic growth or financial inclusion – it is important to understand the essence of modern banking. There are essentially only two institutions which create money as legal tender,

the state through its principal monetary institution, the central bank, and commercial banks. In a modern economy, most of the obligations that arise in exchanges are settled using commercial bank money, or what is generally referred to as deposit accounts or its financial liabilities (promissory notes). The widespread acceptance of bank money has resulted from the acceptance of bank deposits as legal tender in settling obligations, primarily payment of taxes by the private sector, owed to the state.

Commercial banking can be viewed as the extension and decentralization of the state's monopoly power over the issue of legal tender. Banks are not mere financial intermediaries in channelizing savings into investment; instead, they are institutions that overcome the savings constraint faced by an economy to provide finance to businesses – a prerequisite for production that generates new income and wealth, which in turn creates new savings.

When banks were *allowed* to create money that was legal tender, the question arose as to whom this money would go to. Banks in the private sector are driven by profitability and it is assumed that market forces in a competitive environment will drive them to follow prudential lending norms that balance risk and reward while at the same time, maximize their spreads by attracting customer deposits as a cheap source of reserve money required for interbank settlements. Private commercial banks are able to ensure credit is used effectively and efficiently by borrowers in profitable ventures that are by-and-large able to service as well as settle debts.

However, the moot question is whether profit maximization at the micro-level automatically achieves high rates of macroeconomic growth. Although some economists may argue that this is indeed the case, Japan chose a strategy that first identified which sectors are most likely to achieve their national macroeconomic objectives and thereafter ensure that these sectors receive credit cheaply and to the extent required.

The implementation of such a strategy began in the 1930s. Not only were specific industries protected through the passing of specific legislation like the 1936 Automobile Manufacturing Business Act, but they were also given access to long-term credit. Companies were weaned away from capital markets by the imposition of limits on dividends, making them less attractive to investors, while making them more dependent on commercial bank credit as their main source of finance. Simultaneously, consolidation of the commercial banking sector brought down the number of banks to just 61 in 1942 from more than 1400 in 1926 so that the system could be more effectively coordinated and guided by the central bank.

This strategy was further extended after the end of the Second World War when Japan's economy lay in tatters. To revive its economy, the Japanese government proposed to emulate the methods of the wartime economy; however, instead of providing support to manufacturers of weapons, they redirected support to industry and more specifically, to industries that could quickly grow in size and competitiveness. Without such intervention, finance would have naturally flowed into sectors which yielded quick profits and dividends but may not have been to compete internationally. Companies which failed to achieve targets were cut off from cheap credit. At the same, the government ensured protection to low-productivity sectors, which 'mitigated social frictions that would have been brought about by rapid growth of the leading industries.'

Propelled by this strategy, Japan soon recovered and entered a phase of strong growth in the 1950s. The huge increase in demand for credit put pressure on the BoJ to increase interest rates. To regulate the increasing volume of credit creation, the BoJ resorted to window guidance as a 'complementary tool' to ration credit, but it soon developed into 'independent tool' that could be used to provide

credit to targeted sectors without the need to raise interest rates that negatively impacted all industries, across the board. Window guidance became a permanent policy tool of the BoJ and was used effectively – both in terms of the speed and reliability in achieving desired results – along with accommodative monetary policy. Although the commercial banks were privately owned, restricting their ability to open branches and raise deposits made them more dependent on the BoJ for reserve money. The discount rate was held below the money market rate so that commercial banks found it profitable to cooperate with the BOJ's window guidance program.

The deregulation and liberalisation of financial markets in the 1980s led to the erosion of Japan's window guidance strategy, replacing finance from commercial banks with capital markets. This, along with the BoJ's accommodative monetary policy, may have ultimately resulted in Japan's bubble economy that expanded through the following decade but finally burst in 1990, a shock from which it has never really recovered.

While the window guidance strategy has been followed by other Asian countries like South Korea and China, implementing it in India may be fraught with challenges. Nonetheless, to argue that the distribution of credit by privatised commercial banks pursuing profits in a competitive market environment is the *only* effective and efficient system to achieve macroeconomic objectives would be historically naïve as revealed by the success of Japan's window guidance programme.

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