(CP) increasingly became important sources of funding for non-financial firms. The new funding was supplied by domestic savers and other non-leveraged financial institutions such as life insurance companies who purchased the bonds and other securities issued by Japanese companies. Foreign investors also figured among the new funding sources.

As new funding sources opened up, it became profitable for non-financial firms to act as financial intermediaries by raising funding in the capital markets through securities, and then supplying the new funds raised to the banking system by means of newly introduced time deposits with liberalized interest rates. The financial assets of non-financial corporations increased dramatically together with their financial liabilities in the late 1980s. For a brief period in the late 1980s, the financial assets of non-financial companies overtook their financial liabilities.

In this way, the non-financial companies became *de facto* financial intermediaries. They became financial intermediaries that drew market-based finance and supplied financing to the banking system by holding large deposit claims on the banks.

From the banks' point of view, such a development was a double blow. First, they lost their traditional customers – their traditional corporate borrowers. Second, they had to deploy their newly acquired funding from corporate deposits. Hence, the banks were under an even greater imperative to expand their lending to new borrowers. Not only had they lost their traditional corporate borrowers, there was a reversal of roles in which the corporate borrowers became creditors to the banks. They become depositors who supplied additional funding that needed to be lent out.

The imperative to expand lending meant that Japanese banks had to lower their lending standards in order to find new borrowers. Increasingly, such borrowers were the less credit worthy firms such as small and medium sized enterprises (SMEs) that were previously shut out of the credit market, and toward borrowers that relied on real estate collateral. As real estate lending increased, the property bubble gained impetus. Once the structural shift had taken place toward greater credit supply to real estate-based lending, the familiar property boom took hold.

In the rest of this paper, we will outline the argument in more detail. We begin with a conceptual framework that allows us to quantify the total credit supply to an economy by tracing the role of financial intermediaries in an interlocking system of creditor-debtor relationships. The overall supply of credit in a financial system should be seen as the outcome of many interrelated decisions of financial intermediaries in the system.

We then outline the empirical evidence on the broad sectoral developments in the Japanese financial system in the 1980s, as well as chart the role played by particular epochs of financial liberalization. We highlight in particular, the importance of securities markets, and the role played by new securities in tapping sources of financing that were traditionally off limits to borrowers and the role played by newly introduced time deposits with liberalized interest rates that helped banks to expand their liability size.