

succumbed to new regulatory controls, other groups emerged, known as *keiretsu*, that were based on close relationships between banks and non-bank firms.

The close relationships that evolved between banks and non-financial corporations were inevitable in the reconstruction of Japan. Financially, Japan was internationally isolated; it had no well-developed securities markets and it maintained strict interest rate controls. Most savers and borrowers had no options other than placing money with, or borrowing money from, commercial banks.

Due to the lack of alternatives, corporate borrowers relied heavily on commercial banks. Even though banks could hold only 5% of the equity of other firms, and typically held less, the long-term debt financing banks provided over extended periods of time made their relationships more closely resemble those of equity holders than creditors. Equity ties between any two firms in the same *keiretsu* are usually small (normally 2% to 5% of outstanding shares), but across a *keiretsu* network, they can be quite large. Due to extensive cross shareholding and "stable shareholding" agreements, 60% to 80% of *keiretsu* company shares are never traded.

The ability of Japanese firms to borrow extensively from banks, particularly if they are fellow *keiretsu* members, raises the question as to whether they have access to cheaper, more patient capital, and thus enjoy a competitive advantage. Available evidence indicates that Japanese firms do have access to more patient capital, but it is less clear whether capital is (or ever has been) truly cheaper in Japan.

There are a number of factors that suggest that *keiretsu*, while still a dominant institution in the Japanese economy, are declining in importance. With alternative sources of capital now widely available to Japanese firms (including from overseas sources), the customer base of banks is changing. After four years of declining profits, Japanese companies are looking for cheaper funds. At the same time, depositors have the option of holding higher yield securities, so banks must compete for funds. Banks, meanwhile, have become increasingly concerned about the cost of maintaining large shareholding interests in certain customers.

Foreign banks could be among the beneficiaries of weakened *keiretsu* relationships. Three related factors could help increase the market share of foreign banks in Japan: as a group, *keiretsu* firms are no longer the largest commercial bank customers; corporate restructuring in Japan will likely involve cutting the costs of financial services and introduce greater competition; and the operational ties between Japanese banks and non-financial firms are slowly being reduced.