Summary of Discussion at Financial Markets Panel
(Thirty-fifth Meeting)

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Topic	**Local economies and finance in Japan today**
Dates	**Oct 8, 2015 ＜6:00pm-8:30pm＞**
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Issues for discussion

1. **Presentation by Mr. Goto followed by discussion**
2. **Presentation by Mr. Nagano followed by discussion**

Summary of comments

1. Presentation by Mr. Goto followed by discussion

Inoue (organizer):

・Today, in a first for the Financial Markets Panel, we discuss local economies and finance in Japan. This topic is not only important to understanding the transmission mechanisms of monetary policy but should also encourage useful exchanges of views with the Panel for Revitalization of Domestic Finance, which was launched as a sister group to this panel.

Mr. Goto (guest speaker):

・Today I would like to discuss two points regarding the relationship between macroeconomic policy and small and medium-sized enterprises (SMEs), drawing from my book Macro-performance of Small and Medium Enterprises, which was published about a year ago. The first concerns differences in the business cycle due to company size; the second, an approach to SME policy that takes into account prudential policy perspectives.

・ Regarding the first point, I would like to examine the correlation between large enterprises and SMEs using several economic indicators that provide breakdowns by company size: the industrial production indices, the business conditions DI in the BOJ's Tankan survey, real value added in the Financial Statements Statistics of Corporations by Industry, and my own

Stock/Watson-type composite index of business activity. One might assume that the two are naturally correlated, but that is not necessarily the case. If the oft-discussed trickle-down theory, which holds that higher profits at large enterprises will gradually filter down to SMEs, is correct, large enterprises will be the first to peak and the first to trough in the business cycle. Others have used the analogy of the rear set of wheels on a jet aircraft to describe SMEs. When the economy takes off they are the last to leave the ground, and when the economy comes back to earth in a recession they are the first to touch down.

・ There is an extremely strong correlation between large enterprises and SMEs, as indicated by the business conditions DI in the BOJ's Tankan. But while the trickle-down theory and landing-gear analogy may be valid at times, they are not robust theoretical structures when viewed over the longer term. Lag correlation coefficients show that, in the case of industrial production and the Tankan business conditions DI, large enterprises and SMEs respond at the same time to fluctuations in GDP. In the Financial Statements Statistics of Corporations by Industry (real value added) and my own composite index, SMEs lead large enterprises by one quarter, but that is not a particularly wide gap, and in general I think we can say there is a close correlation. When we directly analyze the lag correlation between SMEs and large enterprises using first differences or the Hodrick-Prescott (HP) filter, we find a lag correlation of zero in nearly all cases, with a couple of exceptions (when we used the HP filter to analyze real value added in the Financial Statements Statistics of Corporations by Industry and my own composite index).

・ Taking a different approach and applying the Bry-Boschan method for dating peaks and troughs in the economy, we find that SMEs lead large enterprises by one quarter in the case of the Tankan, Financial Statements Statistics, and my composite index, implying that any time lag between SMEs and large enterprises is quite small. Finally, when we use a Markov switching model to identify economic expansions and recessions and statistically examine the linkage between SMEs and large enterprises, the null hypothesis of perfect correlation was not rejected, while the hypotheses that they move independently of each other or that SMEs lead or lag large enterprises by one quarter were rejected.

・ One of the implications of these findings is that SME activity is useful as an economic variable. When reporting on the Tankan, for example, the media tend to focus on the results for large enterprises, but the BOJ shares the results of SME surveys conducted by its regional branch offices at its branch managers' meetings and elsewhere, indicating this type of information is useful in the administration of macroeconomic policy.

・ Regarding the second point, I would like to ask that you take a look at the list of SME policies. This list shows policies implemented over the last year and was originally presented in the Small Business White Paper. Unless one is an expert in the field, it is difficult to get a general feel for what is happening from the list alone. One reason why SME policy tends to be so complicated is that it contains elements that cannot be characterized purely as economic policy. It incorporates measures that can be described as social policy inasmuch as the government views SMEs as being "underprivileged" and tries to help them, and that goal is seen as being meaningful in and of itself. Still, it is problematic that people tend to view SME policy as a single entity without understanding that it involves a mix of features and intentions, as a result of which discussions are often not as fact-based as we would like.

・ Looking only at the economic policy aspects of SME policy, Kazuhide Uekusa, an expert on industrial organization theory, argues that while these measures are often presented as being part of broader economy-boosting measures, in essence they are more like microeconomic policies intended to rectify market failures. Of course it is not always clear where market failures can happen. An examination of the literature suggests one possibility is imperfect competition. In other words, SME policy is used as a countervailing force when large enterprises exercise monopoly power. There is also imperfect factor mobility. In other words, if labor and capital cannot move smoothly between different scales of businesses, the government may use SME policy to minimize the resulting inefficiencies. On this point, Prof. Ishikawa also noted that people employed by SMEs find it difficult to move to large enterprises. And given the less-than-thorough accounting procedures followed at some SMEs, imperfect information can also lead to market failures, and there may be R&D-related externalities.

・ While it is possible to streamline SME policy on the basis of market failures, a separate discussion is needed regarding what constitutes the appropriate scale or extent of such policy. Broadly speaking, we need to take into account government failures as well as market failures and give careful consideration to the balance between the two. SME policy often tends to receive unconditional support because it sounds like a good thing. The emotional argument that SMEs need help seems to be especially persuasive in the case of financial assistance. Interestingly, the complexity of SME policy is not something unique to Japan. A look at the work of European researchers, for example, suggests the situation is little different there.

・ While Japanese SME policy is quite complex, the fiscal expenditures involved are not particularly large. General account spending (initially budgeted amounts) is less than ¥200bn a year, or some 0.2% of total spending. Sometimes this figure is higher, as in 2009 when crisis response measures took it up to 2.9%. But in general we are looking at surprisingly small amounts.

・ Nevertheless, we also need to take into account of invisible costs when trying to determine the real cost of SME policy. For instance, there are supplementary budgets, which would include such things as crisis measures. Financial support measures are also complicated. For example, the measures themselves are often routed through government-affiliated financial institutions or credit guaranty associations, which means the initial fiscal outlays are small, but if many of the SMEs receiving assistance ultimately fail, the related losses will ultimately be borne by the central government. When we also take into account the cost of lost public funds, the amounts involved can become significant. Tax revenues also decline. I have seen estimates that value the total tax reductions for SMEs at ¥500bn.

・ Recently, financial support has constituted more than half of all support for SMEs, and about half of the remainder consists of personnel costs related to chamber of commerce staff, etc. It can therefore be surmised that only a very small amount of the funds spent on SME measures actually reaches the SMEs. On the whole, SME policy is very complex and, like an onion, offers a variety of different aspects as the layers are peeled away.

Mr. Hosono:

・ When you examined the four data series, were there any major differences in the magnitude of fluctuations at large enterprises and SMEs? Also, you said that employment was the one area in which the two groups exhibited different lag correlations. Is this because large enterprises have greater adjustment costs due to the lifetime employment system?

Mr. Goto (guest speaker):

・ As for your first question, fluctuations generally tended to be larger at large enterprises. Large enterprises had larger standard deviations for the industrial production indices and Financial Statements Statistics of Corporations (real added value), while the only series for which SMEs had a larger standard deviation was my own composite activity index. Interestingly, the fluctuations in employment were also greater at large enterprises. Analysis of different timeframes may produce different results, but this may reflect the fact that large enterprises also make significant adjustments to their payrolls via the mechanisms of part-time and temporary employment. I also looked at the correlation between GDP and the gap in jobs growth rates between large enterprises and SMEs, in line with some US research. What I concluded after calculating the correlation coefficients for a variety of data sets was that—just as in the US—there was a positive correlation between the two, which indicates that employment at large enterprises tends to fluctuate more in response to fluctuations in GDP.

Mr. Hosono:

・ In terms of the lag correlation between the indicators for large enterprises and GDP, why is it that at time zero there appears to be almost no correlation?

Mr. Goto (guest speaker):

・ It may have to do with the fact that SMEs are defined differently in different indicators. For instance, the Labour Force Survey looks at businesses with at least 100 employees, whereas the Census of Manufactures makes a number of changes to how employees are classified. It may also be related to the use (or non-use) of the Hodrick–Prescott filter.

Mr. Kitamura:

・ What percentage of SMEs are you covering here?

Mr. Goto (guest speaker):

・ The Census of Manufactures (business data), which is an exhaustive survey, covers all manufacturers. The Labour Force Survey, meanwhile, is a sample-based survey and does not provide the same degree of coverage.

Mr. Kitamura:

・ This kind of analysis also needs to take into account the different market structures of each industry. For instance, the impact of economic fluctuations would be different in an industry consisting of a handful of huge firms and a large number of SMEs and one in which numerous SMEs of a certain size are competing for a dominant market position.

Mr. Goto (guest speaker):

・ I looked for similar research, but the only example I found that took business size into account when analyzing economic transmission mechanisms was a study using the DSGE model. If we go further back, Gertler and Gilchrist studied the response to financial shocks of firms of various size, but they did not delve deeply into the responsible mechanisms and simply emphasized that SMEs respond more strongly to such shocks.

Mr. Kitamura:

・ If it is necessary to deal with market failures resulting from imperfect competition, why doesn't Japan implement the kinds of anti-trust and pro-competition policies found in the US?

Mr. Goto (guest speaker):

・I think this has something to do with the history of Japan's SME policy. Although the roots of that policy can be traced back to the Meiji era in the late 1800s, the basic model was forged in the postwar years of the 1950s and 1960s. At the time it appears that policymakers discussed options similar to anti-trust policy that would have responded to large enterprises' exercise of monopoly or oligopoly power by breaking them up instead of by trying to protect SMEs. However, the Ministry of International Trade and Industry (MITI) was determined to foster internationally competitive industries and with them the large enterprises needed to support those industries. In the end, Japan's industrial policy opted for protecting SMEs instead.

Ms. Suda:

・The difference in the magnitude of fluctuations between large enterprises and SMEs is not uniform. There may be times, for example, when Tokyo's economy is strong but local economies are sluggish, while at other times the converse may be true. The question of whether a business is dependent on global or domestic demand may be more relevant than its size.

Mr. Goto (guest speaker):

・Although my research did not cover that issue, I agree with Ms. Suda's hypothesis. As large enterprises have much higher export ratios, they are more likely to experience large fluctuations because they are directly exposed to swings in external demand, whether in terms of production volume or the impact of exchange rates on earnings. It is estimated that the kinds of products produced by SMEs constitute about 20% of Japanese exports, with the sorts of products made by large enterprises responsible for the remaining 80%. Meanwhile, SMEs are responsible for 70% of employment while large enterprises account for just 30%.

Mr. Watanabe:

・I have also studied differences in the business cycle due to business size, so I find this discussion very interesting. What indicators does your composite activity index consist of?

Mr. Goto (guest speaker)

・I tried to use the type of data contained in the original Stock and Watson paper whenever possible, but this was often unavailable in Japan. Ultimately I chose to use the BOJ's Tankan (the capex DI), non-scheduled hours worked (overtime), and the number of new job offers. However, I think there is room to reconsider these choices, and different indicators may produce different results.

Mr. Watanabe:

・Regarding the lag correlation, I see that SMEs lag large enterprises by two quarters in the case of labor-related variables, while for the other indicators SMEs are concurrent or lead by one quarter. Does the "real" lag represent the average of these two quantities?

Mr. Goto (guest speaker):

・I think that is probably the case.

Mr. Watanabe:

・With your use of a Markov switching model, are you comparing whether or not the means for the industrial production indices at SMEs and large simultaneously switched?

Mr. Goto (guest speaker):

・Typically, macroeconomic Markov-switching models use a 2x2 transition probability matrix consisting of recession or expansion for the current fiscal year and the same for the next fiscal year. There is a precedent in the literature for expanding this to a two-country model and analyzing economic linkages, and that is what I based my research on. Basically, I replaced Germany and the USA in the original model with SMEs and large enterprises. That breaks down into four states for both this year and next year, so we end up with a more complex 4x4 transition matrix.

Mr. Watanabe:

・When we look at the probability of economic recessions and expansions, the severe drop in economic activity following events like the Lehman Brothers collapse and Japan's March 2011 earthquake means the estimates of ordinary models do not conform exactly to the economy's peaks and troughs. Hence we sometimes assume the error term has a t distribution. But you appear to be assuming a normal distribution, so perhaps there is room for improvement.

Mr. Goto (guest speaker):

・I experienced just the problem you speak of and therefore confined myself to data prior to the global financial crisis. Thank your very much for your advice on an important point.

Ms. Suda:

・Viewed over time, my impression is that SMEs previously led large enterprises, but that characteristic has gradually been lost.

Mr. Goto (guest speaker):

・I have yet to analyze the time-series characteristics in detail. Nevertheless, when I analyzed data up to the mid-1990s, I also obtained a result of no correlation lag between large enterprises and SMEs.

Ms. Suda:

・ The results seem to show that SMEs led large enterprises to some extent...

Mr. Goto (guest speaker):

・ I'm afraid I didn't explain the results very well. For example, SMEs clearly led large enterprises in capex-related indicators, and this trend is more evident the further back we go. I suspect it may be due to funding constraints or a similar factor.

Inoue (organizer):

・ Mr. Goto was kind enough to give the lead-off remarks at the meeting of the Panel for Revitalization of Domestic Finance the other day, and today he discussed a very different topic. I would like to ask for his views on the changing industrial structure for SMEs, something that was discussed in the first half of his book. Specifically, what are some of the major differences in today's industrial structure relative to the past, and what kind of impact does industrial policy have on SMEs?

Mr. Kitamura:

・ Mr. Goto noted the diversity of SME policy, but also said that most of these policies involve financial assistance. How should we interpret this?

Mr. Goto (guest speaker):

・ Small businesses are also heavily impacted by changes in the industrial structure. There is a very interesting difference between the manufacturing sectors in Japan and other industrialized economies. In the US, the UK, and continental European countries like Germany, France, and Italy, the percentage of total employment represented by SMEs declined through the 1970s but has since turned higher. I suspect this is attributable to the rise of mass production followed by its decline after the oil shocks in the 1970s. Japan was the only economy in which SMEs' share of total employment continued to decline even after the 1970s. One reason for this is that labor-intensive industries with large numbers of small operations, such as lumber and textiles, went into decline, while sectors dominated by large enterprises, such as electrical machinery and automobiles, increased their presence. Accordingly, even if the distribution of operations by business size remains constant within individual industries, a change in the industrial structure can reduce the relative weighting of SMEs. Another reason is the diminished presence of SMEs within individual industries. Although the standard view is that this is due to the difficult economic climate, the number of SMEs shutting down has not changed significantly over time—it is the decline in the number of new entrants that is driving this trend.

・ One possible reason for the decline in new entrants is that (what has in a sense been) excessive financial assistance for SMEs has hindered the replacement of the old with the new. Specifically, the protection of existing businesses with financial assistance may serve as a barrier to entry in various markets. I believe that since the 1990s, financial support has prevented the necessary rejuvenation of small business in Japan and thereby sapped the economy's vitality. For this reason as well, I think the growing share of financial support is something that should be reconsidered, as Mr. Kitamura noted.

Mr. Kitamura:

・ Even if that is true, I think public players have stepped in to help foster start-ups, a role that is not being performed adequately by private-sector financial institutions. If so, we also have to look at financial institutions' credit evaluation and risk-taking abilities.

Mr. Kozu:

・ Banks mostly provide debt and supply equity only in a limited way. If the problem is that equity was not supplied to small new start-ups sufficiently, I don't think we can hold the banks responsible.

Mr. Kitamura:

・ I'm speaking of broadly defined financial institutions, and not just banks.

Mr. Oshima:

・ As for the costs of SME policy, there have been times in the past when payments guaranteed by credit guarantee associations increased. The initial amounts budgeted for such payments were small, but the adoption of additional measures in supplementary budgets caused the costs to increase. At the same time, banks continued to supply funds to existing businesses via guaranty associations or in line with the SME Finance Facilitation Act, and ultimately I think they allowed firms to survive that should have closed down to stay in business, thereby weighing on macroeconomic productivity growth. I think this is also part of the reason for the decline in new entrants. Additionally, highly competitive SMEs often invest overseas early on in their development, which has probably affected the data regarding the number of domestic operations.

・ In addition to the fact that SMEs are protected by government policy and have functioned at the macro level as a jobs receptacle, another reason why employment fluctuations have been smaller than at large enterprises is that stable earnings at competitive SMEs have translated to relatively small fluctuations in payrolls.

Mr. Goto (guest speaker):

・ Another reason may be that SMEs find it difficult to hire when the economy is strong, forcing them to take a long-term perspective and hire during recessions, when labor market conditions are not so tight.

Mr. Oshima:

・ There was a time when banks had an urgent need to raise additional capital, forcing them to rely on guarantee association financing in order to continue supplying risk money under the Finance Facilitation Act. I suspect that while this helped maintain employment levels, as noted by Mr. Goto, it also depressed labor productivity growth and, from a macroeconomic perspective, led to the immobilization of economic resources.

Mr. Kozu:

・ Japan's financial supervisory authorities applied the concept of risk management under the Basel regulatory framework all the way down to shinkin banks. One specific approach was to claim that banks supply mainly debt and supply equity in a limited way. If the government had not bolstered its financial support for SMEs, I suspect we would have just seen an increase in small business bankruptcies without any increase in new entrants. The problem is that there are no major private-sector entities willing to provide necessary equity. There are not enough angel investors and not enough structures for finding sufficient wquity, which means people starting a new business are at risk of quickly losing all of their capital. Politicians mostly asked banks to play that roll of equity financing. Meanwhile, the BOJ and the FSA demanded banks to implement better risk management practices, so all that financial support for small business could achieve in the end was to minimize the level of bankruptcies and unemployment.

・So far we have not talked much about start-ups or innovations. An important reason why the government provides a great deal of financial support for SMEs is that banks are unable to provide enough equity inherently and therefor the government must supply equity using public money. Inasmuch as the current administration has emphasized the fostering of new businesses by SMEs—partly as a way of revitalizing local economies—financial support tends to play an increasingly large role within SME policy.

Inoue (organizer):

・ Mr. Kozu's remarks reminded me that one of the experts I spoke to while preparing for the Panel for Revitalization of Domestic Finance ked me where businessmen with a promising new idea go first when they need funding. The answer was the local government, which is generally able to provide ¥3–4mn in unsecured financing via a variety of subsidies.

Mr. Kozu:

・ I belong to a forum which organizes those who actively help revitalization of local economies. Most of the businesses that I see in local areas tend to be far smaller than, for example, the "small and medium-sized enterprises" surveyed in the BOJ's Tankan. People contribute small amounts of money they are able to invest, say a few million yen, as equity in businesses they trust in closed communites. Shinkin banks can then add debt to such businesses and thus it becomes possible for new small start-ups to take off the ground. I think adopting something like the LLP and/or LLC structure to facilitate equity financing is extremely important in terms of fostering new goods-and-services businesses in local economies.

Inoue (organizer):

・ What Mr. Kozu described is a kind of informal finance, but do these organizations have people able to assess the technology and business of the investment candidates? Many say Japan faces serious constraints in this area relative to, say, the US, where there is a large pool of people with start-up experience.

Mr. Kozu:

・ From a fintech standpoint, one possibility is to compensate for a shortage of experienced people with "big data" analyses and link the results to micro finance. I think the issue of small business startups could be addressed to a significant extent if this kind of science based micro finance could put down roots in local areas of Japan.

2. Presentation by Mr. Nagano followed by free discussion

Nagano (guest speaker):

・ Traditionally, central banks see the stable, efficient channeling of funds from entities with surplus funds to those in need of them as the central premise of their policies. For the BOJ as well, it is a key concern whether the banks and shinkin banks that are primarily responsible for financial intermediation are performing this role in a stable, efficient manner. The Financial System and Bank Examination Department where I work is engaged in this type of work.

・ The bubble's creation and subsequent collapse, the declining birthrate and aging population, and the concentration of industry in Tokyo are inevitably leading to a decline in workers' income outside the large cities. As the population ages, channels for the intermediation of funds from pension funds and other fiscal sources have become increasingly important. Some have begun to question whether regional financial institutions can continue to provide financial intermediation services in this climate. The FSA actually proposed asking regional financial institutions to assess their business operations with an eye to a possible merger with some other institution. The BOJ has also begun publishing papers with a comprehensive summary of relevant points to help regional financial institutions make appropriate business decisions. Today I would like to add to this discussion by drawing on those reports to discuss the current state of financial intermediation in local economies along with issues for the future.

・ An important role of the BOJ is to ensure smooth financial intermediation, paying attention to the survival of regional finance as an industry rather than a specific problem of individual institutions. But even if it is possible to envision a new kind of role for regional finance, there is the potential for contagious systemic risk unless we can achieve a smooth transition. In the end, we risk undermining financial intermediation or making it less efficient, which in turn could hinder economic activity. That sort of outcome must be avoided. In this respect, the BOJ looks at individual institutions from the viewpoint of its mutual relationships with the financial system.

・ Regional financial institutions historically had their own niches. But as regional economic activity gradually contracts and loan-to-deposit ratios decline, these walls are breaking down, particularly at the regional banks. The papers I mentioned earlier also note all the factors that have made the business environment more challenging for regional financial institutions, including a shrinking and aging population, the concentration of business in Tokyo and key regional cities, the interest rate environment created by zero interest rates and quantitative and qualitative easing, and competition with government-affiliated financial institutions like Japan Post Bank. The main reason why top-line revenues have not fallen precipitously is that the SME Finance Facilitation Act and monetary accommodation have kept corporate bankruptcies to an absolute minimum, taking credit costs down to abnormally low levels. It is arguable, of course, whether this is a normal situation or not.

・ The fundamental role of regional financial institutions is to help revitalize local economies. However, they have only three realistic options: to engage in high-volume, low-margin competition in major cities like Tokyo and Osaka; to take on risk in the securities portfolio in an attempt to generate profits; or to focus on cost-cutting. The FSA is in the position of requiring financial institution to think seriously whether they need integrations of business and mergers between themselves. The BOJ, while it agrees with the appropriateness of the proposal, thinks the proper approach is to prioritize in enhancing value-added for customers, and to regard integration of business as a measure. Namely, financial institutions may choose mergers when it is the most effective way to contribute to their economies and make profits. If this would not be the case, they need to find a way to survive on their own.

・ Some believe that financial institution earnings will eventually pick up if interest rates rise, but the experience of interest rate normalization at the start of the 2000s suggests it will be difficult to raise lending rates given the intense competition between financial institutions, and there are constraints on how much lenders can increase rates for borrowers with low credit ratings. All in all, rising interest rate is not a panacea. I think the challenges of local economies are structural in a sense, will require not only their own efforts, but also deregulations, subsidies and policy support for regional finance by the public sector. Public finance also need to clarify the supplementary role to the private finance..

・ Japanese finance has a number of different characteristics not found in the west. In the wake of the global financial crisis, western financial institutions faced a regulatory crackdown and were required to sharply rein in their balance sheets. Meanwhile, large-scale monetary accommodation caused a great deal of money to flow to asset managers and other players unaffected by the new regulation. Japan, in contrast, faces a variety of structural problems, some of which were described earlier, and indirect finance retains a dominant position. This makes it difficult for Japan's supervisory authorities to make a meaningful contribution to the global debate on these issues, in light of contrasting environments surrounding financial institutions between Japan and the overseas.

・ The BOJ maintains the stance that it will focus on the role of banks and shinkin banks as the main conduits of financial intermediation. At the same time, it thinks desirable to observe a reorganization of the financial sector via competition and market mechanisms in a voluntary manner. Comparisons of the cost of capital based on reforms to corporate governance and stewardship codes will also change the way banks are managed. Inasmuch as the institution of shinkin banking is based on the concept of sharing earnings with the local economy, they probably need to keep earnings to a level that is appropriate for the local economy rather than trying to boost profits at any cost.

・ The megabanks and regional financial institutions face very different risk management issues. The latter need the ability to manage risk while taking on risk in their securities portfolios, etc.

Important related factors include correlations with interest rate risk and other risk factors as well as their response to rising volatility. At the same time, management needs to be aware of the institution's cost structure and be able to determine what constitutes the optimal size for the investment portfolio. For the megabanks, with their global business operations, the first crucial task is managing foreign currency liquidity. The megabanks need to achieve greater stability in their foreign currency funding inasmuch as they are expanding by borrowing short and investing long. A second issue is the management of overseas credit risk. To the extent that the megabanks are acquiring local financial institutions as part of inorganic growth strategies, the management of growing local credit exposure will become increasingly important.

- One priority for regional financial institutions is contributing to the local economy by fostering industries capable of generating value-added, something that is closely related to the revitalization of local economies. Helping new start-ups and fostering existing businesses are both important in this regard. But as Mr. Goto noted, a growing number of local companies are going out of business. When we look at the number of employees, 4.19mn of the 5.41mn places of business in Japan had fewer than ten employees, while 640,000 had 10–19 employees and 400,000 had 20–49. The customers of regional banks tend to be the kinds of firms with around 300 employees that are surveyed in the BOJ's Tankan. In contrast, the customers of shinkin banks tend to be firms with fewer than 100 employees, and the number of such companies going out of business has increased sharply. One contributing factor is the difficulty of finding successors for current presidents, whose average age is nearly 60. No matter what industry we look at, more than half of all company presidents are over the age of 60, which makes the issue of succession a pressing one.

- With regard to the issue of succession, businesses have only two options: find a successor or go out of business. In the former case, the successor can be either a child or other relative of the current owner, an employee, or someone from outside the company (i.e., a merger or acquisition). But larger financial institutions find it difficult to deal profitably with firms having less than 300 employees in such cases. Even the large regional banks may take on only a dozen business succession cases a year, while private consultants tend to be shunned by many SMEs because of their high fees. The macroeconomic cost can be significant if the owner is too late to address this issue and the company ultimately goes out of business as a result. Not only are the intangible resources that have accumulated over the years lost, but costs are also incurred as employees transfer to other jobs or companies. The revitalization of local economies requires the smooth migration of labor and capital to more productive opportunities, and it would not be desirable to observe these businesses slowly go under.

- As Mr. Kozu indicated, a look at the various plans for the revitalization of local economies suggests that in many cases people are not aware of the PDCA cycle. The state of a local community five to ten years from now will depend first on demographics and second on the future vision of local businesses. As for demographics, we cannot meaningfully change the estimates provided by, say, the National Institute of Population and Social Security Research. What we can change are the future visions of local businesses, and in that sense financial institutions have a key role to play in supporting smooth successions at their client firms. Financial institutions have been criticized for not maintaining a sufficient dialogue with businesses and not prepared well. It seems that Non-financial firms would not rely on financial institutions to solve their own problems for the fear of losing relationships if they confess their challenges. Financial institutions have also their own problem of imbalances of cost-benefit for supporting business succession by their customers unless their sizes are above a certain amount.

- The next five to ten years, which will see an accelerated decline in the birthrate, an aging of the population, and a continuing concentration of economic activity in Tokyo, will be crucial to maintaining stable and efficient financial intermediation services in Japan's local economies. We will also have a better idea by then of the outcome of the competition between financial institutions. This may involve the reduction of costs through mergers. As for the revitalization of local economies, I think regional financial institutions could survive without integration of business, if they take advantage of the PDCA cycle and similar processes to perform the natural task of fostering businesses capable of providing the goods and services sought by local consumers. All in all, the future of local financial institutions is not decided.

Mr. Kitamura:

- Although the average age of company presidents is currently approaching 60, many of them took over the businesses from their fathers around 1990 and have run their businesses for the last 25 years. In that sense, succession is not impossible, and they have plenty of experience. Is the succession situation today substantially different from when the bubble burst?

Mr. Nagano (guest speaker):

・ We may need to examine whether the average age of company owners follows the aging of the broader population. I do not know the answer, but perhaps one of the panel members does.

Mr. Kitamura:

・ At the macroeconomic level, the entry of new businesses led by young owners will lower the average age of company presidents. This kind of change is clearly a good thing, but if we have a situation in which there are few new entrants and existing presidents stay on, the death of the latter may mean the death of the business.

Mr. Nagano (guest speaker):

・ This phenomenon is becoming more common in the manufacturing sector in particular. In non-manufacturing, the tendency for small retail businesses to become franchisees of a national chain in such cases makes it difficult to determine the true rate at which SMEs are closing down.

Mr. Kitamura:

・ At the social level, there is not only the question of how the baby-boomers can pass on their businesses but also that of how to smoothly manage the inheritance process.

Mr. Nagano (guest speaker):

・ The businesses confronting the greatest succession problems are the small operations without clear separations between corporate and personal affairs. The owners of such companies must deal not only with business continuity but also estate planning. The last part of my presentation was to claim that while there were shortage of outside supports for smooth succession, financial institution could play that role in the initial stages and thereby make profits.

Mr. Oshima:

・ Financial institutions also see providing support for the succession process as an important business issue. As Mr. Nagano indicated, the megabanks tend to focus on companies having at least a certain number of employees. In terms of the bundling of corporate and personal services, financial institutions are trying to provide small business owners with securities trading and asset management services in addition to banking. The actual implementation of such plans, however, appears to be quite difficult.

・ In my discussions with regional bank executives, I often hear concerns about interest rate competition with banks in Tokyo and neighboring prefectures along with the challenge of managing risk in the securities portfolio. For example, they are mindful of risk management (including efforts such as starting each new fiscal year afresh) in an environment where the investment focus may be shifting from yen bonds to foreign bonds, Japanese equities, or funds.

Inoue (organizer):

・ If these businesses are significant from a macro perspective but not large enough to be cost-effective for financial institutions to approach individually, couldn’t that justify government intervention as a response to a kind of market failure?

Mr. Nagano (guest speaker):

・ There is an SME support organization that targets companies with 10 to 20 employees, but it can only handle 100 to 200 cases a year, which is little more than a drop in the bucket. Ideally the financial institutions themselves would be willing to consult with extremely small business owners regarding these matters, but the results of questionnaire surveys suggest that many owners do not consult with their banks. In any case, there are limits to what government can do with firms of this size, and I think we should probably look for a solution based on market mechanisms. For the cases of larger firms with sales of 500 million yen or more, with 30 employees and more, or the firms reporting to Tankan survey, however, could have broader range of needs for business succession. If they could properly overcome the challenge with the assistance of outside players – financial institutions as initiators in particular, the problems of smaller firms could solved accordingly.

Inoue (organizer):

・ Or perhaps, in light of Mr. Goto’s presentation, we should pay more attention to the convergence of economic policy and social policy within SME policy.

Mr. Kozu:

・ Inasmuch as the population is shrinking, I do not think an increase in the number of businesses shutting down itself is necessarily a bad thing, although it is important to ensure that the rate of such closures does not exceed the rate of decline in the population.

Ms. Suda:

・ Are you saying that even if banks have SME-related expertise it is not cost-effective for them to utilize this knowledge?

Mr. Nagano (guest speaker):

・ For banks to have this kind of expertise, they need to work together with a wide range of professionals, including lawyers, accountants, and tax accountants. From a bank’s standpoint, it makes little sense to maintain a full staff of such individuals with the goal of securing a business opportunity (business succession) that occurs only once every several decades at its client firms. While the financial institutions that were first to focus on this area have gained a first mover's advantage, it remains to be seen whether they will continue to earn reasonable fees in cases related to the SME Finance Facilitation Act.

Mr. Kozu:

・ The logic regarding business succession is different at joint-stock companies and at private companies. An example of the latter which I came to across was: a current president of a sake brewery merely found a young person that he could trust and appointed him as his successor. Regional financial institutions may provide the same kind of information to regional managers . But the larger regional banks, which may have foreign shareholders and need investor relations with them, have to earn reasonable fees in doing such businesses, while shinkin banks and credit unions generally may face constraints in terms of human capital network and necessary knowledge.

・ In many local areas the population is declining faster than the birthrate would warrant, primarily because young people leave to go universities in large cities and never come back. As a result, some local businesses are forced to shut down as they cannot find qualified successors. Addressing this issue will require financial institutions to bridge human capitals between large cities including Tokyo and Osaka and regional areas. I think financial institutions should enhance this function. The argument seems all the same in case of M&As.

Ms. Suda:

・ I have heard that the inheritance tax also plays a role in the problem of business succession. Are there actually cases in which business owners have gone to Singapore and listed the company there to reduce their inheritance tax burden in Japan?

Mr. Nagano (guest speaker):

・ According to one survey, some 40% of the instances of business succession in Japan involve the smooth transfer of control to a relative of the current president, while another 55% involve the internal promotion of an employee or a leveraged buyout by a group of employees, with pure M&A deals accounting for just 5%. But given that some 60% of SMEs are forced to shut down because they cannot find a successor and that this ratio increases in reverse proportion to the size of the business, I think there is a significant business opportunity here. When, however, financial institutions play a role of supporting the succession in earlier phases, they should obtain the fair returns. With this regard, they may need to be eligible to obtain fees of broking real estates, which tend to be an issue for most succession cases. While it could cause oppositions by real estate brokers, more active reallocation of economic resources would result in revitalization of real estate market, which could benefit the brokers in the end.

Mr. Egawa:

・ Financial institutions normally do not charge appropriate fees when providing consulting services to small business owners. Although they try to recover the cost on their lending rates, it is questionable whether they are able to do so. According to BOJ statistics on the average contracted interest rate on new loans and discounts, the average rate of interest on new loans made by shinkin banks has fallen below 2%, which means banks earn less than ¥200,000 a year on a ¥10mn loan. Some of these institutions may be SME experts, but it remains to be seen whether such a role can be profitable.

Mr. Nagano (guest speaker):

・ That may be true if we look at relationships with client firms solely from the perspective of business succession. But when we look at the situation from the viewpoint of a main bank, developing a stronger relationship with a client firm can help it win a variety of business and contribute to its overall profitability. This includes the kinds of services—such as trusts and real estate—on which it is easy for banks to charge a fee.

Mr. Egawa:

・ Even SMEs in Japan tend to have relationships with more than one financial institution, which means competition for their business tends to be intense.

Mr. Nagano (guest speaker):

・ From Japan's period of high economic growth in the 1960s and early 1970s until around the mid-1980s, it was typical for SMEs to do business with one or two financial institutions. This figure has increased dramatically since the bubble burst, with some SMEs now doing business with ten institutions.

Mr. Egawa:

・ With businesses now asking financial institutions to submit bids for their loans, there appear to be cases in which financial institutions that try to provide consulting services or function as an SME expert find themselves losing the business in the end to lower-priced competitors.

Mr. Nagano (guest speaker):

・ The same phenomenon can be observed on a macroeconomic level.

Inoue (organizer):

・Corporate governance is also seen as an important issue at the Panel for Revitalization of Domestic Finnace. Some appear to be of the view that there is no incentive for SMEs to ensure proper governance. What sort of entity would be capable of exercising efficient governance at SMEs?

Mr. Kozu:

・At firms with just 10 to 20 employees, a single business mistake can quickly lead to bankruptcy, so in fact strong governance tends to work. In such cases, I think what we need is not only to introduce potential successors these companies need or supply debt financing, but, in cases where the business is deemed unsustainable, to recommend firms to be shut down while they still have positive net worth. Often, owners find it hard to make the decision to close businesses and instead wait until the situation has become almost untenable. Meanwhile, it is also true that loans made by smaller financial institutions that have deep roots in the local communities could often be characterized by a combination of high probability of default (PD) and unexpectedly low loss given default (LGD) . This may be because there are cases where relatives of debtors step in to pay back loans. I think governance becomes an issue at firms that are large enough and able to remain in business for a while even if their managements are inappropriate. The discussion of whether serving as an SME expert ultimately "pays" or not could also be applied in such firms. A good example might be large but unlisted companies.

Mr. Nagano (guest speaker):

・The business environment confronting shinkin banks remains very challenging, and there are cases in which these institutions are choosing the (in some senses) reasonable option of a contracting equilibrium while using their own capital. Another option for regional banks facing declining local economies is to diversify revenue sources by strengthening ties with local government bodies and moving into larger cities. In that sense, I think the situation is more difficult for second-tier regional banks that are listed but do not have the strong local ties of a shinkin bank and also face competition from a dominant (first-tier) regional bank.

Ms. Suda:

・Will such institutions gradually be forced out of the market?

Mr. Nagano (guest speaker):

・Top-line revenues will continue to decline under the current interest rate environment, and there are limits to what can be achieved in terms of cutting costs. I think we could not the possibility that some institutions could start reporting losses in about two years' time even if they do not incur losses on risks taken to find a way out of the current impasse. Depending on how large the losses are, that could affect their share price or their deposit base.

Ms. Suda:

・While financial institutions that have lost money because of inappropriate risk-taking activities or improper behavior could be encouraged to shut down, I suspect the government will provide support for institutions that did the best with what they had but were simply unable to keep the business going.

Mr. Egawa:

・In its April Financial System Report, the BOJ noted that many regional financial institutions have increased their investments in funds, typically super-long-term overseas bond funds. While such funds may offer high yields, some of them would not incorporate hedging against exchange rate risks.

Inoue (organizer):

・Something mentioned earlier today was that when a business owner grows old, one alternative to a standard succession is transitioning to a new business. Freeing up capital and labor that are tied to an unsustainable business and utilizing them more efficiently also has positive macroeconomic implications. Engaging small business owners in a dialogue that includes such options is part of governance. Who is responsible for this role?

Mr. Kozu:

・I think it is more useful to ask: "If a good manager walks in the door, how would you help him/her develop his/her business?" From a financial perspective, supply of equity is always crucial. While the appropriate degree of leverage may differ depending on the company and the industry, banks can provide debt if the company has enough equity. I think it is important to establish mechanisms, even using fintech, to prepare enough amount of equity by gathering small portions of money in regional economies

Mr. Kitamura:

・There are a variety of areas in which the Japanese find it difficult to exit smoothly from their current circumstances. For instance, one often finds senior citizens whose children have left home living in large houses by themselves, whereas in other countries they would typically sell them and move to smaller residences. In the business world as well, I would like to see more cases where business owners say to themselves, "I've done enough, and now it's time to retire" and proceed to sell the business.

There are businesses that can be sold. Even if the owner wants to sell, however, he may not know how to go about doing it, and regional banks and shinkin banks may have little information about potential buyers in their territories. Without this kind of market, business succession will not proceed smoothly, and resources will inevitably be wasted as owners effectively throw good money after bad until there is no more.

Ms. Suda:

・ I think that interest rates are important if we want to encourage owners to make the right decision.

Mr. Kozu:

・ Ordinarily, I think the sort of thing Mr. Kitamura described is the role of private equities. The question is whether it is possible to develop a kind of private equity fund that is not acting in a cutthroat competition world.

Mr. Nagano (guest speaker):

・ If we could create the kind of market described by Mr. Kitamura, it would become possible for financial institutions to supply debt financing based on their internal rating systems.

Mr. Kozu:

・ Some regional banks have funds that invest in business "seeds" (start-ups), but I haven't heard of a similar type of fund only for business succession.

Mr. Oshima:

・ We are involved in the fund business, but most of that involves reconstruction-related projects or primary industries expanding into secondary and tertiary industries. For business succession, we try to uncover earnings opportunities in our relationships with individual clients. As Mr. Nagano mentioned, there is little incentive from an earnings perspective for us to get involved in the succession process when the business is small.

Mr. Nagano (guest speaker)

・ From a macroeconomic perspective, this involves the redistribution of production factors. In the case of a joint-stock company, shareholders encourage management (via the share price) to make decisions based on the future potential of the business. As Mr. Kitamura pointed out, the Japanese business culture does not encourage owners to shut down their businesses. I think there would be a real and sustained rejuvenating effect on Japan's economy if owners in their forties and fifties were to manage their companies with the intention of closing them down ten years later, or if they were ultimately to sell their businesses on the secondary market.

Ms. Suda:

・ Does the US have a mechanism like this even for smaller companies?

Mr. Nagano (guest speaker):

・ While some regional banks have become massive institutions with nationwide networks, credit unions are putting up a surprisingly tough fight and earning high interest rates on their face-to-face business. A great deal of their lending is unsecured, and banks are reluctant to expand their balance sheets. However, I cannot honestly say whether there is a mechanism that enables old businesses to be replaced by the new in the US economy.

Mr. Oshima:

・ In the US there are people in the private sector who can supply equity, and with the relatively short time cycle for business it is standard practice for them to exit successful deals via an IPO. In this kind of environment, I think it is possible for commercial banks to demand reasonable interest rates and supply funds to slightly riskier firms. In Japan, meanwhile, banks' risk tolerance is bound to diminish amid this environment of low interest rates and thin spreads. I agree with Ms. Suda that it makes sense to use the interest rate mechanism to weed out unsustainable businesses, but that could create a great deal of pain at the local level and could well invite public backlash. In any case, whether it is the interest rate mechanism or something else, I don't think we can change the status quo unless there is some system capable of encouraging owners to call it quits.

Ms. Suda:

・ With financial institutions continuing to compete in an environment that does not allow them to earn reasonable returns on their money, I think we also need to do something about the phenomenon of "overbanking" in Japan.

Mr. Oshima:

・ Mr. Goto noted that one feature of Japan's labor market is that once an individual joins a company he tends to stay there, so there is relatively little horizontal movement of people between companies. I think this also has something to do with the phenomenon of overbanking.

Mr. Kozu:

・ The large number of financial institutions in and of itself does not directly contribute to Japan's surplus of savings over investment. While I agree that unsustainable financial institutions need to exit, I don't think that alone will solve the problem.

Ms. Suda:

・ A financial institution's ability to earn a reasonable return on its operations depends on the circumstances of its client firms as well as itself, but in any case I do not think Japanese financial institutions in aggregate are earning a reasonable return today.

Mr. Egawa:

・ The BOJ's average contracted interest rate on new loans and discounts has been steadily declining for the past several years and now stands at 0.5–0.6% at the megabanks. The weighted average for all financial institutions is less than 1%. In the US, meanwhile, the corresponding figure is about 3%. Given that the cost of funds in the two countries is not that different, to what can we attribute the large difference in lending rates?

Mr. Nagano (guest speaker):

・ The BOJ is using monetary policy to depress not just the yield curve but also credit premia. Against this backdrop, financial institutions face the ever-present question of how to overcome the obstacles to higher earnings. The withdrawal of unsustainable institutions might change this situation.

Mr. Kozu:

・ In Japan, I think macroeconomic policy incidentally serves as a form of SME policy. There is a kind of market failure behind it.

Mr. Goto (guest speaker):

・ I agree. We could understand that the BOJ has used financial support for SMEs as a kind of macroeconomic policy, and it is also engaged in large-scale intervention on the financial markets.

Mr. Tokushima:

・ Japan lacks both private-sector equity providers and clear exit paths for businesspeople and investors. When a company implements a business plan, for example, the absence of a well-defined PDCA framework makes it more difficult to wind down a project. Some Japanese firms, like the manufacturers that are exposed to global competition, have shown themselves able to make bold decisions, but that sort of capability is seldom demonstrated at domestic firms, including most SMEs. We clearly need more unsustainable businesses to close their doors, and when that happens the next question is how to redistribute the business resources that will be freed up to more productive areas of the economy. I myself spend most of my time working on demographics-related problems, and in some respects I think these problems are closely linked to the issue of business rejuvenation, as was suggested today.

Mr. Hosono:

・ The second-tier regional banks are said to face a very challenging business environment. Is this because some of them take on more interest rate risk than they should? And inasmuch as the BOJ is responsible for financial system stability as well as monetary policy, will the existence of financial institutions with too much risk hinder the Bank's exit from quantitative and qualitative easing?

Mr. Nagano (guest speaker):

・ I believe the decision to wind down QQE will be made based on the state of prices and economic growth at the macroeconomic level, so when the BOJ ultimately starts considering an exit I expect that not only will prices be rising but that the real economy will be relatively strong. Nevertheless, rising interest rate would not solve all the problems at financial institutions, because their ability to raise lending rates according to market rates would depend on competition among them and credit ratings of borrowers. All in all, while it is difficult to envision the institutions that we monitor triggering systemic risk under such conditions, there is a possibility that some of them could suffer from operational losses due to failures of raising lending rates.

Inoue (organizer):

・ I look forward to discussing this topic again in coordination with the Domestic Financial Revitalization Committee. My thanks to all of you for a long but very interesting discussion.

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