3. Financing of Non-Financial Companies under Financial Liberalization: Japan's Bubble Case

As with the mortgage boom in the United States, the 1980s bubble in Japan is also linked with the development of securities markets as a funding source. The corporate bond market had started in the late 1970s, but was initially off-limits to most firms due to strict qualifying standards. However, during the 1980s, the corporate bond market became increasingly accessible.

In 1979, issuing of unsecured bonds and convertible bonds were permitted, but the criteria were so stringent that only two companies in Japan qualified (Toyota Auto and Matsushita Electric). However, by 1988, the number of firms qualifying for unsecured straight bonds increased to approximately 300, while the number of firms qualifying for convertible bonds increased to around 500.[4] Also, starting in 1987, the issuing of CP (unsecured short-term liabilities) was permitted for Japanese firms for the first time.

As a result of the opening up of market-based funding for non-financial companies, the relationship between the banking system and the non-financial company sector underwent a fundamental shift in the late 1980s. A subset of the non-financial companies – especially the large manufacturing firms – ceased to rely on bank financing, and tapped the capital markets instead.

Even more significantly, the non-financial companies that had good access to market financing raised surplus funding from the markets, and then deposited the surplus in the banking system in the form of time deposits with liberalized interest rates that attracted high rates of interest. The time deposits with liberalized interest rates were introduced in the process of financial liberalization in 1985.[5] In effect, the non-financial companies transformed their roles vis-à-vis the banking system. They went from being a *debtor* to the banks to becoming a *creditor* to the banks.

The implications for the total supply of credit to the economy as a whole can be seen from the equation:

$$\sum_{i=1}^{n} y_i = \sum_{i=1}^{n} e_i\left(1 + z_i(\lambda_i - 1)\right)$$

The non-financial firms in effect became integrated into the financial system by intermediating between the capital market and the banking sector. The number of banks in the intermediary sector (given by *n*) increased. They borrowed from the capital markets by issuing bonds, or raised new equity by issuing new stock. Then, they supplied this funding to the banking system by depositing the proceeds in the banks. Ultimately, these deposits would be matched by assets on the banks' balance sheets.

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4 Hoshi and Kashyap (2001, p. 229-230).

5 The role played by time deposits with liberalized interest rates in the flow of funds was significant. This was not only because the financial product yielded competitive market interest rates, but also because it had flexible terms above the regulated minimum term. We discuss their role in detail in a later section.