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Chapter 4: The Role of Small and Medium Enterprises in Japan's Political Economy

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1. Introduction

Chapter 1 on syncretization in Japan's financial system introduces regional banks as a sector that has seen little change in its basic business practices since its establishment in the immediate post-war period. For regional banks, non fee-based retail banking remains their primary source of income; in contrast, their global counterparts and larger city banks in Japan have greatly diversified their income sources by offering a myriad of financial services and products and generating income through service fees. This chapter seeks to understand why sectors such as regional banks have retained such seemingly outdated features and practices despite being surrounded by significant forces of change. Why and how does resistance to change survive and what are the institutional and systemic factors that support this resistance?

The answer to this question lies with the regional banks' primary customers, small and medium enterprises (SMEs). Regional banks have largely retained their original forms and remained in business due to the numerous policies that support and protect Japan's 4.2 million SMEs. Such policies exist because SMEs and their employees are a critical source of votes and provide a large source of employment in a system with minimal welfare provisions for the structurally unemployed. For their part, SMEs have retained their strong political influence by fully utilizing their organizational structures to ensure continued protections. As demand in Japan's domestic market continues to remain weak, however, Japan's inefficient SME policies have begun to reach their limits. So-called zombie firms can no longer be propped up by public funds alone while more competitive firms have turned to markets outside of Japan. In recent years, public support for SMEs has diminished, putting the future of their primary funders, the regional banks, into question.

During the two decades following the 1990 bursting of the economic bubble, SMEs, which were once the target of compensation for industrial policies favoring large firms, have become polarized along two dimensions. First, SMEs themselves have split into inefficient zombie firms that are largely dependent on public funds and protective policies for survival, on the one hand, and competitive global firms that are innovative and resilient on the other. Second, the labor force supplying SMEs has also bifurcated into regular and non-regular workers, with the latter growing rapidly. Japan's SME policies have come to reflect this reality by propping up the non-competitive firms which remain a source of employment and a substitute for welfare policies for the structurally unemployed while establishing numerous new policies in hopes of stimulating the growth of more innovative and globally competitive firms. This chapter closely examines this overall trend in SME policies while paying particular attention to policies regarding financing, the most critical resource for SMEs.

The chapter begins by taking a comparative approach to the role of SMEs in Japan, demonstrating the particularly strong emphasis that Japan has placed on SME survival and employment during the high-growth years. But numbers alone cannot explain SME survival, especially during the last two decades of slower economic growth when SMEs would have been among the hardest hit. The chapter next opens the black box of SMEs to uncover their organizational structure and how it functions to successfully promote their interests. Doing so shows SMEs cooperating and organizing along different interests to ensure their survival. This chapter has paid special attention to policies regarding funding and employment. While hindering market efficiency and competition for capital and labor, these policies help keep unemployment low and thus serve as a social safety net in lieu of a more fluid labor market and sound welfare system. Finally, the chapter connects the survival of regional banks to the political savvy of SMEs. It shows that regional banks have continued to survive by earning a majority of their profits from lending to SMEs, but with the associated risks significantly reduced with the help of public funds. The conclusion examines the viability of Japan's SME policies and, consequently, the continued survival of regional banks in their current form.

2. What are SMEs and why are they influential?

Strength in numbers

Past studies of Japan's political economy have largely focused on big businesses and the mega-banks that serve them; much less attention has been given to the remaining 99% of Japanese firms which are SMEs. These SMEs have long served as the workhorses for Japan's most politically vociferous industries such as construction and manufacturing, in which SMEs make up 99.9% and 99.5% of the firms respectively.[1] Yet SMEs have been largely left out of the literature and scholarship on Japan because SMEs were, by design, not the designated engines of Japan's spectacular post-war growth. Instead, Japan's post-war industrial policies channeled their energy and resources towards large firms in export oriented industries while treating SMEs merely as the targets of compensatory policies to mitigate such biases.[2] Japan's powerful post-

[1] SME Agency, *SME White Paper 2011* (original data from the Ministry of Internal Affairs and Communications, 2009 Economic Census – Basic Survey)

[2] SME policies of the post-war period have been discussed in a dedicated chapter in (Calder, 1988) which also includes a timeline of SME policies in the appendix. (Estévez-Abe, 2008) also discusses SMEs in the context of Japan's welfare policy. Japanese language scholarship on SMEs typically examines specific aspects of SME policy. For work on SME funding, see (Yamori, 2004) among others.

war economic organizations such as the *Keidanren* are dominated by large corporations, as are chambers of commerce and other industry based organizations. In contrast, many SMEs have historically worked under larger corporations as *shita-uke* or dedicated suppliers, striving to meet the demands of their boss companies in exchange for relative stability and longer term predictability in the supply chain relationship.

By all accounts, SMEs should be facing far greater difficulties in a country like Japan, with its high labor costs and scarce raw materials. This is especially true in sectors like manufacturing, where neighboring countries with much lower labor costs and more abundant supply of raw materials and energy resources have quickly improved their manufacturing skills and technological know-how. In the non-traded sectors such as services and construction, large firms should also have the advantages of greater buying power and the economies of scale. Under certain conditions, some SMEs may be more resilient to economic stress than their larger corporate brothers since their daily overhead is smaller and SMEs tend to have more flexibility in labor costs with fewer full-time employees. However, under conditions of prolonged economic slowdown as experienced by Japan, SMEs should be the least likely to survive. Why then have regional banks and their SME customers survived and how have they protected their interests?

The secret to SMEs' success comes in part from their numerical dominance. SMEs in Japan include all firms with less than 300 million yen[3] in capital or less than 300 employees.[4] According to the 2009 economic census, Japan had a total of 4.21 million enterprises[5], of which 4.20 million (99.7%) were considered SMEs. Among them, 3.67 million (87.0%) were considered small enterprises with fewer than 20 employees (five or few employees for wholesale, retail, and service industries).[6] In short, all but a handful of firms in Japan are SMEs. Even by international standards, Japan has a relatively large number of SMEs per capita; while the US has just 5.9 million SMEs or .019 per capita[7], and Germany has just 1.7 million SMEs or .020 per capita, Japan has .033 SMEs per capita. Although these numbers suggest that Japanese SMEs could have a considerable amount of influence in policymaking, they are more often portrayed as powerless and at the mercy of larger corporations or industrial bureaucrats for their survival.

One reason why SMEs today have the image of being the underdog is because after two decades of economic slowdown, their numbers are far below their peak. The total number of SMEs

[3] Roughly 3.7 million USD in 2012.
[4] Exceptions to this definition, as stated in the revised Small and Medium-sized Enterprise Basic Act, include: wholesalers (less than 100 million yen in capital or less than 100 employees); retailers (less than 50 million yen in capital or 50 employees); services (less than 50 million yen in capital or less than 100 employees). The more typical definition of SMEs used globally is less than 250 employees.
[5] Note that the term enterprises (*kigyo*) differs from establishments (*jigyosho*) or company (*kaisha*). Any given enterprise can have one or more establishments. Data on SMEs often use establishments as the base unit and are then agglomerated into enterprises. Companies are a subset of enterprises.
[6] As defined by the SME Agency. (The Small and Medium Enterprise Agency, 2012)
[7] 2008 data for firms. (Bureau, 2012)

increased rapidly in the high growth era (1955-72) but has now returned to numbers last seen in the 1960s. In 1963, there were roughly 3.99 million establishments, peaking at 6.64 million establishments in 1991 before declining back down to 5.80 million establishments (making up 4.19 million enterprises, a 12.8% decrease) in 2009.[8] The number of employees (*jyugyoin*) has seen similar trends, with 23.6 million employees in 1963 increasing to 48.2 million employees in 1996 before declining back to 28.3 million employees in 2010 (a 41.2% decrease). However, SME employees still make up 66.0% of all employees, and this strength in employment numbers which both stabilizes the economy and directly translates into votes is another key source of influence for SMEs.

SMEs as source of employment

Despite nearly two decades of economic stagnation, one of the surprising forces of stability for Japan's political economy has been the relatively low levels of unemployment, which reached a peak of 5.4% in 2002 and has since hovered around 5%. (See Graph X in Introduction) Unlike other developed nations such as the U.S., France, and Spain which have experienced political upheaval in response to spiking levels of unemployment, Japan's unemployment rate has remained manageable. However indicators of firm profitability and other measures of economic health would suggest much higher levels of unemployment for Japan. What explains this discrepancy?

One reason behind Japan's relatively low unemployment rates is the employment demand created by SMEs. As early as 1953, 73.5%of Japan's entire work force in manufacturing was employed in firms with fewer than 300 employees.[9] In 1972, shortly before the first oil shock, 78.4% of the total non-agricultural labor force worked for SMEs. This number peaked at 81.7% in 1981 despite the slowdown in economic growth after the two oil shocks of the 1970s which hit SMEs especially hard.

Over the last two decades of slower economic growth, SME employment in Japan has remained unusually high relative to other developed countries, making up 66.0% of the non-agricultural labor force in 2010. Among Japan's 42.97 full time workers, 28.34 million work for SMEs, of which 9.12 million work for small firms. In the manufacturing and service sectors, each of which employ roughly a quarter of Japan's workers, the share of the labor force working for SMEs is much larger than in the major Western industrial nations.

[Table on The Heavy Concentration of the Japanese Labor Force in SMEs (in percentages) about here]

This relatively large ratio of employment in SMEs underscores the critical role SMEs play in mitigating an otherwise rigid labor market with few opportunities for horizontal movement or

[8] Here, establishments are used as the unit of analysis, since in the immediate post-war period, the vast majority of SMEs had just one establishment and data was collected per establishment.

[9] (Calder, 1988) p. 314.

temporary adjustments for both employees and employers. As Calder notes, many SMEs serve as a “labor reservoir” from which employers large and small can hire as many workers as they need for as long as they need.[10] During the first half of the high-growth period (1955-1962), non-traded sectors such as services and construction increased SME employment at a rapid rate. In the years following, these domestically oriented sectors were not only shielded from global competition, but also benefitted from legal constraints on the expansion of large-scale businesses, particularly in the retail and service sectors. Admittedly, such protections led to growing inefficiency and redundant employment in these non-traded sectors, but rapid economic growth and the growing affluence which increased demand for specialty shops and services was able to absorb part of this growth in employment. Even during the 1980s when mechanization and automation expanded rapidly, large firms took the brunt of the labor cuts while SMEs which are typically slower to incorporate new technology and less able to afford large capital investments necessary for labor-cutting retained their function as Japan’s labor-sponge. In 1986, unemployment in Japan remained a low 2.8 % compared to 6.9% in the US and 11.7 % in Europe.[11]

The role of SMEs as a sponge for excess labor has similarly allowed Japan to maintain relatively low levels of unemployment in the post-bubble era. However, along with the slowdown in the economy, the labor adjustment mechanism has evolved from redundant employment in protected sectors to an increase in non-regular employment, shifting the costs of maintaining lower unemployment from employers onto workers. Non-regular employment includes part-time and temporary workers, dispatched workers from temporary labor agencies, and contract workers. During the last two decades, non-regular employment has increased rapidly from 20.2% of total employment in 1990 to 35.7% in 2011.[12] Among firms with less than 30 employees, over 37% of employees are non-regular workers.[13]

SMEs have always relied more heavily on non-regular workers relative to large firms, but the surge in non-regular hires occurred in the post-bubble years. Between 1987-93, during the latter bubble years, large firms expanded their work force by hiring full-time regular workers, pushing many SMEs out of contention for the best employees. Under this pressure, SMEs began increasingly hiring non-regular workers. After the bubble burst, large firms cut back on hiring regular workers, making way for some SMEs to increase their regular workforce. However, by 1997 with the onset of the Asian Financial Crisis, hiring of all workers ground to a halt, with firms of all sizes rapidly decreasing their hiring of regular workers. When the economy began a slow recovery in 2002, new hires were primarily non-regular employees. By 2009, even large firms had more than 30% of their labor force made up by non-regular workers.

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[10] (Calder, 1988) p. 315.
[11] (Calder, 1988) p.316.
[12] Calculated from the Labor Force Survey (*Roudouryoku Chousa*) (2011) and Special Survey of the Labor Force Survey (*Roudouryoku Chousa Tokubetsu Chousa*) (1990).
[13] (Japan Ministry of Health, 2010).

For employers large and small, hiring non-regular workers has several benefits which become increasingly attractive when the economy sours. The most important advantage is the low cost of non-regular workers who typically earn much lower wages. Whereas the average regular SME worker made about 286,000 yen per month in 2005, the average for non-regular workers was 125,000 yen or less than half that of regular workers.[14] Cost savings also come from the absence of benefits paid to most non-regular workers. Employers also favor non-regular workers for their flexibility, allowing short-notice adjustments to hiring according to need.

One of the keys to success for SMEs in maintaining such favorable labor conditions has been their shared interests with big businesses. In times of economic plenty, SMEs and big business often stood in conflict over labor issues. Whereas large firms hired more regular, full-time workers who stayed with the same firm over many years, SMEs with their more volatile business environment had long placed greater value on flexibility and lower cost. As such, SMEs lobbied for minimal benefits for non-regular workers, seeking to keep regulations pertaining to their workforce largely separate from those pertaining to workers in larger firms. In contrast, larger firms were more willing and able to bear the costs of employee benefits and pensions in exchange for long-term employee loyalty. But the post-bubble economy changed the labor outlook for many large firms who needed to drastically cut back on labor costs. Under these new economic conditions, SMEs found themselves partnered with big business in a successful effort to fend of efforts to obtain greater benefits for non-regular workers. The deregulation of human resource outsourcing and businesses built around the market for non-regular workers (such as temp agencies) have further facilitated such efforts.

Thus despite two decades of economic slowdown, SMEs continue to fulfill an important social security role by continuously providing jobs for workers who would otherwise be structurally unemployed. Japan has traditionally paid relatively low welfare payments, and retirement comes early relative to the potential working years of the average Japanese worker.[15] But Japan's labor market for mid-career hires still remains extremely tight, with the vast majority of full-time regular employees hired upon graduation. Thus flexible work opportunities in SMEs fill an important gap in the labor market. Although Estévez-Abe has shown that Japan has augmented nominally low welfare payments with the "functional equivalents" of welfare payments[16], SMEs and their non-regular positions have provided much needed employment opportunities to further make up for low welfare payments, especially for the young, the elderly, and women.

In short, while both the number of SMEs and their employees reached their peak shortly after the bursting of the economic bubble, SMEs still have a large influence in the Japanese political economy through their dominant size in firm numbers and employment, especially in some of the more politically influential, non-traded sectors. However, numbers alone do not guarantee political influence as collective action problems abound and internal conflicts of interests are

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[14] (2007, 2011), Part 3 Section 1.
[15] (Calder, 1988) p.316.
[16] (Estévez-Abe, 2008)

sure to emerge.[17] Many other potential interest groups with large numbers, such as labor unions and consumers, have had varying levels of influence while smaller groups have had disproportionately large impact.[18] The ability to provide-jobs in a slow economy certainly keeps politicians interested in the plight of SMEs, but it is the organizational structure of SMEs that amplify their voices on the political stage.

3. SME organization

In order to overcome the collective action problems that often limit the influence of large interest groups, SMEs have deftly used a nationally hierarchical but locally mobilized organizational structure to protect and defend their diffuse interests. Furthermore, their organizations cut across a wide range of industries with varying interests, making it effective for gaining concessions in broad policy areas including financing, taxation, labor, and welfare regulations. Their coordination mechanisms have three distinct features which together have proven extremely effective in promoting their interests.

First, SMEs organize and mobilize locally based on shared interests in invigorating local economies. These shared interests often involve local infrastructure such as shopping districts and transportation routes that almost exclusively benefit SMEs with a physical presence in the locality. As such, these groups often have names that include the infrastructure name such as, "The SME Organization for the Promotion of Tatehashi Shopping District". These types of locally based organizations prove effective in harnessing the cooperation of local politicians whose electoral future depends heavily on the support of such local organizations. Prefectural and municipal assemblymen who are typically elected from small communities are particularly responsive to such overtures. Elections for local assemblymen continue to follow the multi-member system in which multiple politicians are selected from each electoral district, greatly reducing the share of votes necessary to win a seat. Such institutional features of the local electoral system have also influenced how locally based SME organizations mobilize. Many SMEs belong to local industry groups such as hospitality services or noodle stores. These local groups support local assemblymen with their votes in exchange for their promise to promote projects and policies favorable to their group. SMEs find this kind of mobilization effective precisely because their limited but reliable votes make a difference in local elections.[19]

Second, SMEs also organize vertically, with local groups falling under nationally hierarchical organizations. These vertical organizations are put to work when lobbying central level

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[17] According to theories of collective action, large groups with diffuse interests such as SMEs cannot compete against smaller groups with better defined interests such as big corporations in the export sector. (Olson, 1971)

[18] Scholars such as Okimoto and Rosenbluth have characterized consumers as a politically weak interest group in Japan. However, Vogel argues that Japan's consumers are a group whose assumed interests are not necessarily their preferences, and in fact, consumers have been satisfied with many of the policies assumed to be anti-consumer including the continued protection of the agriculture and retail sectors. (Okimoto, 1982; Rosenbluth, 1989; Vogel, 1999)

[19] Author interview with a municipal level Chamber of Commerce, Aichi Prefecture, 2011. (Interview 110915_Aichi_CoC)

bureaucrats and politicians. This vertical hierarchy facilitates funneling necessary resources, such as manpower and funds, to lobby for national policies such as trade restrictions and tax exemptions. While this type of lobbying in the nation's capital may be commonly observed in other countries, Japan's SMEs are particularly keen to organize nationally in order to influence central level bureaucrats as much as, if not more than, their own Diet representatives. This is because bureaucrats in Japan have long been responsible for drafting legislation, and this is especially true for detailed policies that involve SMEs. SME policies are especially dominated by the SME Agency which falls under the Ministry of Economy, Trade and Industry, with minimal input from regional offices, making it imperative for SME organizations to have a tightly controlled, nationally hierarchical organization in order to effectively influence bureaucrats at the national level.[20]

Third, and perhaps most importantly, SMEs also organize horizontally, creating broad networks both locally and nationwide. At their base, SME networks are organized by industry. Within broader categories such as manufacturers, more specific industry groups such as textile producers or electronics manufacturers form their own networks across the country. However, what makes SMEs politically effective is another horizontal layer of organization that cuts broadly across a much wider range of interests and industry groups. One such example is the Japan Association of Life Sanitation Industries (*Zenkoku Seikatsu Eisei Dogyo Kumiai Rengo*) or Seiei for short. This association brings together 18 different businesses with shared interests in "sanitation" broadly defined. They include seemingly unrelated industries such as bath houses, restaurants, ice makers, hotels, and even theaters. Each of these business categories has their own industry-specific organizations, but they come together under one organization, Seiei, to lobby for policies that involve shared concerns for their broader group.[21] A prime example of a shared interest among this group of primarily service providers is in keeping part-time workers flexible both in terms of the number of hours they work per day and in the length of their contracts. By focusing on common goals to agglomerate interests across a range of industries, associations like Seiei allow SMEs to overcome the collective action problems that often cripple similarly diverse groups.

Furthermore, associations like Seiei have evolved to become adept at using size to their advantage. In 2001, the latest year for which data is available, Seiei member SMEs together employed 6.50 million employees out of a total of 53.58 million employees nationwide, namely 12% of all SME employees.[22] Through its organization, Seiei, for example, promotes national policies favorable to its members by creating its own standards and rules that are first put into action by member SMEs. Calorie count indications and recycling regulations for food containers

[20] Author interview, SME Agency, 2011. (Interview 110924_SMEA)
[21] Seiei itself provides a number of services that make the organization attractive to its member SMEs. Members get access to a wide range of information through a dedicated database, receive information on loans and other financial matters and, most importantly, gain access to a broad network of SMEs.
[22] Data on the number of workers under Seiei from (2001). Data on total employees from (Communications, 2001) "The Special Survey of the Labour Force Survey (*Roudouryoku Chousa Tokubetsu Chousa*)", 2001.

are two such examples.[23] These standards and rules are often adopted wholesale as national regulations for all firms large and small, owing primarily to the strength of Seiei as a consolidator of interests across numerous SMEs from various industries. By taking advantage of their large membership, horizontal organizations like Seiei become especially influential and effective at promoting and protecting policies favorable to SMEs.

4. Support and protection for SMEs

Still, dominance in numbers and effective organization alone do not adequately explain the nature of support and protections given to Japan's SMEs. The survival of Japan's SMEs despite nearly two decades of economic slowdown owes much to the design and content of SME policies themselves.

Calder has shown that among major industrialized nations, Japan is unique in systematically designing policies that serve the interests of small firms.[24] During the high growth period, SME policies compensated SMEs for many of the disadvantages that came from a national industrial policy focused on promoting big business. Since such compensatory policies were designed as a safety net for hard times rather than as an encouragement for innovation or high performance, Japan's SME policy was comprehensive and multifaceted so as to reach the widest range of SMEs.[25]

Historically, small businesses worldwide have been politically influential, overcoming problems of collective action particularly during times of economic or political crisis. Examples include Germany and America in the early 1930s, when small business became a critical swing group in national politics.[26] However, even in times of relative stability and economic growth, Japan's public policies have strongly favored SMEs along multiple dimensions, including through subsidized loans[27], tax policies, export policies and competition policies. Such policies not only overshadowed the policy stances of other major conservative administrations such as those of Reagan and Thatcher, but also those of socialist governments in France and Italy.[28]

Key among all of the policies in place to protect SMEs are policies and institutions that help SMEs gain access to capital. SMEs in Japan, like SMEs everywhere, are inherently at a disadvantage for raising funds. Their small size makes them more sensitive to the ups and downs of the surrounding economy, creating greater uncertainty in their profitability and thus

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[23] Author interview, Seiei officer, 2011. (Interview 110912_Seiei)

[24] (Calder, 1988)

[25] A 1978 survey by the Organization for Economic Cooperation and Development comparing SME policies among industrialized nations showed that Japan had the most extensive range of policy tools, using all major means of support covered in the survey. (Organization for Economic Cooperation and Development, *Industrial Adjustment Policies*, (Paris: OECD, 1978) as cited in Calder 1988, p 317))

[26] (Arno J. Mayer as cited in Calder 1988).

[27] In 1982, Japanese government agencies for small business finance disbursed 17.5 times the volume of loans and undertook 13.3 times the volume of loan guarantees of the American Small Business Administration, according to Japanese government unpublished data. (Calder, 1988)

[28] (Calder, 1988) p. 313.

their risk profile. Thus SME policies tend to focus heavily on funding needs, and as a consequence on regional banks. While regional banks are not the only financial institutions through which SMEs raise capital, regional banks themselves rely heavily on the continued existence of preferential policies for SMEs to remain in business. In short, regional banks and SMEs have a symbiotic relationship, assuring each other's survival.

Giving SMEs access to capital

One of the main reasons why regional banks have retained their traditional business style is the continued dependence of SMEs on bank loans for capital. The average SME gets over 50% of their capital in the form of loans from financial institutions.[29] In general, the smaller the firm, the more it depends on borrowing for funds. In 2001, firms with less than 20 employees received 66.9% of their capital from loans by financial institutions whereas firms with more than 300 employees received just 24.2% of their capital from such loans.[30] Larger firms can raise funds through financial markets by issuing corporate bonds or equity. In contrast, raising funds through equity capital remains a challenge for SMEs, even though their equity ratio has increased in recent years.[31]

SMEs' heavy reliance on bank loans for funding is worrisome in light of the significant decline in loans outstanding to both SMEs and large enterprises. For large firms, this is less worrisome since, as noted above, they are better able to raise funds on domestic or international financial markets. For SMEs, however, the decline in loans is a direct reflection of their financial health. Loans to SMEs from all types of financial institutions peaked in 1994 at 345.3 trillion yen and have declined since then to just 251.9 trillion yen in 2010, a 27% reduction in outstanding loans.

[Graph X Total Outstanding Loans to SMEs, 1992-2010 about here]

While the total number of SMEs has also declined by 13 % during this period, the 27% decline in loans has been much more acute.

While outstanding loans to SMES may be falling, SME lending still remains vitally important, not only for the SMEs that take out loans but especially for the financial institutions that provide them. For private banks, loans to SMEs became the largest portion of their overall loan portfolio in the mid-1990s. Whereas in 1965, just 41% of all bank loans went to SMEs, by 1997, the ratio had risen to 70%.[32] This ratio has remained stable in the years following, reaching 71.3% in

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[29] (1986-2011) 2001.

[30] By 2003, these numbers had decreased to 55.7% and 21.9% respectively. (SME Agency, SME White Paper 2005, p.92; original data from the Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Annually.*)

[31] In 2003, large enterprises had an equity ratio of over 30% while SMEs had an average of 20%. The ratio of corporate bonds for large enterprises was over 5% while for SMEs the ratio was less than 1%. (SME Agency, SME White Paper 2005, p.92; original data from the Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Annually.*)

[32] Bank of Japan, *Keizai Toukei Nenpo* (Annual Statistics on the Economy), 1999.

2005 and declining slightly to 68.0% by the first quarter of 2012.[33] Today, regional banks such as Suruga Bank and Kinki Osaka Bank top the list of banks with the largest ratio of loans to SMEs at 95.2% and 92.7% respectively. City banks have a smaller ratio with Mizuho Corporate Bank the lowest at 37.3%, but their average remains around 60%.[34] In contrast, in the U.S., the ratio of lending to SMEs falls as bank assets increase, and banks with assets of 10 billion USD or more[35] have an SME lending ratio of just 24.0%.[36] The dominance of SMEs in their loan portfolios helps explain why Japan's regional banks have steadfastly retained their traditional forms of banking while other financial institutions have undergone significant change in the face of global competition and other external pressures.

Several factors have contributed to the high ratio of lending to SMEs by financial institutions in Japan. First, large enterprises successfully shifted away from borrowing as their primary source of funds. Instead, they raised funds on financial markets by issuing corporate bonds and shares, which left retail-oriented banks evermore dependent on profits made from loans to SMEs. Second, the development of direct financial markets for SMEs, both in Japan and abroad, has been stunted by a lack of necessary information and know-how and consequently higher risk. Lastly, and perhaps most importantly, banks are able to earn a higher margin of profit by lending to SMEs rather than to large enterprises, making SMEs more attractive as customers. As will be discussed later, the competition for loans to high-paying SME customers has increasingly become a source of concern for regional banks, which are being crowded out by both larger city banks and smaller credit cooperatives seeking a larger piece of the SME loan market.

Government affiliated financial institutions

From the viewpoint of SME policy, however, government-affiliated financial institutions have long been the central pillar of SME financing. During the high growth period when SME policy was best characterized as compensatory, Japan created several government-affiliated financial institutions[37] exclusively to fund SMEs and micro businesses that could not gain adequate access to private bank loans. The main targets of these institutions were SMEs that did not have enough collateral (typically real estate) to secure loans or lacked sufficient financial information for satisfactory evaluation. At its peak, government-affiliated financial institutions provided 10.4% (2004) of all funding for SMEs, and 70% of SMEs have used such funds.[38]

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[33] Data from Tokyo Shoko Research, various years, http://www.tsr-net.co.jp/english/ (accessed July 1, 2012).

[34] Data from Tokyo Shoko Research, 2012.

[35] In fiscal year 2011, the average Japanese regional bank had assets of 50 billion USD. (Calculated from data available at Regional Bank Association of Japan website: www.chiginkyo.or.jp (accessed June 23, 2012)

[36] (1986-2011) 2005.

[37] These included the People's Finance Corporation (*Kokumin Seikatsu Kinyu Kouko*), the Agriculture, Forestry and Fisheries Finance Corporation (*Norin Gyogyou Kinyu Kouko*) and the Japan Finance Corporation for Small and Medium Enterprise (*Chusho Kigyo Kinyu Kouko,* est 1953).

[38] Data on loans from government-affiliated financial institutions from SME White Papers, 2005; Data on the percentage of SMEs that have used funds from government-affiliated financial institutions from Graph 4-2-1, A Survey of Japan's Firm Performance (*Waga Kuni Kigyo Keiei Jittai Chousa*), Agency for Small and Medium Enterprises, December, 2009.

Government-affiliated financial institutions benefitted many SMEs that would otherwise have gone bankrupt during the last two decades of slow economic growth. By providing direct loans to SMEs using public funds, thereby bypassing the more stringent requirements of profit-seeking private banks, these institutions allowed SMEs to survive during tough economic times. In so doing, they indirectly helped to keep unemployment and bankruptcy numbers relatively low. Preventing SMEs from going out of business has been a particularly big concern for government-affiliated financial institutions which operate under direct government control and directives to keep businesses alive and within Japanese borders, thereby stopping business flight overseas. Bankruptcies among SMEs peaked during the years following the Asian Financial Crisis from 1998-2002, but have declined since then.[39]

At the same time, however, the direct distribution of public funds to prop up weaker firms has met criticism for allocating valuable funds to inefficient sectors of the economy. Opponents are concerned that by injecting public funds into the marketplace via government-affiliated financial institutions, the laws of supply and demand no longer determine the price and allocation of funds. The use of public funds to keep firms afloat also invites accusations of unfair competition from both domestic and foreign firms that do not have access to such funds. Such criticisms, and the government's own realization of the decline of competitiveness among SMEs, have led to a gradual downsizing of such programs.

In recent years, as has been the case for SME loans from regional banks, the post-bubble economic slowdown has led to a decline in funding via government-affiliated financial institutions. The total amount of such loans peaked in 1992 at 30.9 trillion yen and has been declining since then, reaching 22.1 trillion yen in 2010, a 28% reduction. The amount of loans from government-affiliated financial institutions as a percentage of total loans given to SMEs has remained steady at roughly 9% throughout this period, but the absolute amount has declined significantly. These trends suggest that while the government can justify shouldering a certain percentage of SME loans, the actual amount of loans distributed must be in line with broader economic decline.[40]

Furthermore, there have been additional signs that suggest the government's growing sensitivity to the excessive influence of public funds in the SME loan market. One such example was the move to merge, privatize, or abolish several government-affiliated financial institutions. Of greatest impact to SMEs was the creation of the Japan Finance Corporation (JFC) in 2008. Established by merging four policy-based financing institutions[41], the JFC has greatly reduced the overall operation of government-affiliated financial institutions including a reduction in personnel and a decline in the number and amount of loans distributed. The JFC has reduced total funding for SMEs over the last few years from just under 8 trillion yen in 1999 (under the

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[39] Tokyo Shoko Research, Ltd. *Business Failure News (Monthly)*, various years.
[40] Author's interview with a veteran loan officer from a government-affiliated financial institution, December 2011.
[41] The fourth institution included a finance portion of the Japan Bank for International Cooperation (*Kokusai Kyoryoku Ginko*).

former Japan Finance Corporation for Small and Medium Enterprise) to 5.6 trillion yen in 2008 (under the JFC's SME unit).[42] Similar reductions were made for the People's Finance Corporation, another government-affiliated financial institutions established post-war, and its successor in the JFC.[43] Other institutions such as the Japan Finance Corporation for Municipal Enterprises (*Kouei Kigyo Kinyu Kouko*) and the Shoko Chukin Bank (*Shoko Kumiai Chuou Kinnko)* were abolished or privatized.[44] Today, JFC accounts for 5.6% of all loans to SMEs and the Shoko Chukin Bank accounts for another 3.9%, leaving the bulk of loans (90.5%) in the hands of private financial institutions.[45]

Credit guarantees

As opposed to government-affiliated financial institutions which primarily distribute public funds directly to SMEs through loans, the government can also facilitate the distribution of loans from private banks by using public funds to guarantee such loans. These credit guarantees help reduce the risk associated with loans to SMEs for their lenders, and also serve to help fill the so-called middle-risk gap left by the private market. The middle-risk gap refers to the hole in the interest rate structure in the loan market between lower rates for proper loans given to healthy firms and the much higher interest rates for risky loans used by loan sharks and other informal money lenders. Schaede argues that Japan suffers from this middle-risk gap due to a confluence of systemic reasons such as the shift away from using real estate as collateral and political pressures. As a result, private banks are neither willing to take the higher risks nor do they have the information necessary to accurately assess the associated risks and set the appropriate price.[46] Thus for SMEs with higher risks, one of the only ways to obtain a loan from a private bank is to make use of publicly funded credit guarantees.

During the years following the bursting of the economic bubble, the use of credit guarantees gradually increased, rising even more rapidly after the Asian Financial Crisis in 1997. Between 1990 and 2000, the total amount of outstanding loans to SMEs using credit guarantees nearly doubled from 20 trillion yen to over 40 trillion yen.[47]

[Insert Graph: Credit Guarantee Use by SMEs]

The proportion of total borrowing backed by credit guarantees also rose, peaking around 1998-1999. In 1990, just 5.3% of all outstanding loans to SMEs from private financial institutions

[42] Japan Finance Corporation, www.jfc.go.jp (accessed July 15, 2012). This number has increased somewhat following the 2011 Tohoku Earthquake.
[43] The People's Finance Corporation had outstanding loans of 7.2 trillion yen in 2006 which declined to 6.5 trillion yen in 2010.
[44] The Shoko Chukin Bank began its transition toward privatization on October 1, 2008 and is expected to be fully privatized by 2022. www.shokochukin.co.jp (accessed June 28, 2012)
[45] Japan Finance Corporation, www.jfc.go.jp (accessed June 15, 2012)
[46] (Schaede and Kenkyūjo, 2004)
[47] Japan Small Business Research Institute (http://www.jsbri.or.jp/new-hp/statistics/s3.html)

were backed by credit guarantees.[48] By 1999, the ratio of loans covered by credit guarantees had more than doubled to 12.9%; for regional banks, this ratio was even higher at 18.2%.[49]

From the perspective of the lenders, however, the number and amount of loans covered by credit guarantees were insufficient. Although up until 2007 credit guarantees covered 100% of the loans they guaranteed, leaving lenders with no risk on these loans, qualification criteria for credit guarantees set by the credit guarantee agency remained difficult, granting guarantees to only a fraction of the SMEs that applied. Furthermore, many SMEs requested multiple loans, only some of which were covered. Thus despite the reduction in risk afforded by these publicly funded credit guarantees, private financial institutions still needed to shoulder the risk for the vast majority of the loans they made. This reality contributed to the continued difficulty many SMEs faced in obtaining loans despite the large amount of public funds poured into credit guarantees. In fact between 1990 and 2000, the decade during which the use of credit guarantees nearly doubled, SME lending by private financial institutions declined rapidly. For regional banks, loans to SMEs grew at 6.1% in 1990, but that growth rate was down to (-2.6%) by 1999, the peak year for credit guarantee coverage. This decline in loans was even more acute for larger city banks who are much less dependent on SMEs, falling to (-12.0%) in 1999.[50]

While credit guarantees provided limited security for private financial institutions, they were crucial to many SMEs who were partially or fully dependent on such guarantees to obtain funds. According to a 2005 survey by the National Conference of Association of Small Business Entrepreneurs, as many as 57.4% of all SMEs had used or were using credit guarantees to receive a loan from a private financial institution.[51] This number is consistent with several other estimates given in interviews by SME owners and regional bank loan officers. Moreover, around two in three enterprises using credit guarantees had access only to guarantee-backed loans.[52] These numbers suggest the critical role of credit guarantees in giving many weaker SMEs access to credit, especially in times of need.

As was the case for government-affiliated financial institutions, however, criticism came from those who saw publicly funded credit guarantees as an inefficient use of increasingly scarce funds. In a study of large Japanese banks, Caballero, Hoshi and Kashyap (2008) examined the effects of extending credit to otherwise insolvent borrowers.[53] They showed that keeping so-called zombie firms alive reduces the profits for healthy firms, which discourages their entry and

[48] Data from the monthly report of the predecessor to the Organization for Small & Medium Enterprises and Regional Innovation, Japan, Monthly Report of Credit Guarantees. (*Chusho Kigyou Sogo Jigyoudan, Shinyo Hoken Geppo*)
[49] Graph 213-2 from the SME White paper, 2000. (http://www.chusho.meti.go.jp/pamflet/hakusyo/H12/Z213-02-00.htm)
[50] Graph 211-5 from the SME White paper, 2000. Ibid.
[51] National Conference of Association of Small Business Entrepreneurs 2005 Survey, survey of 1005 firms, (http://www.doyu.jp/research/theme/data/option200505.html)
[52] P.95 (1986-2011) English version 2005.
[53] Cabarllero, Hoshi and Kashyap, AER 2008 Zombie Lending and Depressed Restructuring in Japan

investment. Furthermore, zombie-dominated industries exhibit more depressed job creation and destruction, and lower productivity. While credit guarantees may prolong the lives of weaker SMEs with little risk to their financial lenders, defending the cost performance of these valuable public funds became increasingly difficult. That credit guarantees covered 100% of the risk, leaving the lending financial institutions and the SMEs themselves with very little risk if any, also raised concerns for potential moral hazard problems. The credit guarantee agency tried to overcome this problem by setting strict standards for credit guarantee qualification, but lenders had weak incentives to monitor borrowers with credit guarantees. SME loan policy thus came under increasing pressure to reconsider its focus on protecting older SMEs at the cost of forgoing loans to new, innovative firms in emerging industries. With the revision of The Basic Laws Governing SMES (*ChuShoKigyo Kihon Ho*) in 1999, Japan's overall SME policy slowly began to move away from a compensatory and protective stance geared towards saving weaker firms to one more focused on strengthening and expanding profitable firms and encouraging the birth of new firms.[54]

The decline of credit guarantees

In response to these newly growing concerns over the use of public funds and the overall decline in its availability, the use of credit guarantees began to decline in the 2000s. The number of newly guaranteed loans declined from 2.24 million loans in 1998 to 0.87 million loans in 2011, a 61% decline; the amount of newly guaranteed loans declined from 29.0 trillion yen to 11.6 trillion yen, a decline of similar proportion during this same time period.[55] The total amount of outstanding loans using credit guarantees, however, declined from 43.0 trillion yen to just 34.4 trillion yen in 2011, a much smaller decline of 20% due to loans carried over from the surge in credit guarantee use during the 1990s.

In response to concerns about potential moral hazard problems, credit guarantee coverage was reduced from 100% to 80% in October 2007, placing the remaining 20% of the risk of default in the hands of the lending institutions. The number of guaranteed loans that went into default increased immediately after the 2008 Lehman Crisis, but by 2010, the number of defaults had returned to the pre-crisis levels of 2006. Newly guaranteed loans also increased in number by about 20% in 2008, but by 2011, that number had hit an all-time low. As of the time of writing, it is still too early to see if lenders have improved their ability to assess risk, and if the rates of default have declined as a result of changes in the credit guarantee coverage ratio. Nonetheless, such regulatory changes may also have contributed to the decline in the use of credit guarantees.

Labor regulation also moving away from favoring SMEs

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[54] Column 2-1-1, SME White Paper 2011, http://www.chusho.meti.go.jp/pamflet/hakusyo/h23/h23/html/k211200.html

[55] During this time, the number of SMEs declined from 4.84 million in 1999 (available data closest to 1998) to 4.20 million in 2009 (the most recent data available) or a decline of 13.2%, a much smaller decline than the decline in guaranteed loans.

The move away from compensatory and protective policies has also extended beyond SME financing and into areas such as labor and tax policies. For example in recent years there has been growing concern over the rise in the number and proportion of non-regular workers in the workforce, especially among younger workers. Historically, non-regular workers had been dominated by housewives and older workers who explicitly sought flexible, non-regular work. In 1990, 37.9% of female workers were non-regular workers, the vast majority of them housewives working part-time; in contrast, only 8.7% of male workers were non-regular workers. More recently, younger workers who would prefer to have regular employment have taken on non-regular work out of necessity. In 2011, 17.2million workers (35.4% of all workers) were non-regular workers, of which 9.1 million (54.6% of all female workers) were part-time female workers and as many as 2.7 million (20.1% of all male workers) were part-time male workers.[56] These trends have led to the bifurcation of the labor force between regular and non-regular workers, creating greater disparities in income levels, benefits coverage, and long-term earning potential among workers of the same generation. In an effort to mitigate this growing divide between regular and non-regular workers, benefits have been extended to non-regular workers who work over a certain number of hours. Such new regulations, which passed despite the resistance of SMEs eager to keep labor costs low and their labor force flexible, attests to the declining influence of SMEs. The more recent passage of the consumption tax increase is yet another example of new legislation that disadvantages SMEs. [57] Since SMEs are often responsible for purchasing the materials that go into the parts they supply, the consumption tax increase makes them shoulder a hike in input prices that they cannot pass onto their purchasers due to an imbalance in bargaining power that favors the larger firm buyers. While the government is considering legal stipulations banning this practice[58], stiff competition among SME suppliers make such costs virtually impossible to pass on.

5. **SME policies going forward**

Overall, the current state of SME policies, especially as they pertain to SME financing is a mixed bag.

Dominance in numbers and deft organization have not spared SMEs from the economic hardships experienced by the rest of Japan. The economic slowdown since the early 1990s has taken a toll on the profitability of SMEs. The effectiveness of using public funds to support weaker SMEs remains questionable in light of the fact that SMEs' total labor productivity and total factor productivity have both improved little since the mid-1990s.[59] After 2008, many have had increasing difficulties gaining access to capital and many more have gone bankrupt. What

[56] Labor Force Survey (*Roudou Ryoku Chousa*), various years, Ministry of Internal Affairs and Communications, Japan.
[57] The increase in the consumption tax was approved by the upper house in August 2012.
[58] Sankei News Online, August 11, 2012 (http://headlines.yahoo.co.jp/hl?a=20120810-00000001-fsi-bus_all). Specific data available from the Central Federation of Societies of Commerce and Industry (*Zenkoku Shoukoukai Rengoukai*)
[59] (2007, 2011) Graph 2-1-23 Total Labor Productivity; (Maeda, 2012)

has not happened in this sector, however, is exposure to foreign competition, which forced many larger corporations to change their business practices. The same could be said of regional banks. In their heyday, regional banks had branch offices that extended well beyond their local base area with some banks opening offices in overseas locations. But unlike their mega-bank counterparts, few regional banks were forced to merge in order to remain competitive and even fewer were directly exposed to foreign competition.

While policies for supporting weaker SMEs have continued to decline in the 2000s, the 2008 Lehman Shock and 2011 Tohoku Earthquake have reversed some of these trends, leading to the reemergence of a wide range of support measures. In particular, there has been a resurgence in efforts to facilitate financing for SMEs. After the 2011 Tohoku Earthquake, Japan was reawakened to the existence of numerous SMEs who had carved out niche positions in the global economy. As Schaede has shown, many of these SMEs serve as critical links in the global supply chain, producing high value added components and holding large market shares in a wide range of products.[60] Numerous emergency measures were put in place after the earthquake to ensure the survival of these firms. But even these SMEs have been threatened by rising energy prices and an overall slowdown in both the domestic and global economies.

Additionally, there has also been a renewed effort to stimulate the growth of profitable healthy firms and encourage the birth of new firms. These include SMEs with ambitions to develop operations overseas, those attempting to develop new businesses or change their main line of business, and start-ups.

More traditional forms of support for SMEs have also regained traction. For example, renewed efforts have been made to revitalize shopping districts (*shotengai*) which are typically filled with small, independent retail shops as opposed to franchises and chain stores. City centers in locations outside of the major metropolitan areas have also received additional revitalization funding to support struggling SMEs.

6. Conclusion: the fate of regional banks

SMEs remain at the heart of the Japanese economy, and remain the primary employer for the majority of Japan's workers. It is not an exaggeration to state that the future of the Japanese economy depends in large part to the future of SMEs themselves and how they are influenced by the policies that govern them. In particular, the fate of regional banks has been and continues to be closely linked to the fate of SMEs. As such, the ups and downs of SME policy directly influence the performance of regional banks.

Since their establishment, regional banks have served their local SMEs and regional governments, nurturing long term relationships with both parties. These relationships gave regional banks a significant advantage over their larger domestic or foreign competitors by providing them with critical information about the profitability and business forecasts of local

[60] (Schaede, 2012)

SMEs. Lenders have long had a difficult time amassing this type of information from SMEs, building a "conventional wisdom" about the compatibility of smaller banks and SME lending through relationship lending.

This conventional wisdom held true to some extent prior to the age of information technology. Regular personal visits from loan officers served as the primary source of borrower information. Torre et al (2008) have shown, however, that there is now a significant gap between this conventional wisdom and what banks armed with vast amounts of information and technology can actually provide. Larger city banks with better funding and more staff have a clear advantage in consolidating and analyzing the information necessary to make SME lending profitable. Additionally, as the economy slows and profits shrink, competition for the SME market has increased, with larger city banks and smaller credit cooperatives both fighting regional banks for profit shares. For ambitious and profitable SMEs looking to expand or go overseas, larger banks provide services beyond banking alone such as larger networks of business contacts, making them more attractive than regional banks that are limited in what they can provide. Some have even suggested a limited future for regional banks whose original roles have lost relevance.[61]

A number of possible futures may lay in store for regional banks, ranging from rapid consolidation via large scale mergers, as was the case for city banks, to overseas expansion similar to the trajectory of some of Japan's most active SMEs. Whatever the case may be, what is for certain is that those regional banks that are holding onto the old model of retail banking have a limited lifespan. As public support for weaker SMEs continues to diminish, regional banks who also depended on this support will need to find new sources of profit.

[61] Author's interview with a former official from the Ministry of Finance.

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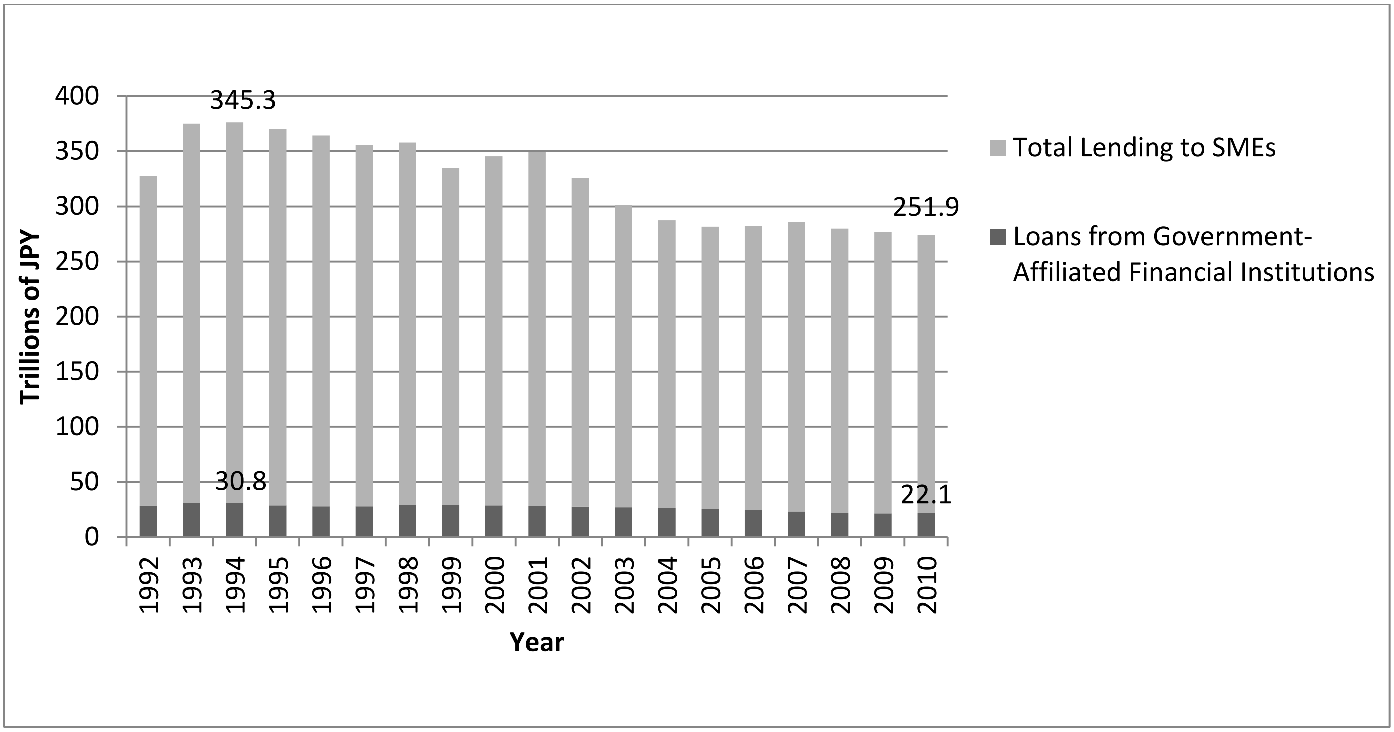
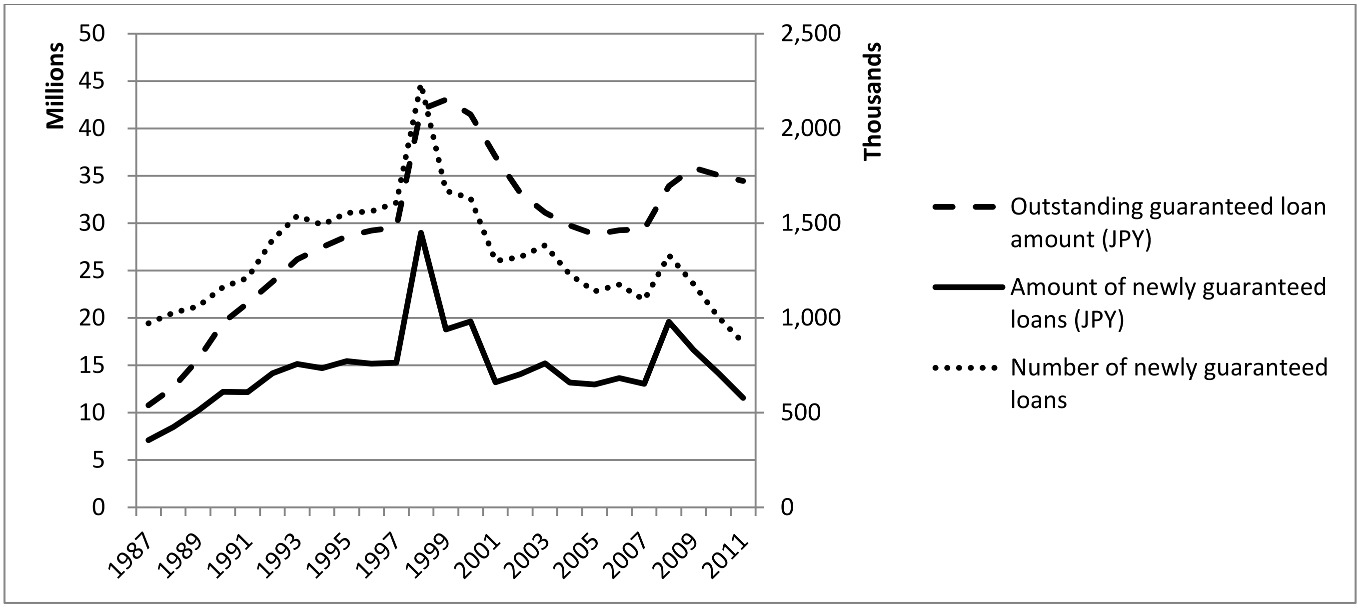
Table X. Number of Small and Medium Enterprises,

Table X. Loans to Small and Medium Enterprises, 1992-2010



Sources: SME White Papers various years. Original data compiled by SME Agency from sources including Bank of Japan, *Financial and Economic Statistics Monthly*

Graph X. Use of Credit Guarantees by Small and Medium Enterprises, 1991-2011



Source: Japan Small Business Research Institute