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TOSHIHIRO HORIUCHI

EUI Working Paper RSC No. 94/3

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JAPANESE PUBLIC POLICY FOR COOPERATIVE SUPPLY OF CREDIT GUARANTEE TO SMALL FIRMS - ITS EVOLUTION SINCE THE POST WAR AND BANKS' COMMITMENT -

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I INTRODUCTION

In this paper I investigate the mechanism of credit guarantee supply to small and medium-sized (hereafter small or in some cases smaller) firms in Japan, provided cooperatively by several players from both the public and private sectors. The system was initiated by local governments before World War II, and continued by the central government. I examine the evolutionary development of this cooperation and its organization in the post-war period.

Recently involvement of the governments is not only through supplying funds to either of specialist institutions dealing with credit guarantee supply - the Small Business Credit Insurance Corporation (SBCIC) and Credit Guarantee Associations (CGAs) - but also through monitoring them. SBCIC, founded by the central government, plays role of a central bank. It has a principal-agent relationship with CGAs. In 1990 there are 52 CGAs in Japan and each was founded by local governments along with the investment from private banks.[1]

This cooperative credit guarantee supply involves private banks (small and large), firms demanding credit guarantee and CGAs supplying it. It is the banks that have more business information and thus can more accurately evaluate the business risk of small firms than CGAs. In this paper, I analyze the mechanism of the division of labor among banks, CGAs, SBCIC and governments.

This analysis has an important international implication for restructuring of former Communist bloc economies. As Kornai [1993] has pointed out, these countries have great expectations about Japan's specialized knowledge. He indicated two weak points - one the banking sector and the other the small firms sector.[2] The credit guarantee supply know-how developed in the post-war period is seen an important and rational solution to improve Kornai's two weak points.[3]

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[1] 47 CGAs are organized by prefectures; each of remaining 5 is founded by a large city such as Yokohama or Osaka.

[2] See the comment by Janos Kornai [1993], at the symposium *The World Economy in the 21st Century and Japan - Beyond the Economic Crisis*, held by the Japan Economic Research Center (cosponsored by Nihon Keizai Shinbun, Inc.) and published in JCER REPORT Vol.5 No.6, 7 June, July 1993.

[3] Because the credit guarantee supply mechanism has become an important topic, recently SBCIC and CGAs' Federation have organized several assistance programs for Asian countries to transfer the system for their countries' small firms development. As far as

From theoretical work on the role of collateral in loan arrangements under conditions of asymmetric information, (see for example by Campbell-Kracaw [1980], Diamond [1984], or more specifically, Chan-Kanatas [1985]) government intervention for credit guarantee is necessary for small firms who do not have enough collateral assets to borrow money from banks.[4] This intervention has been improved and become more sophisticated in the post-war period, to organize an efficient monitoring system. The experience of an evolutionary improvement process is a key factor for possible transplantation of the system. The paper, first, makes a positive investigation into the process and then normatively evaluates the system from the economic point of view.

The paper is composed of five sections. Section II provides an overview of the history of the evolution of the system. Section III discusses the activity of the cooperative credit supply using various facts. It is to be emphasized that about 40 percent of small firms in 1990 use the credit guarantee. Section IV contains the policy evaluation of the system. Section V summarizes the paper.

II HISTORY AND ORGANIZATION

In this section I review the historical development of the cooperative mechanism and policy for credit guarantee supply to S-M firms since just before World War II. Breaks in this development come at the end of war, the late 1950s, late 1960, and around the first oil crisis.

2.1 History.

2.1.1 Pre war period.

Many associations of banks and firms incurred huge lending losses due to the increased bankruptcy of their lending small client firms in 1930s. The city governments of Osaka and Nagoya initiated giving rescue funds to banks or associations. It was in 1932 that it became possible for such governments to get financial

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the situation of the related researches is concerned, we have not sufficient detail analysis about the small firms like that of large corporations. However, in this field the situation is changing, demanded more in the period of financial liberalization since 1980s. For example, we have several discussions on small firms' bank relationship such as Horiuchi [1993] or an overview by Patrick-Rohlen [1987].

[4] This argument is so general that the existence of collateral means the imperfection of the loan market. Then a possible question is how firms having insufficient collateral assets can enter the market or if they have to disappear.

support from the central government for such rescues, but under strict conditions. In 1937 the central government expanded this support system to include the losses of local governments caused by their guarantee of a supply of credit to small firms. With the introduction of this measure, the division of labor between the central government, local governments, and banks in the guaranteed supply of credit began to dawn.

Another start was made in this period for a specialist credit guarantee organization. It was a copy of German credit guarantee system planned by Tokyo Prefecture Government in 1935 - according to the volume of *30 Years of Small Business Credit Insurance Corporation* (Hereafter *30 Years*) published by SBCIC. In 1935 the task force group organized by the Tokyo City Government recommended that the government establish a specialist association for credit guarantee. The Tokyo Credit Guarantee Association was founded by both Tokyo City Government and Tokyo Prefectural Government in 1937. The Kyoto and Osaka City Governments followed and established their own associations in 1939 and 1942 respectively.

The motivation to establish these associations was to mitigate loan market asymmetry, which requires that borrowers supply collateral to obtain financing. Small firms with fewer assets for the supply of collateral cannot gain access to loan markets without policy intervention. The rational motivation of these associations notwithstanding, they did not succeed in achieving the desired function because there was no strong commitment of the central government (such as those introduced later on after the war).[5]

2.1.2 Post war cradle period before 1958.

During this period the Japanese credit guarantee system built its core structure, composed of two elements. Initially, however, just after the war, the government of occupied Japan needed to negotiate with the Occupation authorities, who requested that the system be abolished. This was due to its origin as a copy of an institution from fascist German. Nevertheless, following the strong desire of the government, particularly declared at a 1948 cabinet meeting, the system was approved to continue by the Occupation authorities, and then two core elements were founded.

First, various local governments established each credit association in each area with considerable capital investment from private banks.[6] The number of total credit associations in Japan increased from 4 at the end of 1947 to 48 at the end of 1949. In these days Business Association Law regulated the activity of CGAs, and thus the monopolistic guarantee supply through the association

[5] See Teranishi [1993] for a discussion of the war time financial system.

[6] Investment of private banks has not been major and thus any measure was sought to absorb more investment as discussed later on in the paper.

was frequently questioned by Fair Trade Commission (FTC). To have an independent law control and to have free hand from FTC control for their activity, a new rule was introduced in 1953 - the Credit Guarantee Law. This was the real start of the specialist credit guarantee association in Japan.

Second, at the time of the preparation of the Credit Guarantee Law, the Ministry of Finance (MOF) and the Ministry of International Trade and Industries (MITI) each had a plan to found a specialist government financial institution for credit insurance. In 1950 the Occupation authorities allowed the government to introduce a special account for insurance under the control of Small Business Agency - a division of MITI. Following this permission, the government enacted the Special Account Law for Small Business Credit Insurance in December 1950. Through this account the government could supply insurance service only to banks having lending relationships with small firms. However, in 1951, the government could supply insurance service directly to CGAs. This was truly the beginning of the direct relationship between the specialist credit guarantee organization and the specialist credit insurance organization in Japan.

Since then several measures were incorporated in the insurance system such as reduction of insurance fees, preferential treatment of smaller firms, expansion into more banks, or direct lending through the account to CGAs. However, these measures caused duplications between the CGAs' support and the SBCIC's support, because the latter could have access to small firms through its insurance relationships with banks. Also, the introduction of government lending to CGAs necessitated an adjustment for fund allocation among various CGAs. Further the introduction of several advantageous measures resulted in increased losses for the account and required a reorganization for efficient management. Under the circumstance, an insurance organization independent from the government was needed to bring incentives for more efficient management.

Much quicker action was required because of the tightened monetary policy that would have negative effects on small firms' borrowing availability. Following the recommendation of the Financial System Research Committee to the MOF, a new special independent insurance institution - the Small Business Credit Insurance Corporation (SBCIC), to be monitored jointly by the MOF and MITI - was founded by the government in 1958.

According to the Article 1 of the Small Business Credit Insurance Corporation Act, the purpose of the SBCIC is to ameliorate business loan supply of banks to small firms by insuring the credit guarantee of CGAs and by lending funds to CGAs. On July 11, 1958, its official start of the SBCIC, the total amount of paid-in capital amounted to 10.7 billion yen, all of which came from the central government. At the end of this fiscal year - March 1959 - its total amount of insuring reached 569 billion yen.

2.1.3 Organization sophistication period in high growth era in the 1960s.

During this period the credit guarantee system became more sophisticated, for example by the introduction of new insurance channels or the continuing capital investment by the government. In this period the system became the most important element for the framework of policy toward small firms.[7]

Among several improvements of SBCIC measures, the most important started in 1965 and allowed the SBCIC to cover bank loan contracts without any collateral deposited at banks. Using this channel, firms could borrow money from banks without depositing any collateral. However, they were required to have a personal guarantor. A more preferential measure without either requirement was introduced for much smaller firms in 1965. At its start-up stage, it targeted loans of less than 300 thousand yen, but several qualifications were required. For example, the lending firm must have less than 5 normal employees (2 employees in service industries), the industry coverage is limited, and applicants must have more than three continuous years business experience in the same industry and in the same location.

It was originally intended that both measures would end at the end of fiscal year 1967. However, the Task Force of the Finance Committee recommended in 1966 that the Small Enterprises Policy Council to make them permanent.[8] At the same time a preferential lending from the SBCIC was introduced, to strengthen the fund base of CGAs. Also the investment of private banks to CGAs was approved for tax exemption treatment.

Organizational problems appeared suddenly after the tightened monetary policy in the late 1960s. In the mid-1960s, just before the occurrence of the problem, the money market was relaxed to bring business reflation and a recovery of bank lending to small firms.[9] CGAs could respond quickly to this policy requirement by increasing their credit guarantee supply, strengthened by several measures introduced in the previous period. Tightened monetary policy, a few years later, caused banks to suddenly suppress their lending to small firms.[10] The result was many bankruptcies of small

[7] Comparatively speaking, the measure is not direct but indirect because it can be applied to every firm belonging to small firms category. However, as shown later in the paper, the measure had some direct elements, such as limiting applicants by industry or by region.

[8] See *30 Years* for the membership of the task force committee.

[9] Lending to small firms used to expand more quickly than that to large corporations in the relaxed money market.

[10] This behavior of banks is related with the current issue in 1990s recession period when banks, particularly large banks who had been expanding their lending to small firms, have been

firms. Banks requested CGAs to execute their guarantee payment and thus the SBCIC had to increase its insurance payment. Short-term business fluctuations and discretionary macro monetary policy caused an urgent need to reorganize the system.

First, CGAs and the SBCIC were asked by the government to exchange business information more frequently and efficiently. The SBCIC, as the central bank of the system, founded a research division and expanded its monitoring division. Further, an agreement was taken among the SBCIC, CGAs, and their monitoring government agents at the MOF and MITI. Though the agreement did not aim at any explicit reorganization but rather for some implicit management improvement, - and therefore was referred to as Voluntary Improvement Measures (VIM) - it could reinforce the influence of SBCIC on the system.

In VIM, the SBCIC emphasized that CGAs and the SBCIC have to cooperate under a trustful principal-agent relationship. Though such a trustful relationship, the SBCIC can reserve the potential power to request CGAs to inform it of credit guarantee plans and can order modifications depending on credit guarantee performance. VIM requires CGAs to increase monitoring of small firms credit risks. However, including other measures, every measure is implicit except for the control of the SBCIC through its lending to CGAs.

2.1.4 International consideration period since 1970.

Adjustment in the previous period made the management of the SBCIC more flexible to adapt to each year's business policy, particularly to international policy needs in more recent period. In 1971 a preferential insurance was started for pollution protection investment of small firms. In 1980 the SBCIC introduced another preferential insurance for small firms investing in new technology augmented plant and equipment.[11] Also the coverage of small firms was expanded following the new definition of small firms by the Small Business Fundamental Act in 1973 - including firms of up to 100 million yen paid-in capital, compared to the previous upper limit of 50 million yen.

In 1971 a preferential measure was introduced for firms who might suffer from increased import competition due to preferential tariff treatments to exporting countries. Another typical example is the preferential insurance for the adjustment assistance to small firms in declining industries, which followed the purpose of the Act for Temporary Measures for Specified Depressed Regions enacted in 1973 targeted.[12]

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changing this stance because of the greater expected risk to them after deflation of asset market prices.

[11] MITI defined the type of new technology in detail.

[12] For the declining industrial policy see Sekiguchi-Horiuchi [1988]. The adjustment assistance was the most urgent policy

As typically shown in the above example, the credit guarantee system could flexibly follow current general economic policies in each period since the 1970s, even an international policy.[13] However, this policy situation has caused the SBCIC and CGAs to pay more attention to short-term than long-term credit guarantee supply since 1970s. Indeed, in the late 1980s when the yen exchange rate has appreciated, various temporary measures were introduced, as in late 1960s, and caused a sharp increase of credit guarantee supply.

2.2. Discussion on the relationship among multiple players.

The following is a brief discussion of the organizational framework from the point of the principal-agent theory.

2.2.1 Chain of multiple principal-agent relationships.

As shown in Figure 1, there are six players in this cooperative organization - i) central government authorities of MOF and MITI, ii) SBCIC, iii) local governments, iv) CGAs, v) banks, and vi) small firms. Among them the positioning of local governments has some different elements from others. Other players are involved in the chain of multiple principal-agent relationships. First, MOF plus MITI and SBCIC are in a principal-agent relationship; the former are the principals of SBCIC. Then SBCIC and CGAs are also in a principal-agent relationship. CGAs and lending banks are in a principal-agent relationship for credit guarantee contracts. Further, needless to say, banks are the principal of firms in lending contracts. In this chain relationship the SBCIC performs the role of the central bank under the monitoring of two government authorities and thus has a monopoly power, to some extent, in the credit guarantee system.[14]

Figure 1 Chain of principal-agent relationships
for cooperative credit guarantee supply

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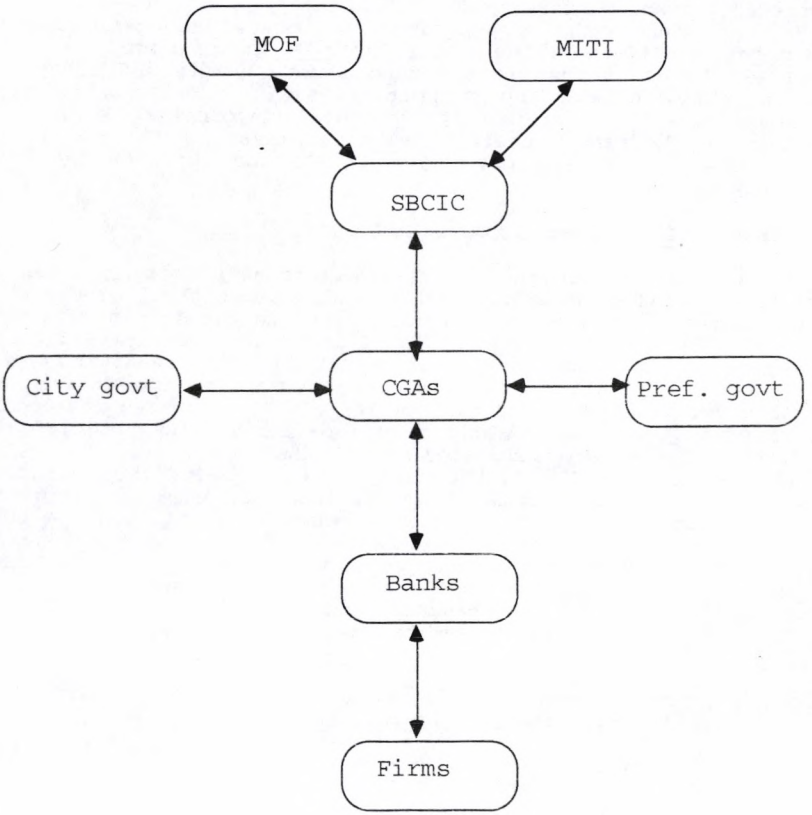
issue since 1970s. The Japanese framework was approved to bring most efficient success among developed countries.

[13] The international trade liberalization usually has to cause the reallocation of resources and thus temporarily the unemployment of resources from declining sectors. Thus the employment absorption is a critical policy issue. Small firms are major target to absorb these unemployed people.

[14] MOF and MITI used to take a competitive position for political power. Here we will neglect this issue of the different emphasis among two government departments. However, it is not MOF but MITI that tends to take more care for firms.



2.2.2 Unique position of local governments.

Compared to the SBCIC, the power of each local government in the system is less monopolistic and the relative position is more complicated. It is true of course that each local government, as the major investor, can control the management of its CGA through its capital and lending investments in CGA. In other words, it shares the principal role of CGA with SBCIC. However, its position fluctuates, as at some time for CGA and against SBCIC or at

another time against CGA and for SBCIC because it has to be monitored by the central government, of which SBCIC is the sole direct agent for credit guarantee activity.

Thus each local government locates among the central government, SBCIC, and the CGA to display complicated behavior. Nevertheless its purpose is to bring a more stable and prosperous local economy through the support of small firms in its area. Following this basic stance of the local government, each CGA - though sandwiched among their local governments, SBCIC, banks, and firms - has a long-term and trustful relationship with its local government.

2.2.3 Relationship viewed from working fund.

Table 1 looks into the relationship among the central government, local governments, SBCIC, CGAs, and banks from the point of the long-run development of working fund in the system. The total amount of paid-in capital of the SBCIC increased from 15 billion yen at the end of the 1960 fiscal year to 617 billion yen at the end of fiscal year 1990. All of them are composed of investment from the central government. By using this capital SBCIC increased its lending investment in CGAs from 26 billion yen to 411 billion yen from 1965 to 90. All of them are allocated among CGAs to achieve its desired regional distribution.[15] On the other hand, besides this allocated money, each CGA borrows money from its local government - increased from 14 billion yen to 620 billion yen during the period from 60 to 90. Therefore, needless to say, as far as each CGA's fund investors' distribution is concerned, the major sponsor has not been the SBCIC but its local government because the lending investment of the local government is always larger than the lending investment of SBCIC, and also because the local government has capital investment.

Table 1 Fund raising of Credit Guarantee Associations (CGAs) and Small Business Credit Insurance Corporation (SBCIC)

Fiscal year	1960	1965	1970	1975	1980	1985	1990
SBCIC (bil. yen, %)							
1. Paid-in capital							

[15] The total amount of the central government's budget for small firms reached 195 billion yen in fiscal 1991. In this total its investment to SBCIC reached 33.9 billion yen .

Credit guarantee

	15	34	69	157	278	395	617
2. Central government investment flow							
	2	7	12	23	58	43	26
CGAs (bil. yen, %)							
1. Total net-worth							
	n.a.	19	44	114	244	428	707
2. Paid-in fund in #1							
	n.a.	11	22	48	97	138	184
3. Local governments paid-in fund in #1							
	n.a.	10	17	35	63	91	121
4. Private banks paid-in fund in #1							
	n.a.	1	5	14	32	45	59
5. Total borrowing							
	n.a.	44	107	263	448	638	1031
6. Local governments in # 5							
	n.a.	14	43	140	225	321	620
7. SBCIC in # 5							
	n.a,	26	64	123	223	317	411

Source: SBCIC and Federation of All Credit Guarantee Associations (eds.), *Activity Survey*, various issues.

Capital fund investment from its local government and banks is shown in this Table. The government investment has been considerably larger than the banks' investment. From 1965 to 1990 the sum of both investments increased from 11 billion yen to 180 billion yen.

Also CGAs have their own saving reserves amounting to 7 and 523 billion yen at '65 and '90 respectively.

Each CGA sets the limit of the total credit guarantee supply, which usually reaches to about 50 times of the total capital fund totalling 707 billion yen at 1990.[16] This special importance of the capital fund notwithstanding, the total amount of the working fund - capital plus borrowing reaching to 1,737 billion yen at 1990 - is as important as the former because a CGA can earn net flow income by investing borrowing money from the SBCIC as shown later on in the paper.

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[16] This multiplication factor varies from the lowest of 35.0% to the highest of 60.0% among various CGAs. In 1990, there are 19 CGAs applying 60.0% and the average of 52 CGAs is 51.6%. This multiplication factor was changed frequently, for example, five times since the first oil crisis. It is an interesting question for further research to analyze this process and the difference among CGAs.

2.2.4 Moral hazard.

The cooperative purpose of all players is to supply efficiently credit guarantee to small firms in order to achieve the stability of Japanese economy, its long-run growth efficiency, and income distribution equalization. Generally speaking, there is no conflict of interest among them regarding this cooperative purpose.[17]

However, each player including the government authority may have its own organizational purpose which would cause moral hazard problems in the credit guarantee system. For example, banks seek to expand their lending to as many as small firms as possible, regardless of their inefficient projects, because the banks do not need to take into consideration any possibility of bankruptcy under the guaranteed contract by CGA. Also each CGA may have its organization utility in expanding its credit guarantee and may cause inefficient insurance payment by the SBCIC.[18] Then, the SBCIC also may seek a similar organization object by expecting continuing government investment. Of course, end users of the credit guaranteed firms can behave opportunistically, too.

The cooperative supply mechanism as a whole has some built-in mechanisms - implicitly or explicitly - to mitigate moral hazard behavior in order to achieve system efficiency. The VIM agreement is a typical implicit example brought by this built-in mechanism. According to the VIM agreement, each CGA's credit guarantee plan can be checked by the SBCIC and it has to accept any modification requested by SBCIC.

2.2.5 Other mechanisms coping with moral hazard.

As far as explicit instruments are concerned, the SBCIC can control the allocation of its lending investment among CGAs by differentiating the lending conditions. This possibility can work as a powerful threat to force an efficient effort of CGA because they have to depend on the lending investment of SBCIC. On the other hand, a CGA can control its credit guarantee allocation differentially among banks by observing each bank's monitoring attitude or capability for small firms loan arrangement. This allocation control can depress the moral hazard of banks, particularly because banks

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[17] From the point of private banks' view, the equalization of income distribution among various regions or many sized firms may not be accepted unanimously. Also, this regional factor may cause conflicts of interest among various local governments. This situation is similar to the conflicts of interest among member countries of EC. In the credit guarantee system, we assume that the central government can solve this conflicts.

[18] Because CGA guarantee officers are people living in the same area of client small firms and tend to follow their requests.

could not expand their lending to small firms without the guarantee system. Also it is important that small firms are not usually able to access directly to CGAs. In this situation small firms tend to have long-term relationships with banks, reducing the information asymmetry among the firm and the bank and working to decrease the moral hazard of firms.[19]

Finally, central government monitoring can be maintained by the notorious Japanese administrative guidance. MOF and MITI can efficiently monitor the SBCIC because there is less information asymmetry among them and SBCIC. Either MOF or MITI usually sends its retired officer to SBCIC as the top executive. Also it is easier to collect information about the business conditions of numerous small firms in all over Japan from only SBCIC rather than from many agents like CGAs or banks.[20]

III PERFORMANCE OF ACTIVITY

In this section I trace the development of the credit guarantee activity since 1960, just three years after the establishment of the SBCIC, in a long-term perspective.

3.1 Long-run trend.

3.1.1 CGAs' growth.

Long-run rapid growth of the credit guarantee activity is observable in Table 2. The growth rate during the 30 years from 1960 to 1990 is 7.7% in terms of the number of guaranteed contracts, and 18.4% in terms of outstanding guarantees.

Table 2 Growth and composition of credit guarantee by CGAs and SBCIC

Fiscal year	1960	1965	1970	1975	1980	1985	1990
Overview of outstanding growth							
1. Number of contracts (1,000)	275	574	965	1,617	1,976	2,118	2,541

[19] The main bank relationship can thus appear for small firms, although the content of the relationship may differ among large corporations and small firms. See Horiuchi [1993].

[20] See Horiuchi [1990] for a discussion of the business associations in Japan with an emphasis on the information sharing and collection.

Credit guarantee

2. Outstanding (bil. yen)							
	124	493	1,315	4,435	7,129	9,266	19,478
Diffusion rate in the total (%)							
1. User firms							
	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	23.8
2. Guaranteed contracts							
	n.a.	14.8	n.a.	31.7	33.9	33.6	39.3
3. Guaranteed amount							
	n.a.	3.9	4.4	5.8	5.8	4.7	6.3
CGAs flow/stock ratio (%)							
1. Number of contracts							
	143	122	86.2	63.3	53.0	47.3	45.7
2. Amount							
	143	131	104	81.0	73.0	67.0	62.7
CGAs payment							
1. Number of contracts (1,000)							
	10	14	25	28	52	52	16
2. Amount (bil. yen)							
	3	10	25	66	184	220	88
CGAs stock of claim							
1. Number of contracts (1,000)							
	n.a.	n.a.	n.a.	162	302	442	443
2. Number of firms (1,000)							
	n.a.	n.a.	n.a.	n.a.	213	296	303
3. Amount (bil. yen)							
	n.a.	n.a.	n.a.	180	655	1,180	1,220
SBCIC insurance acceptance							
1. Number (1,000)							
	377	703	818	1,018	1,043	993	1,019
2. Amount (bil. yen)							
	142	594	1,274	3,505	5,118	6,068	10,045
SBCIC major insurance (%)							
1. Normal: Number							
	30.0	29.9	32.3	32.5	29.5	37.0	35.8
2. Normal: Amount							
	55.6	63.5	58.0	60.1	55.4	63.3	70.0
3. No collateral: Number							
	n.a.	23.8	65.3	64.2	66.8	59.0	61.1
4. No collateral: Amount (%)							
	n.a.	14.3	41.1	38.5	43.2	35.8	29.0

Source: *Ibid.*

In the course of this history of high growth, the system has been expanding the coverage of firms. The share of firms using the credit at the end of fiscal year 1990 reached 23.8%. The number of contracts increased 39.3% at the same time. The relatively higher rate of diffusion of the number of loan contracts means that the credit guarantee is supplied more to smaller firms rather than to medium-sized firms. This is a reasonable consequence because the smaller a firm is, the less it demands for loan. This size effect appears also in the degree of diffusion viewed from the outstanding of guaranteed loan. At the end of fiscal year 1960 the rate of diffusion was only 2.5% of the total outstanding of small firms loan. However, even viewed from this measure, it increased from this low level to 6.3% at the end of fiscal year 1990.

3.1.2 Long-term guarantee and risk taking.

Before the 1980s, most credit guarantee contracts ended within one year. For example, in 1965 the annual flow amount of credit guarantee reached 646 billion yen and the stock amount at the end of 1965, 493 billion yen, was less than the annual flow. This comparison also appears in the number of contracts. The number of contracts guaranteed during the year reached 701 thousand, however, the number of stock, 573 thousand, was less than the flow. This trend of short-term credit guarantee supply had continued before 1980, and shifted gradually to longer and longer supply. Recently about half of credit guarantee contracts have continued for more than at least one year.

This evolutionary growth of credit guarantee supply has been accompanied with small payment of CGAs. In each year the rate of payment of CGAs to total credit guarantee outstanding at the end of the year is only 1 or 2% of the total stock, though it fluctuates as discussed later on using an example since the 1970s.[21] Against this payment CGAs can cover almost all of their payment through the insurance contract with SBCIC. After CGAs pay to banks as guarantors, CGAs can keep the claim to client small firms as long as CGAs would not write off. The amount of CGAs' claim reached 180 billion yen at the end of 1975. On the other hand, during this one year CGAs paid 66 billion yen to banks. The amount of claim has increased steadily from this level to 1,220 billion yen at the end of 1990. This amount is so large that it reaches about 6.3% of the total stock.

3.1.3 SBCIC insurance growth and composition.

The SBCIC's insurance acceptance has grown as shown in lower part of Table 2. Though the number of acceptances has increased little (from 377 thousand contracts in 1960 to 1,019 contracts in

[21] This is an interesting question to be analyzed empirically, in particular as regards CGAs' policy to determine when payments are agreed.

1990), the amount of insurance acceptance has increased as much as that of CGAs - from 142 billion yen in 1960 to 10,045 billion yen in 1990. Even after inflation adjusted by the consumer price index the growth rate during this 30 years period reaches to 9.2%.

The insured amount of no collateral credit guarantee has been about one third of total insured amount. Its share in total number of insurance contracts has been about two times of the amount share. Thus, the average size of insurance amount per contract of no collateral guarantee contract has been about a half of that of other contracts.[22] It has continued as the majority measure for client smaller firms since its introduction. Compared to this majority of credit guarantee without collateral, another special measure without collateral or personnel guarantors has been limited to a few per cent in total number of contracts.

3.1.4 Guarantee fee and insurance conditions.

Though both CGAs and SBCIC have achieved high growth and have shown several important structural changes, the management performance of CGAs and SBCIC has fluctuated during the period of thirty years, as shown in terms of revenue and expenditure trend in Table 3.

Table 3 Loss and income of CGAs and SBCIC

Fiscal year	1960	1965	1970	1975	1980	1985	1990
CGAs (100 million yen, persons)							
1. Guarantee income	n.a.	71	155	457	813	1,019	1,756
2. Return of investment	n.a.	35	111	342	532	711	1,026
3. Insurance fee payment	n.a.	24	61	175	268	362	693
4. Management expense	n.a.	30	56	205	359	500	683
5. Net profit	n.a.	9	47	100	294	308	898
6. Total working asset	n.a.	799	2,186	8,096	11,099	17,036	27,167
7. Total employment	n.a.	2,987	3,714	4,780	5,205	5,503	5,818

[22] Some of them have no collateral but are not approved as no collateral insurance mainly because the borrowing size is larger than the limit.

Credit guarantee

SBCIC (100 million yen, persons)

1. Insurance fee income	5	25	58	173	269	358	778
2. Payback of insurance payment	6	20	82	150	553	880	1,071
3. Insurance payment	15	57	158	409	1,224	1,478	570
4. Management expense	1	4	9	19	28	31	47
5. Net profit	2	-	-11	-	-363	-111	561
6. Government investment	18	70	115	230	580	430	335
7. Total asset	154	354	709	1,799	2,953	4,179	10,238
8. Total employment	191	381	408	404	396	423	418

Note. 1. Figures of SBCIC before 1985 do not include its special account for machinery industry insurance. At 1985 its total asset amounts 156 million yen, about 3.7 % of the above total asset.
Source: *Ibid.*

Needless to say, the credit guarantee fee is CGAs' major revenue source in client firms. The annual fee is normally 1% of total guaranteed borrowing, with 0.1 to 0.6 percentage point reduction for loans of smaller amount of borrowings, depending on policy of each CGA.[23] The insurance fee cost for CGA is considerably lower than the guarantee fee rate of 1%, applied equally to all CGAs by the SBCIC. In 1990 the annual insurance cost was 0.57% of guaranteed loans outstanding, therefore, CGAs can pass through most of credit risk to the SBCIC through insurance contracts. However, this risk transfer is limited so that the insurance covers up to 70% of total guaranteed amount and less than 12 million yen per contract.[24] Nevertheless, subsidy from local governments can compensate most of the amount - 50 to 100% depending on the policy of each local government - that cannot be covered by SBCIC insurance. Thus, CGAs do not usually incur business losses due to credit guarantee supply. Therefore, CGAs could have accumulated the saving fund reaching to 523 billion yen at the end of fiscal 1990.

3.1.5 CGAs revenue and expenditure.

[23] There are also some reductions of a similar rate for special guarantees of temporal measures.

[24] The coverage limit for no collateral loan becomes 1.5 million yen and 80%.

Table 3 shows the long-run trend of the performance of CGAs and SBCIC from the point of revenue, expenditure, and number of total employees. The major revenue sources of CGAs are the credit guarantee fee and investment income. Major expenditures are three - management, insurance, and borrowing. During the 1990 business year, CGAs' total revenue reached 280 billion yen, of which 175.6 billion yen from credit guarantee fee revenue and 102.6 from investment income. On the other hand, the total cost was 169 billion yen, of which 68.3 billion yen for management, 32 billion yen for borrowing interest, and 69.3 billion yen for insurance. Thus, the net revenue was to 111 billion yen.

In 1990 CGAs made 1,162 thousand contracts, totalling 12,204 billion yen, with staffs of 5,818 employees including executives (211 persons). The average number of credit guarantee contracts per person during the year was about 200. This efficient supply was made possible by two factors: one the banks' monitoring client firms and the other that most of clients are repeaters (81.8% in terms of number of contracts in 1990).

3.1.6 Management of CGAs.

Although CGAs can assign the major role of screening firms and evaluating their credit risks to banks, it is the CGA management's decision whether or not it can give a firm credit guarantee. To do this each CGA has own ceiling limit and has a special committee composed of managing executives and credit guarantee specialists, with a few to 20 committee members. Each CGA has several regular monthly meetings for the decision over the ceiling of credit guarantee. On the other hand, for credit guarantee below the ceiling amount, each CGA permits executives or managers to decide the supply by themselves.[25] This simple decision process is made possible by information from banks under long-term mutual relationships.

3.1.7 SBCIC revenue and expenditure.

In 1990 the SBCIC had annual revenue of 77.8 billion yen of insurance fee and 12.4 billon yen of lending investment income from CGAs. The SBCIC paid insurance of 57.0 billion yen to CGAs and recovered 107.1 billion yen. It made 56.1 billion yen profit during the year. Nevertheless, it introduced an investment of 33.5 billion yen from the central government. This considerable and steady investment of the government has been maintained since the establishment of the SBCIC. Using this stable investment, SBCIC has been able to write off any losses and to perform the role of the lender of last resort as the central bank.

[25] The limit varies from top executive to middle credit managers and also by each CGA.

The number of total employees has been maintained at around 400. This is less than one tenth that of CGAs. This small number assumes that it usually follows the insurance application of CGAs without case-by-case screening. Indeed, the SBCIC usually makes an insurance agreement contract with each CGA about the planned amount of credit guarantee supply every six months and follows the application. Therefore, even the size of SBCIC's biggest section in the organization, the screening section, can be made quite small.

3.2 Current situation.

At the end of fiscal year 1990, 1,162 thousand loan contracts are guaranteed by the system, which amounts to 12,204 billion yen in total. Table 4 shows the detail of this distribution by size of borrowing amount, by type of arranging banks, by purpose of borrowing, by maturity period, and by industry. Also during this one year the amount totalling 57.0 billion yen is paid by SBCIC to CGAs through the insurance contract. The distribution of this payment is also shown in Table 4 by type of failure factor, by type of arranging banks, and by size of firms.

Table 4 Detail activity of CGAs and SBCIC in 1990 (Unit=%)

CGAs' credit guarantee acceptance composition (%)

1. Number by size of borrowing					
	1.Less than 1 mil. yen	2.8	4.Less than 5 mil. yen	28.7	
	2.Less than 2 mil. yen	12.0	5.Less than 10 mil. yen	17.9	
	3.Less than 3 mil. yen	14.5	6.More than 10 mil. yen	24.1	
2. Amount by type of contract processing banks					
	1.City banks	46.2	4.Credit associations	13.6	
	2.Regional banks	25.7	5.Credit Unions	1.6	
	3.Mutual banks	11.3			
3. Amount by type of borrowing purpose					
	1.Investment money	15.9	2.Working capital money	84.1	
4. Amount by maturity					
	1.Less than 1 year	27.7	4.Less than 4 years	1.5	
	2.Less than 2 year	34.1	5.Less than 5 years	14.6	
	3.Less than 3 years	6.0	6.More than 5 years	16.1	
5. Amount by industry					
	1.Agri. & Fishing	0.1	14.Machinery industry	3.4	
	2.Mining	0.2	15.Electric machinery	2.1	
	3.Manufacturing total	28.5	16.Vehicle	1.0	
	4.Food industry	2.6	17.Metal	5.2	
	5.Textile industry	3.5	18.Other manuf.	3.1	
	6.Wood & pulp ind.	1.1	19.Construction	19.6	
	7.Furniture etc ind.	0.8	20.Service ind. total	51.5	

8.Paper	0.7	21.Whole sales	17.8
9.Printing	2.3	22.Retail	13.1
10.Chemistry	0.6	23.Restaurants	2.9
11.Rubber & plastic	1.0	24.Trans. & warehouse	2.6
12.Leather	0.4	25.Other service	15.1
13.Ceramics	0.9		

SBCIC' insurance payment composition (%)

1. Amount by type of cause

1.Declining market	36.0	5.Excessive investment	6.6
2.excessive competition	13.6	6.Financial distress	7.9
3.Bankruptcy of clients	9.4	7.Loose management	14.5
4.Sales money collection delay or problem	4.7	8.Disasters or accidents	7.2

2. Amount by type of processing bank of loan contract

1.City banks	21.5	4.Credit associations	22.3
2.Regional banks	33.9	5.Credit Unions	4.7
3.Mutual banks	15.4		

3. Amount by employment size of firms

1.Less than 2	29.2	4.21 to less than 50	11.0
2.3 to less than 5	22.6	5.More than 51	4.6
3.6 to less than 20	32.6		

Source: *Ibid*

3.2.1 City banks.

Most credit guarantees are supplied for working capital through city banks to small firms in service industries. This working capital majority notwithstanding, the credit guaranteed amount is relatively large and the maturity is long. The share of numbers of loan contracts with more than 10 million yen is about a quarter of the total number of guaranteed contracts, and the average maturity is longer than a few years. The supply of this relatively long term and large amount of credit guarantee can be made possible, first because most current users are repeaters as shown previously in the paper, and second because each CGA has long-term relationships with banks.

Though the target of credit guarantee is of course the category of small firms, small banks - for example, such as regional banks or second tier regional banks - have only about a half share of total amount of credit guarantee. City banks have 46.2% share of total guaranteed lending. This is simply because CGAs can depend on city banks more than small banks due to less risks and higher

creditworthiness of client firms with relationships with city banks.[26] Additional data is shown in Table 4.

3.2.2 Fluctuations of insurance payment.

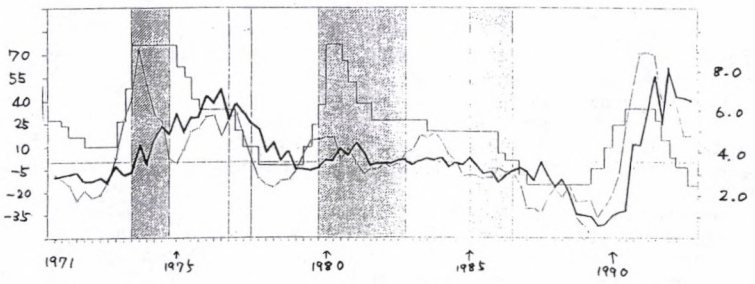
Insurance payment is concentrated to smaller firms of less than 5 employees in declining industries. Compared to the majority of city banks in arrangement numbers as shown above, city banks' presence in insurance payment is significantly smaller than the above majority share. On the other hand, most insurance payment is caused by contracts arranged by regional banks or credit associations. In particular, although credit associations have 13.6% in total amount of credit guarantee in 1990, they cause about 22% of total insurance payment during the year.

This insurance payment is followed by the request of CGAs who have to pay to lending banks on behalf of bankrupt firms. The payment amount of CGAs fluctuates with business fluctuations, as shown in Figure 2. The trend of bankruptcies leads CGAs' payment. Bankruptcies appear at the same time as discount rate changes by the Bank of Japan. Mutual relationships among the discount rate, guarantee payment, and the bankruptcies exist even in the period of financial liberalization since late 80s.

[26] This has been accelerated by the financial liberalization in 1980s. The credit guarantee service of CGAs has worked as the leverage of city banks' entry into small firms loan market in the period. See Horiuchi [1993].

Figure 2 Percentage change to previous year of CGAs payment and bankruptcies, and the discount rate in Japan since 1970s

CGAs guarantee payment (Left)
Number of bankruptcies (Left)
Discount rate (Right)
Shaded area shows the period of economic recession.



Credit guarantee

Financial liberalization can expand the accessibility of firms to new private credit guarantee market supplied by non-bank private financial institutions. Thus, the necessity of the public supply could be reduced in the period. However, public supply through CGAs and SBCIC has increased in the period, to an extent similar to the previous period. Then, the system incurred considerable insurance payment, i.e., increased loss. This is due to the active supply of guarantee through CGAs, requested by urgent policy to make the Japanese economy adapt to the hike of yen exchange rate since 1985. This is an example of the effect of short-term bias emphasizing the current policy issue.

IV POLICY EVALUATION

This section discusses the policy evaluation of Japanese credit guarantee system from two points - organization efficiency and economic efficiency.

4.1. Organization efficiency.

4.1.1 Public and private relationship.

The organization has two facets - public and private. The following analysis focuses mainly on the public element of the organization. Needless to say, the organizational efficiency has to be affected by the relationship among both sectors and also by the organizational efficiency of the private sector.[27] The Japanese system for credit guarantee supply to small firms assumes a close relationship among public and private sectors, such as typically shown for example, the investment of private banks to CGAs or their involvement in monitoring of firms.

Also it presumes a long-term relationship between banks and small firms, and the management efficiency of banks searching for firms with efficient projects and for analyzing their credibility.[28] Because of banks' management efficiency and their relationship with firms and also their commitment to CGAs, the credit guarantee system can be maintained by only about 6,000 staffs in total in the public sector - SBCIC and all CGAs.

4.1.2 Dynamic efficiency.

Although the public sector achieves this labor efficiency, it had to face to management problems some times since

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[27] The relationship between the government and private enterprise sectors is discussed from the point of industrial policy. See Komiya [1988] and various papers in the edited volume.

[28] This relationship is so-called main bank relationship in Japan. See Horiuchi [1993].

the start of the 1950s. Indeed, if we take a snapshot of the public facet of the system at any time of its evolutionary development, we would find several inefficiencies or management reorganization necessities of the organization. This can be easily examined by the fact that there have aroused several important reorganizations in the 1950s and 1960s.

However, from a dynamic point of view, it has always displayed flexible management to achieve efficient organization and has adjusted to policy requirements. After the continuous reorganization period from the cradle period of late '50 to the VIM agreement in 1968, the system could reach the stage to be able to quickly respond to general economic policy issues in each period, such as the industrial adjustment due to the international trade liberalization or the appreciation of yen. Because of this flexibility and the central government's strong commitment, which can be enforced politically assuming the efficient and flexible management of the SBCIC, the system could cover the majority of small firms in Japan in 1980'.

4.1.3. Incentive structure efficiency.

In the system, the SBCIC performs the leadership role as the central bank to control and reorganize the system following the monitoring of the central government - implicit and explicit. For other agents like CGAs, local governments, and banks, the system has had such a dynamically flexible incentive structure that they could follow the control or guidance of SBCIC - again implicit and explicit.

Most moral hazard problems are solved by a combination of both explicit and implicit incentives or punishments, which assumes that agents have long-term relationships among themselves. Although it will need further research to identify the contribution of each factor, I conclude that the explicit commitment assumes the implicit guideline as an indispensable monitoring channel.

We need both channels for efficient organization. Therefore we cannot neglect the explicit measure such as the control of lending conditions to each CGA by SBCIC even though the Japanese system depends strongly on implicit guidelines. The system has been reorganized to reach an optimum mixture of implicit and explicit controls or incentives. Through this evolutionary development, the imperfection of the market for loans to small firms has been mitigated and thus the investment of the central government could have been approved politically even in the period of the government budget deficit.

4.1.4 Administrative guidance.

Looking into the detail of the mechanism of the dynamically efficient organization of the system, first the system provides an opportunity to enhance information exchange among players

and thus reduces information asymmetry.[29] This smooth information exchange is revealed by the high labor efficiency maintained by the small number of employees - only about 6,000 in total for making more than 2 million contracts per year.

However, this organization efficiency in terms of contacts per employee presumes both the commitment of banks and the powerful monitoring of central government. We have already reviewed the commitment of banks. The main concern of the central government is to assign a reasonable budget to the credit guarantee through its investment control over the SBCIC. Generally speaking, the budget for small firms policy tends to increase relatively more because of their political power.[30] The SBCIC can become a buffer for the government to adjust to pressures from politicians. However, this situation will cause organizational inefficiency of the SBCIC because it faces reduced possibilities of punishment. The government seeks to mitigate this possibility mainly through administrative guidance and through its control of the budget allocation to SBCIC. This type of influence on the government agent like SBCIC is so common that we can conclude that credit guarantee system is an example of the Japanese management practice.[31]

Therefore, from the international view point, we may ask reasonably a difficulty in its transplantation to other countries, unless they have few experiences of administrative guidance which assumes a mutual and trustful relationship among the government and private sectors. This prerequisite of the efficient mechanism of the administrative guidance may be a bottle neck for the purpose of its transplantation into other foreign countries.

4.2 Economic efficiency.

4.2.1 Overview.

As far as the contribution of the system to the Japanese economy is concerned, two facts are enough for the general overview. First, the Japanese economy depends on small firms, particularly in terms of employment. Most small firms in local areas - for example in food, construction, or retail industries, all of which are major industries depending on credit guarantee supply - can supply employment opportunities for local people and can stabilize the local

[29] This may induce employees to work harder because of more information exchange.

[30] See Yokokura [1988]. The agriculture sector is an exception. Government subsidy for agriculture has usually expanded more than for small firms.

[31] This also has caused some costs in Japan, however, although it is an interesting question it is more difficult to estimate the costs. This situation is so popular in Japan as criticized as workaholic salary man. Most of large corporations depend heavily on meeting for the management, from top to bottom.

economy. Second, the economy presumes the division of labor between small firms and large corporations via the subcontracting relationship. Most small firms in the electric and machinery industries - another major user of the credit guarantee - are subcontractors of large firms and can contribute to the growth of the economy through export growth. It is those firms of both categories that need credit guarantee services because they have fewer assets and low creditworthiness than large corporations.

Speaking a little bit formally, the mitigation of the information asymmetry among banks and small firms - the purpose of the credit guarantee system - is concluded to have improved three economic goals: i) the stability of the Japanese economy, ii) its long-run growth efficiency, and iii) the equalizaton of income distribution. Absorption of employees, particularly in local areas, can contribute to the stabilization of the economy. Of course, this can work to mitigate the inequality of income distribution among city areas and local areas. Also it can function to mitigate the inequality among large corporations and small firms. All is well known. Going beyond this, the final point is its indirect contribution on the diffusion of technology, not only production technology but management technology. The presence of small firms supported by the credit guarantee could enhance the diffusion because about a quarter of all small firms in Japan introduce the credit guarantee. From the point of the long-run growth of the Japanese economy, this is seen as the most important factor.

Nevertheless, we can ask some negative effects of the credit guarantee supply to small firms who have inefficient projects and cause inefficient insurance payments. This possibility can happen more if CGAs are forced to supply credit guarantee to firms in the short-term horizon. Indeed, we have already shown some recent results since the 1980.[32]

4.2.2 Technical discussion.

Our final discussion is about the financial mechanism performed by the credit guarantee system. The division of labor for the credit guarantee supply can be compared with the division of labor for the syndication loan arrangement for large corporations. For small firms the syndication loan is not efficient mainly because of the small size of borrowing amount. However, even for them, it is

[32] As far as the more general evaluation of small firms is concerned, it used to change since the post war. From 1950s to 60s the presence of many small firms was seen to imply the inefficiency of the Japanese economy and the major small firms policy to expand the size. However, in the 1980s and later on, the situation has changed completely. The presence of huge number of small firms can be seen to enhance the adjustability of Japanese economy.

reasonable to diversify fund raising sources.[33] In the credit guarantee supply system, the manager role is played by a bank. The bank evaluates the risk of the project of its client firm, arranges the loan contract, and supplies its money. CGA can become a follower to supply risk taking service to the bank because the information produced by the bank is trustworthy in the long-run relationship between the CGA and the bank. Of course, this active risk taking is made possible by CGAs' dependence on the SBCIC.

Without the commitment of the CGA, the bank could have reduced its lending under the reasonable assumption of increased risk with the amount of lending. Following this reasoning, under the circumstance without a public credit guarantee mechanism, credit creation by the banking system could have been reduced. As a possible consequence, more money would have been allocated to large corporations through capital markets. Therefore, it seems probable that the public credit guarantee system for small firms has contributed significantly to the growth of the market for loans to small firms.

V SUMMARY

Credit guarantees supplied to small firms through two specialist public organizations has expanded their availability of funds. Access to the bank loan market is made possible for smaller firms with few collateral assets. This mechanism can be compared to syndication loans for large corporations. Because of the expanded credit supply to small firms, the Japanese economy has been able to accommodate many small firms and to display flexible adjustment to economic shocks.

In this mechanism, one of the most important characteristics is cooperation among various players including private banks, governments, and specialist government organizations. These players are incorporated in a chain structure of principal-agent relationships and of efficient incentives. These incentives are either implicit or explicit. The central government monitors the cooperative supply and affects it through the administrative guidance.

Another characteristic is the long-term relationship between firms and banks. Under this private sector business practice, Credit Guarantee Associations and the Small Business Credit Insurance Corporation can maintain considerably higher efficiency in terms of guarantee supply per employee.

[33] See Horiuchi [1993] for further discussion about the fund raising source diversification.

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