A Regulatory Cartel Model of Decisionmaking in Japanese Finance

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Japan is typically viewed from the West as a consensus-based society[3], characterized by public-spirited cooperation which eliminates the need for many of the formal legal procedures and institutions common in the United States[4]. There is considerable merit to the traditional view: negotiation and cooperation do influence the formulation of private bargains and public policy in Japan, and appear to substitute for the more "legalistic" procedures used elsewhere in the developed world.[5] Yet, although undoubtedly accurate in part, the received wisdom about Japan is not wholly accurate either, at least to the extent that Japan is seen as following fundamentally different economic or cultural laws than the rest of the world.

This article presents a theory of the consensus norms in Japan – with specific reference to Japanese finance – that does not depend on any fundamental differences between Japan and the West. We model decisionmaking in Japanese finance as a form of "regulatory cartel." In part, the basic purpose of the regulatory cartel is similar to the purpose of any cartel: to control entry and output and thereby increase price above the market-clearing level. The Japanese regulatory cartel differs from the standard industrial cartel familiar from price theory textbooks in that (a) it is extremely far-reaching, extending not only within industries but across industry groups; and (b) responsibility for coordination and enforcement of the cartel is vested, not only in groups within particular industries, but also in bureaucrats and, ultimately, in politicians. As we will demonstrate, many features of the "consensus" style of decisionmaking in Japanese finance can be understood as effective methods for enforcing division of markets and control of output and price in the face of threats to defect by weaker members of the cartel. The Japan of consensus, cooperation, and social cohesion is similar, in some respects, to a big-city political machine in which all the politically influential groups receive their share of the benefits as long as they adhere to the rules of the game and remain loyal to the politicians who retain the ultimate control over the system as a whole.[6]

The model is composed of two sets of norms,[7] which we call "bargaining norms" and "substantive norms." Bargaining norms arise out of the institutional context of Japanese finance. They shape the structure of negotiations and the resolution of disputes[8] in the financial industry, thereby determining the process by which regulation is made and enforced. The dynamics unleashed by these bargaining norms in turn generate a second set of norms that substantively shape the operation of the financial industry. Substantive norms govern primary conduct and encourage or discourage particular forms of behavior.[9] Together, these norms constitute the "rules of the game" in Japanese finance.

I. TRAITS OF JAPANESE FINANCIAL REGULATION

Before constructing our model, we survey six salient features of Japanese financial regulation identified in the existing literature: limited competition, regulatory concentration and patterning, "convoy" style regulation, avoidance of failure, informality, and gradual "legalization." These traits provide the backdrop for our analysis and offer an alternative vision of approaches to regulation for readers accustomed to U.S. regulatory practices.

1. *Limited Competition*: One prominent trait of Japanese financial regulation is limited competition. Competition is limited through extreme compartmentalization of distinct sectors of the financial industry. The banking and securities industries are separated, and the banking industry is subdivided into numerous sectors including commercial banking, trust banking, long-term credit banking, and regional banking. Each segment of the banking industry serves a distinct segment of the market.[10] With certain exceptions, players in one sector are not permitted to engage in business in any other sector.

The separation between industry sectors is maintained through informal and formal entry barriers.[11] As in the United States, statutory barriers divide the securities and banking industries.[12] Divisions between the various facets of the banking business are also maintained by statute. A licensing system controls entry into each segment of the financial industry. This poses substantial barriers to entry, because the proclivity of regulatory authorities is to reduce, rather than to expand, the number of licensed firms.[13] The opening of new branches in a given sector is strictly controlled by the Ministry of Finance (MOF), which enforces its branching regulation through informal administrative guidance.[14]

2. *Regulatory Concentration and Patterning*: In contrast to the "complex, even baroque" U.S. system of financial regulation,[15] most regulatory functions in Japan are concentrated in a single agency. MOF has jurisdiction over the banking, securities and insurance industries. It shares regulatory authority for financial matters only in respect to a limited number of issues: principally an agricultural credit cooperative system under the supervision of the Ministry of Agriculture, Forestry and Fisheries (MAFF) to be discussed in detail in Part II, a postal savings system operated by the Ministry of Posts and Telecommunications, and, with respect to the conduct of monetary policy, the Bank of Japan, which has significant elements of independence even though, in legal form, it is an arm of the MOF.[16]

Extensive "patterning"[17] is evident in the institutional structure of Japanese financial regulation.[18] MOF's organizational design reflects the compartmentalization of the industries it regulates. Separate and relatively autonomous bureaus oversee the banking and securities industries. Individual bureaus are further subdivided into sections which mirror specific segments of the regulated industry. For example, the Banking Bureau is divided into sections responsible for the commercial, long-term credit, and trust banking sectors of the banking industry, respectively.

3. *Convoy Style Regulation*: Japanese financial regulators set policies and rules with the weakest member of the industry sector in mind. This is commonly referred to in Japan as a "convoy" system of regulation, because the group is allowed to move no faster than its slowest member.[19] In the securities industry, the convoy system is reflected in a fixed commission scale designed to keep the smallest securities firms afloat. In banking, it was reflected for many years in fixed interest rates.[20]

4. *Avoidance of Failure*: A fourth key trait, related to the convoy system, is the avoidance of failure by financial institutions and the informal mechanisms utilized to avoid failure.[21] There have been no failures of Japanese financial institutions involving losses to depositors in the postwar period.[22] Bank regulators everywhere, of course, seek to avoid failures. Japan stands out, however, for the way in which failure has traditionally been avoided. A deposit insurance mechanism modeled after the U.S. system was established in 1971. Rather than rely on the formal legal mechanisms supplied by the deposit insurance system, however, MOF has maintained a distinctive approach to financially troubled institutions. MOF arranges for stronger institutions to absorb insolvent institutions through what amounts to administratively orchestrated purchase and assumption ("P&A") transactions.[23] Strong banks, acting under MOF's guidance and encouragement, purchase the assets and assume the liabilities of failing institutions. Thus, deposit insurance has been of largely symbolic import.[24]

Japanese bank disclosure practices reflect this approach to failure. Troubled financial institutions have traditionally minimized disclosures of nonperforming assets. Simultaneously, they have liquidated a portion of their stock portfolio in order to show a profit. These measures helped to maintain an aura of financial soundness while mergers and other financial assistance were arranged behind the scenes.[25]

5. *Informality*: As both cause and effect of the preceding traits, Japanese financial regulation is characterized by extremely infrequent resort to formal laws and legal institutions. Hideki Kanda was the first to contrast what he labels the "ex ante monitoring" of legislation and administrative rulemaking in Japan with the "ex post monitoring" which predominates in the United States.[26] In Japan, selected parties with competing interests

meet and reach advance consensus on a legal norm for a particular financial activity. Once such a consensus has been reached, industry participants virtually never challenge the resulting rule, since they have participated in its formulation. In the United States, by contrast, judicial challenge to administrative rulemaking is frequent.[27]

Other observers, including one of us, have drawn a similar distinction between "preclearance" and "postclearance" strategies of decision-making.[28] Preclearance, used in Japan, is an "inherently fluid and informal" "continuous process of compromise and reconsideration" in the formation of policy and the resolution of disputes.[29] Postclearance, the hallmark of U.S. decisionmaking and conflict resolution methods, is more formal and segmented into a series of distinct stages. Litigation and formalized processes play an integral role in postclearance strategies.[30]

6. *Gradual Legalization*: Finally, the literature identifies a gradual process of "legalization" of financial regulation in Japan. One commentator, for example, argues that a reduction in administrative resources and an increase in pressure from forces external to Japan have required the government to narrow the scope of its involvement in the economy and to clarify the legal basis for its actions.[31]

The movement toward greater legalization is suggested both quantitatively by studies of formal and informal governance methods in Japanese finance over time,[32] and anecdotally by the passage of a number of highly visible statutory reforms in recent years aimed specifically at reducing the discretion of regulators.[33]

II. JAPANESE FINANCE AS A REGULATORY CARTEL:

Our assertion is simple: cartel theory offers useful insights into both the process and content of Japanese financial regulation.[34] The term "cartel" is commonly associated with unlawful and unfair conduct; we ask readers to table those connotations and to think of a cartel, at the most general level, as a cooperative group that coordinates decisions in order to generate and allocate benefits to the group that would not exist in the absence of cooperation. From the perspective of third parties, group cooperation can have positive or negative effects, or both.

The essence of a cartel is coordinated decisionmaking.[35] In standard cartel theory, the object of agreement is price, output, or allocations of markets. In Japanese finance, the object of coordinated decisionmaking is the substantive terms of regulation.[36] Japanese finance can profitably be viewed as a "regulatory cartel" in which both the regulated and the regulators cooperate in order to enforce market segmentation, control entry, regulate output, and allocate the gains of the cartel's activities among the various participants. We describe the Japanese system as a "regulatory" cartel because in place of the private rulemaking, enforcement, and dispute resolution activities that characterize a typical industrial cartel in standard economic theory, the functions of control of output and entry are vested in government agencies as well as in private sector cooperation. The Japanese regulatory cartel, moreover, is characterized, not only by control of output and entry within a particular product market, but also by cross-market connections, functioning either at the administrative or the political level, which bring non-competing industries into contact with one another within the framework of an economy-wide framework of regulated industries – a sort of "cartel of cartels" governing the overall Japanese political-industrial system.

Coordinated decisionmaking, particularly over long periods of time, is not a naturally occurring phenomenon; it requires constant and extensive information exchange, intensive cooperation, and effective dispute resolution. In Japan, coordinated decision making on matters of financial regulation is facilitated by distinctive institutional arrangements related to ministerial compartmentalization and the extensive patterning discussed above. These arrangements infuse decisions with private party input from below, and channel issue-specific political interests from above. Simultaneously, they provide mechanisms for public-private interaction, dispute resolution, and consensus-building.

The concentrated and compartmentalized nature of Japanese financial oversight has important effects on the formulation of policy and the resolution of disputes. MOF's sweeping mandate to regulate virtually the entire financial industry reduces the number of issues requiring cross-jurisdictional adjustment, and facilitates interest balancing. As one prominent scholar of Japanese finance observes, "[b]ecause MOF is a single institution, it is able to forge decisions that take into account its various parts."[37] Indeed, MOF's policies often seem calculated to carefully balance the interests of competing groups under its jurisdiction.[38]

The structure of the financial industry facilitates policy coordination among competitors in the same sector. Both the banking and securities industries are led by a small group of major players serving as front-line contacts with MOF. The major firms often lead their industries by example after consultation with senior Finance Ministry officials. Leadership is also provided by *gyô kai* – powerful industry associations led by the same major firms.[39] These respective roles are played by the largest of the twenty "city banks" and the Federation of Bankers Associations in the banking industry and by the "Big Four" securities firms and the Securities Industry Association in the securities industry. Consultations and conflict resolution within an industry and between an industry and its regulator often occur through the medium of the *gyô kai*.

Employment patterns in the banking and securities industries enhance information exchange and identity of interests between the major industry players and MOF officials. Specific bank and securities firm employees at each stage of the corporate hierarchy are assigned to remain in daily contact with their counterparts at the relevant MOF bureau. The large firms benefit from these practices through close, ongoing contacts with the regulators; ministry officials, in turn, obtain information and advice from the major firms. Japanese firms and ministries are characterized by quite rigid hierarchical organization, operating under fairly clear-cut understandings as to the proper administrative level at which contact with outside parties can be made. Persons within the ministries maintain contact with their counterparts at the same hierarchy level in the private sector.

An important part of the process of industry-ministry contacts in some sectors is the practice of persons from the regulated industry being delegated to work for a period of time – usually one or two years – at the regulatory agency. These delegations save money for the agencies, since the salaries of the private-sector worker may be paid by their private employer while they work in the public sector. They also greatly facilitate the establishment of contacts and the exchange of information between the public and private spheres. To a lesser extent, the process of staff exchange also works in reverse: personnel from the government may be delegated to serve for a year or two in a private sector job in the regulated industry.[40]

For smaller firms especially, another important employment-related practice is *amakudari*, in which bureaucrats parachute into lucrative private-sector positions at the end of their careers in public service.[41] While the prevalence of the practice varies across Japanese industries, it is widespread in finance. The rationale behind *amakudari* is that retired bureaucrats provide an important link between the new host firm and the ex-official's former agency. Lacking such established links, smaller firms disproportionately hire retired bureaucrats.[42] It is believed that a firm's contact base, information flow, and public image of stability and competence will all be enhanced by hiring an ex-official. [43]

Yet another institution that facilitates coordinated public-private interaction is the *shingikai* (consultative committee). Statutorily created consultative committees are attached to and appointed by administrative agencies. Their principal ostensible role is to examine significant policy issues under the charge of their parent agencies. Committee membership differs from ministry to ministry, but in general the committees are staffed by scholars, bureaucrats, interest group representatives, members of the mass media, labor representatives, and lawyers.[44]

Although the committees are often derided as ornamental rubber stamps, to dismiss them as meaningless would be a serious mistake. In fact, the committees perform an important role in facilitating group decision making and resolving disputes. This they accomplish in a number of ways. They provide a supplementary channel for public-private interaction beyond the means previously described. They serve as listening posts for ministry officials while shielding the bureaucrats from direct exposure to interest group influences, and they give affected interests a stake in policy outcomes, since interested parties have participated in the process of policy formulation.[45] Above all, they are "a means of adjusting all kinds of conflicting interests" within the affected ministry.[46] As one commentator puts it, consultative councils "act as a bridge between the social system and the political system and make contact with the other machinery of interaction."[47]

At the top of the policymaking network, a distinctive political mechanism infuses the regulatory process with interest-group concerns. LDP legislators have coalesced into issue-specific groups called *zoku* (tribes), which exert influence on the ministries. The *zoku* legislators work to support industries in their districts by developing a special relationship with the relevant bureaucracy. Once the relationship is established, they lobby for policy proposals, mediate between the bureaucracy and interest groups, and participate in the pertinent LDP policy-making process.[48] Once again patterning is evident, as the *zoku* legislators are arranged hierarchically according to their degree of influence with the ministry and specialized according to the bureau or section of the ministry where they operate.[49] Not surprisingly given the locus of bureaucratic power, the *zoku* legislators often seek results at the section level of the ministries.[50]

This segmented and hierarchical institutional design gives rise to the following set of bargaining norms that controls consensus formation and conflict resolution in Japanese finance:

1. *Internal Cooperation*: If possible, policy conflicts or issues are to be resolved within the group principally affected, without percolation up to the next level. Large firms and *gyô kai* lead the coordination process.

2. *Brokerage and Facilitation*: If internal resolution is not possible, policy conflicts or issues percolate up to the next major level of authority – typically the appropriate bureau within the ministry responsible – with brokerage and facilitation services to be provided by that higher level authority. Such services include extensive consultations with affected groups, sponsorship of negotiations, informal persuasion, interest balancing, and public relations efforts.

3. *Negotiated Inter-jurisdictional Resolution*: If policy conflicts or issues spill over between jurisdictional lines, such conflicts or issues will be resolved through negotiations between higher level authorities, if possible. The higher level authorities will be the Administrative Vice Minister and other upper echelon career officials within a single ministry if the issue affects two industries under the jurisdiction of the same ministry. If the issue affects two industries under the jurisdiction of different ministries, the higher level authorities will be the ministers of the two ministries.

4. *Channeled Political Intervention*: If resolution through inter-jurisdictional negotiations is not successful, policy conflicts or issues will be resolved through overt political intervention in the bargaining process. Often, political intervention will take the form of pressure applied by *zoku* legislators at the bureau or section level of the relevant ministry.

These bargaining norms represent approaches which the regulatory cartel undertakes to deal with increasingly difficult problems. It should be noted that when a problem becomes incapable of resolution at one level so that the system moves to the next level of bargaining, the process does not necessarily cease at the previous level. The relevant actors can continue discussions at the previous level, even after impasse, on the theory that consensus may still be possible at the lower level once the higher level bargaining process has commenced, or at least that continuing lower level discussions can facilitate the bargaining at the higher level or levels. Accordingly, as a problem becomes more complex and difficult to resolve, several levels of bargaining are likely to occur simultaneously.

These bargaining norms and the institutional design which generates them supply the infrastructure for regulatory coordination in Japanese finance. For example, a policy conflict or issue involving only the banking industry will be resolved internally by the banking industry if possible, typically through the mechanism of the Federation of Bankers Associations. If an internal solution is not possible, the Banking Bureau will broker a resolution of the issue. If the issue affects the securities industry as well, resolution will implicate both the Banking and Securities Bureaus. If possible, such problems will be worked out between the director generals of these bureaus, with input from the *gyô kai* and major firms in the industries. Particularly thorny issues affecting both industries will be resolved at the ministry level through a Coordination Bureau in consultation with the Administrative Vice Minister, the highest ranking career bureaucrat in the ministry.[51] The most problematic issues, and those most likely to be resolved through overt political intervention, are those that involve industries under the jurisdiction of more than one ministry.[52] Such issues are resolved through high-level inter-ministerial consultation. The operation of senior political leaders and *zoku* legislators will be most evident in these cases.

The much-discussed Japanese practice of *nemawashi* (laying the groundwork for a consensus-based decision) can best be viewed as the organic manipulation of the institutional machinery by actors subject to these bargaining norms.[53] Discussions led by *gyô kai* and major firms are held at the industry level to formulate an initial policy position; bureaucrats broker deals and facilitate negotiations among competing interests with an eye on political realities; *shingikai* are assembled to coordinate and legitimate compromises; and *zoku* legislators are mobilized when the process does not appear to be generating a result favorable to specific interest groups.

Having identified the bargaining norms of decisionmaking in Japanese finance within the framework of cartel theory, we turn to an analysis of how the dynamics set in motion by these bargaining norms affect the substance of Japanese financial regulation. Again, it turns out that cartel theory provides an explanation for several of the seemingly "unique" features of the Japanese system.

Cartel theory predicts that once a mutual understanding has been reached as to price and division of output, the second task of cartel members is to "promote mutual confidence that there will be adherence to these decisions."[54] Adherence to the group's decisions is problematic because cartels are inherently unstable. Since each individual member of a cartel will be better off if it can provide consumers slightly better terms than those offered by other cartel members, there are powerful incentives to cheat on the cartel. Simply put, the raw allocations of profits, power, and prestige that accompany cartel-like behavior constantly threaten to undermine the cooperation essential to continued functioning of the cartel. Those with the most to gain (or the least to lose) by operating outside of the agreed system will have incentives to discontinue cooperation. Thus, institutional settings and bargaining norms that facilitate coordinated group decision making simultaneously unleash powerful incentives for individual members of the cartel to defect from the group.

As members of a cartel, players in Japanese finance are subject to the same centrifugal forces. In order to deal with incentives that are self-destructive to the group, the following substantive norms have been generated by the bargaining dynamics in Japanese finance:

1. *Survival of the Weakest*: Policies (rates) are set to permit the survival of the weakest member of the group. The weakest member of the group is also the one most likely to defect from the group's norms because the benefit this member obtains from abiding by those norms may be outweighed by the benefit it can obtain through defection. Because defection by one member can threaten the entire structure, the weakest member has a credible threat that places it in a strong bargaining position vis-à-vis its counterparts. In consequence, the substantive norms of the group are likely to protect the weakest member in order to insure this member's continuing loyalty to the group. The norm of survival of the weakest benefits the stronger as well as the weak members. In addition to enhancing the durability of the cartel as a whole, the survival of the weakest norm may support pricing arrangements that allow the weakest member to stay in business, while allowing more efficient producers to earn supercompetitive profits.

2. *No Exit (No Failure):* Almost a corollary of the principle of survival of the weakest is that of no exit: no group member is allowed to exit (fail).[55] This enhances stability both by

preventing failure by weaker members and by increasing public confidence in the management of the group.

3. *Responsibility and Equitable Subordination*: When the danger of financial failure grows, the parent or principal source of funding for the failing entity is expected to take responsibility by extending financial assistance and by subordinating its claims to those of other creditors, even if not legally required to do so. This norm encourages monitoring by stronger group members, by imposing both monetary and reputational costs on stronger players who allow smaller players under their jurisdiction to fall into difficulty.

4. *Implicit Government Insurance*: The preceding norms lead naturally to a substantive norm of implicit insurance provided by the government. If strong members are expected to assist weaker members and if no member of the group is allowed to fail, some entity must backstop the strong members. Thus, an implicit grant of government insurance is inherent in the operation of the other norms. Put differently, the responsibility and equitable subordination norm extends even to the government.

We believe that the best explanation for the existence of these norms is the incentive to cheat on the regulatory cartel. Together, the substantive norms instill confidence in and prevent exit from the group, enhance group stability, and encourage monitoring of weaker group members by stronger members.

Viewing the bargaining and substantive norms as animated by cartel-like dynamics provides a powerful explanation for the observable behavior of regulators and regulated in the Japanese banking industry. Due to its central position in the decisionmaking matrix, control over group entry, and role as ultimate guarantor of the financial system, MOF serves as an enforcer of the regulatory cartel (subject to potential intervention by the LDP if MOF is unable to resolve the conflict). The function of the cartel is to coordinate decision making on the regulation of the financial industry and to maintain both group member and public confidence in those decisions.

As with cartel behavior generally, a central aim of cooperation in this regulatory system is to generate and allocate rents: Votes, political patronage, and bribes are allocated among political elites; regulatory property rights and concomitant distributions of power, prestige and budgetary appropriations are allocated among separate ministries; similar rights are allocated among intra-ministry bureaus; licenses to engage in lucrative activities are allocated among industries; and profits are allocated among large and small firms.

The cartel perspective explains the infrequent resort to formal legal institutions in Japanese finance, and we believe, in Japan generally. Informal "ex ante monitoring" or "preclearance"[56] is the process by which the decisions of the regulatory cartel are made and enforced. Courts are seldom involved in Japanese finance because they are competing enforcement agents whose basic attributes undermine cooperation and politically attuned interest balancing. Institutionally, courts lie outside the network of consensus-building mechanisms that facilitate the regulatory cartel. Courts deal only with litigants, who almost by definition are one-time players that have strong incentives to defect from a cooperative game.[57] Similarly, formal administrative procedures are designed to protect the integrity of bureaucratic decisionmaking and to provide redress for those aggrieved by agency action. There are far fewer occasions to use such procedures where public-private interaction takes place among a limited number of repeat players following informal norms that govern the regulatory process. For similar reasons, Japanese attorneys have not broken into the most influential spheres of Japanese government and business. Their expertise lies not in engineering agreements among recognized players, but in litigating on behalf of those who have either left or been excluded from the game.[58]

Cartel-like regulatory interaction in Japanese finance has had substantial positive effects and considerable staying power. It provided stability in times of stress caused by high growth, led to enormous public confidence in the abilities of bureaucratic elites to manage the economy wisely and in the public interest, and virtually eliminated costly resort to formal legal institutions and divisive litigation in the formulation and enforcement of financial regulation. Plausible arguments might be made that ex ante monitoring is justified on efficiency grounds over formal rulemaking.[59]

However, cartel-like regulatory activities have produced harmful effects as well. Such activities are nontransparent by definition, making it difficult to discern the rationale supporting policy decisions and the process by which decisions are reached. The possibility of corruption or undue influence cannot be entirely discounted. Cartel-like activities are rigid to the extent that they protect vested interests and remain impervious to outside influences. They harm consumers by facilitating and reinforcing an economy characterized by pervasive entry controls, market segmentation, and anticompetitive pricing and production processes. Perhaps most seriously, the need to prevent cheating by barring exit from the group creates enormous moral hazard by forcing the government implicitly to underwrite risky behavior. Over time, the incentives generated by cartel-like regulation can create an environment in which individual actors rationally pursuing their own interests lead to disaster for the system as a whole.

The bargaining and substantive norms outlined above will operate best in a stable, high growth environment, where most policy questions relate to the allocation of expanding rents. In such an environment, bargaining among group members is likely to be relatively harmonious and incentives to defect less compelling.

First, relatively high levels of economic growth facilitate decision making within the regulatory cartel. When the social pie is expanding, the groups that stand to gain from the increase in wealth are likely to be more cooperative and to reach agreement on allocation more readily than when the pie is contracting. This is, in substance, an instance of the "endowment effect" under which people generally demand more to give up an asset they possess than they are willing to pay to obtain an asset they do not yet have.[60]

Equally importantly, in such an environment rents will also be generated to those outside the group, limiting exogenous attacks on cooperative behavior. If persons outside the cartel are also sharing in the increase in social wealth, even if they are getting less of a share than persons within the cartel, they are likely to be less hostile to the cartel and less willing to expend resources to break it down than they would be, say, if they were asked to share in a decrease in social wealth.

Second, decision making through the regulatory cartel is likely to be more effective, other things equal, in stable times than in unstable ones. If growth and development occur within predictable and expected boundaries, the existing structure of agreements and allocations of rents will not be strained and accommodations can easily be made for the changes that do occur. Overall, the Japanese economy has been quite stable during most of the post World War II period, with growth patterns that were not only high, but, in general, quite predictable.

The other side of this analysis is that cartel-like decision processes are much less well equipped to cope with either low or no-growth economic conditions, or with unusual or unforeseen economic developments. When the social pie is shrinking, the endowment effect suggests that the parties to the cartel will fight hard to avoid losing benefits to which they have become accustomed. Persons outside the cartel will become frustrated in bad times and will seek to undermine its foundations. And major exogenous shocks, such as sudden increases or decreases in asset or share price values, new technologies, or competition from players operating outside the group will upset the existing political deals and destabilize the cartel. Thus, norms of the cartel which hold up well in good, stable times may not survive the stress of hard times: for example, the survival of the weakest principle may encounter serious strains in hard times if the stronger firms are required to expend massive amounts of resources to rescue the weaker ones.

Accordingly, while informal decision making in the regulatory cartel is likely to cope well in the type of high-growth, stable environment that characterized the Japanese economy for most of the post-World War II period, it appears much less suited to managing the allocation of losses in a low-growth or no-growth economic climate characterized by increasing global competition, such as that which has existed in Japan for most of the 1990s. The gradual legalization of Japanese finance, in our view, is the result of the inherent inability of group members to coordinate and enforce decisions on divisive issues, and the corrosive effects of international market forces on Japanese bargaining and substantive norms. The regulatory cartel in Japanese finance, in short, may not survive the stresses that follow from Japan's evolution into a politically pluralistic, economically mature, industrial society.

Notes

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3 *See, e.g.,* R.E. NOHE, A Different Time, A Different Place: Breaking Up Telephone Companies in the United States and Japan, 48 Fed. Com. L.J. 307, 314 (1996) ("The regulatory situation in Japan is in stark contrast to that in the United States....[I]n Japan, the policy-making process occurs through consensus building..."); S.R. SALBU, Regulation of Insider Trading in a Global Marketplace: A Uniform Statutory Approach, 66 Tul. L. Rev. 37 (1992) ("Japan's version of capitalism...is colored by a relatively homogeneous and cooperative society. Applied to the economy, these characteristics manifest themselves in an emphasis on planning and consensus.") (footnote omitted); E. VOGEL, Japan as Number One 53-64 (1979) (describing a meritocratic bureaucracy that governs by consensus).

4 As one observer comments, "Some Japanese have justified relying on [non-binding administrative] guidance by arguing that theirs is such a harmonious society and that bureaucratic dictates are so respected that the most efficient means of regulating the huge financial markets is not through cumbersome legislation and the courts, but with extra-legal commands". J. STERNGOLD, Regulation, Japan Style, N.Y. Times, Sept. 9, 1991, at D1. *See also* D.F. HENDERSON, Security Markets in the United States and Japan: Social, Economic, and Political Differences, 14 Hastings Int'l & Comp. L. Rev. 263, 297 (1991) ("the impact of law on Japanese society is quite diluted; Japan is best seen as, in larger part, socially, and not legally governed").

5 Comparisons of the relative "legality" of a society are, of course, highly problematic. While our exposure to the legal systems and societies of the United States and Japan leads us to believe that Japan is less formally and overtly legalistic than the United States, that point remains unproven. Indeed, many of the usual barometers of a country's legalistic tendencies, such as the number of licensed attorneys, *see* D.C. BOK, A Flawed System of Law Practice and Training, 33 J. Legal Educ. 570 (1983), are simply red herrings resulting from an inversion of the causal link between socio-political interaction and legal institutions. *See* C.J. MILHAUPT, *Shôji torihiki ni okeru bengoshi no yakuwari: Nichibei no hikaku bunseki* [The Role of Lawyers in Business Transactions: Japan and the United States in Comparative Perspective], 96-2 Amerikahô (forthcoming 1996).

6 The consensus style of decisionmaking in Japan, however, appears to be breaking down in the low-growth, politically mature environment of the 1990s. For discussion of the changes that are occurring in Japanese finance, seen through the lens of the "Jusen" housing finance bank disaster, *see* C. MILHAUPT/G. MILLER, Cooperation, Conflict, and Convergence in Japanese Finance: Evidence from the "Jusen" Problem, 29 Law and Policy in International Business (forthcoming 1997); C. MILHAUPT/G. MILLER, Japanese Financial Regulation as Seen from the "Jusen" Problem) Jurisuto (forthcoming 1997)(in Japanese).

7 The term "norm" in this Article is used to mean both community consensus-based obligations as well as the regular course of conduct in the community. *See* R.D. COOTER, Law from Order: Economic Development and the Jurisprudence of Social Norms 2-3 (unpublished manuscript, on file with authors).

8 Robert Ellikson employs a typology of rules and norms in a general theory of social control. *See* R.C. ELLIKSON, Order without Law 123-264 (1991). Our term "bargaining norms" roughly corresponds to the categories of rules he labels "procedural," "constitutive" and "controller-selecting." Over the past few years, the analysis of extra-legal social norms has become a matter of intense interest to American legal scholars. *See*, e.g., C.R. SUNSTEIN, Social Norms and Social Rules, 96 Colum. L. Rev. 903 (1996); L. LESSIG, The Regulation of Social Meaning, 62 U. Chi.

L. Rev. 943 (1995); E.A. POSNER, The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action, 63 U. Chi. L. Rev. 133 (1996); and Symposium, Law, Economics, and Norms, 144 U. Pa. L. Rev. 1643 (1996).

9 ELLIKSON, Order without Law, *supra* note 8, at 132-33.

10 The basic division is as follows: Large commercial banks accept deposits and make short-term loans. Long-term credit banks issue debentures and finance long-term investment by private corporations. Trust banks engage in trust and custodial services. Regional banks specialize in local lending to small businesses.

11 M. MABUCHI, Deregulation and Legalization of Financial Policy, *in*: Political Dynamics in Contemporary Japan 130, 137-38 (G.D. ALLINSON/Y. SONE eds., 1993) [hereinafter Political Dynamics].

12 With certain recent exceptions for majority owned securities subsidiaries, the Securities and Exchange Law prohibits banks from engaging in the securities industry. *Shôken torihiki hô* [Securities and Exchange Law], Law No. 25 of 1948, art. 65. Simultaneously, and subject to a similar exception for majority owned banking subsidiaries, securities firms are prohibited from engaging in the banking business. *Ginkô hô* [Banking Law], Law. No. 59 of 1981, art 4.

13 For example, not a single new securities firm was licensed from the adoption of the licensing system in 1965 until 1993, when certain bank affiliates were allowed to enter the securities business pursuant to a series of statutory financial reforms. In the banking industry, MOF launched a series of "efficiency campaigns" aimed at encouraging the merger of small banks into big ones. *See* F. MCCALL ROSENBLUTH, Financial Politics in Contemporary Japan 121-28 (1989).

14 K. UEDA, Institutional and Regulatory Frameworks for the Main Bank System, *in:* The Japanese Main Bank System 89, 93 (M. AOKI/H. PATRICK eds., 1994) [hereinafter Main Bank System].

15 J.R. MACEY/G.P. MILLER, Banking Law and Regulation 63 (1992); *See also* K.E. SCOTT, The Dual Banking System, A Model of Competition in Regulation, 30 Stan. L. Rev.1, 7 (1977) (providing a schematic overview of "the tangled web of [U.S.] banking regulation").

16 *See* G. MILLER, Decisionmaking at the Bank of Japan: 28 Law & Pol'y Int'l Bus. (forthcoming 1997).

17 Patterning occurs when subsets of an organism replicate the defining characteristics of the whole. *See* D.G. LITT, ET AL., Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan, 139 U. Pa. L. Rev. 369, 440-41 (1990).

18 Y. SONE, Structuring Political Bargains: Government, *Gyô kai*, and Markets, *in:* Political Dynamics, at 295, 303 ("The manner in which government ministries and agencies compartmentalize society is reflected. . . [pervasively]. Committees in the Diet, policy bodies in the LDP and other parties, and many shingikai [advisory bodies], too, all basically conform with the principles of ministerial compartmentalization.").

19 *Id*. at 302.

20 ROSENBLUTH, *supra* note 13, at 123.

21 *See, e.g.,* R. DALE, Japan's Banking Regulation: Current Policy Issues, in Japanese Financial Growth 33 (Charles A.E. GOODHART/G. SUTIJA eds., 1990).

22 *Id*.

23 M. YOSHITOMI, The "Jusen" Debacle and the Japanese Economy (speech given at Wharton School of the University of Pennsylvania, April 17, 1996, on file with authors).

24 The marginal role of deposit insurance in Japanese banking is reflected in the resources and institutional design of the Deposit Insurance Corporation (DIC). Until a recent set of reforms discussed in Part III infra, DIC's professional staff numbered less than ten, it was headed by a deputy-governor of the Bank of Japan and its offices were located within the Bank's headquarters. *Id*.

25 J. CHOY, Tokyo Draws Roadmap to Solve Bad-Loan Crisis, Japan Econ. Inst. Rep., No. 22B, June 16, 1995, at 3.

26 H. KANDA, Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan, 12 U.Pa. J. Int'l Bus. 569, 583-85 (1991).

27 *Id*.

28 LITT, ET AL., *supra* note 17, at 434-35.

29 *Id*.

30 *Id*. at 434.
31 MABUCHI, *supra* note 11, at 130.
32 *Id*. at 148-50.
33 *See, e.g., Gyôsei tetsuzuki hô* [Administrative Procedure Law], Law No. 88 of 1993 (attempting to circumscribe bureaucratic use of informal administrative guidance); *Kin'yû kikantô no keiei no kenzensei kakuhô no tame no kankei hôritsu no seibi ni kansuru hôritsu* [Bill to Implement Measures for Ensuring the Sound Management of Financial Institutions], Law No. 94 of 1996 (instituting a system of "prompt corrective action" to reduce MOF's discretion in dealing with failing financial institutions).
34 At least two other commentators have suggested that Japanese finance is animated by cartel-like behavior. *See* K. HAMADA/A. HORIUCHI, The Political Economy of the Financial Market, *in*: 1 The Political Economy of Japan: The Domestic Transformation 223, 240 (K. YAMAMURA/Y. YASUBA eds., 1987) (arguing that MOF and the Bank of Japan indirectly "supported the formation and maintenance of cooperative behavior, including quasi cartels among financial institutions"). *See* also M.A. MCKEAN, State Strength and the Public Interest, *in*: POLITICAL DYNAMICS, *supra* note 11, at 72 (using collective action theory and game theory to explain Japanese regulatory behavior). Our work differs from these prior accounts in that we use cartel theory to explain the procedural and substantive rules of the game in the financial industry.
35 *See* P. AREEDA/D.F. TURNER, 2 Antitrust Law 280 (1978). For a classic exposition of cartel organization, *see* G. STIGLER, The Theory of Price (4th ed. 1987).
36 To be sure, decisions on regulation can effect firm profits in the same way as decisions on price, output or markets.
37 ROSENBLUTH, *supra* note 13, at 20 (footnote omitted).
38 MACEY/MILLER, *supra* note 13, at 63. Treatment of new financial products is a prime example of interest balancing. Whenever a new financial product is developed in Japan, a battle breaks out between the securities and banking industries over the right to handle the product. In many cases, MOF engages in overt trade offs between the two industries in order to keep both groups reasonably satisfied. *See* KANDA, *supra* note 26, at 574-82. So important is interest balancing that "MOF . . . place[s] priority on the issue of which industry handles each new product over the issue of investor protection." *Id*. at 575.
39 *See* SONE, *supra* note 18.
40 For a description of staff exchange at the Bank of Japan, *see* MILLER, *supra* note 16.
41 On the practice of *amakudari*, *see* K. E. CALDER, Elites in an Equalizing Role: Ex-Bureaucrats as Coordinators and Intermediaries in the Japanese Government-Business Relationship, 21 Com. Pol. 379 (1989). U. SCHAEDE, The "Old Boy" Network and Government – Business Relationships in Japan, *in*: Japan: Economic Success and Legal System 345-369 (H. BAUM ed., 1997).
42 *Id*.
43 *See id*. (arguing that *amakudari* performs an equalizing role, as ex-bureaucrats provide regulatory benefits, information and insurance against adverse governmental action to the smaller firms where they tend to land).
44 *See* F. SCHWARTZ, Of Fairy Cloaks and Familiar Talks: The Politics of Consultation, in Political Dynamics, *supra* note 11, at 217, 222-23 tbls.9.2 & 9.3.
45 *See id*.
46 *Id*. at 231.
47 L. DION, The Politics of Consultation, 8 Gov't. & Opposition 332, 335 (1973) (discussing the role of consultative councils in political systems generally).
48 L. W. FARNSWORTH, "Clan Politics" and Japan's Changing Policy-making Structure, 12 World Econ. 163, 164-76 (1989).
49 *See id*. at 171-73.
50 SONE, *supra* note 18, at 304.
51 ROSENBLUTH, *supra* note 13, at 20.
52 For case studies demonstrating that financial policy making proceeds far less smoothly when MOF shares financial oversight with another ministry, *see* J. HORNE, Japan's Financial Markets: Conflict and Consensus in Policymaking 214-15 (1985); ROSENBLUTH, *supra* note 13, at 167-208.

53 For discussion of *nemawashi* at the Bank of Japan, *see* MILLER, *supra* note 16.
54 G.A. HAY, Oligopoly, Shared Monopoly, and Antitrust Law, in Economic Analysis and Antitrust Law 160, 162 (T. CALVANI/J. SIEGFRIED eds., 1988).
55 An exception exists where a weak firm is merged into a stronger firm.
56 *See supra* notes 26-30 accompanying text.
57 *See* R.J. GILSON/R.H. MNOOKIN, Disputing through Agents: Cooperation and Conflict between Lawyers in Litigation, 94 Colum. L. Rev. 509, 513 (1994).
58 Licensed Japanese attorneys – persons who have passed the extremely demanding Japanese bar exam – are qualified to appear in court and specialize in making court appearances. The vast majority of the graduates of Japanese law faculties do not become attorneys. Some do end up in elite positions in government or business in which they participate in the delicate adjustment of interests that characterizes the Japanese regulatory cartel. Their participation, however, is as law-trained generalists rather than as practicing attorneys.
59 *See* KANDA, *supra* note 26; H. KANDA, Globalization of Financial Markets: Law and Regulation from a Japanese Perspective (unpublished manuscript, on file with authors).
60 *See* generally H. HOVENKAMP, The Endowment Effect and Legal Policy, 20 J. Legal Stud. 225 (1991).