



Encouraging Entrepreneurial Activity using Loan Guarantees: The Credit Supplementation System in Japan

Miwako Nitani, PhD Student and Allan Riding

Abstract

Loans that support the expansion of small enterprises may convey significant benefits to the borrowing firms and, through job creation and retention, to the rest of society. Previous studies have documented that loan guarantee programs can be an effective means of supporting start-up, growth, and survival of new and risky enterprises. Consequently, many governments and trade associations have intervened in credit markets by taking on the role of guarantor of loans that financial institutions advance to SMEs. By far, the most active loan guarantee program in the world is the Japanese Credit Supplementation System which has guaranteed more than \$80 billion \$US in loans over its history. It seems a paradox, therefore, that the level of entrepreneurial activity in Japan is extremely low by international standards. Therefore, this paper investigates the strengths and weakness of the Japanese loan guarantee system. Possible explanations for the paradox are provided as a basis for amendments to the Japanese scheme, changes that may then provide greater encouragement to entrepreneurship in the Japanese context.

Introduction

Small and medium sized enterprises (SMEs) play a significant role in innovation, job creation, social stability, and the general health of economy. They are often considered a fertile source of new ideas and products, an efficient and prolific job creator, the seeds of big businesses, the leading source of innovation, the fuel of the nation's economic engines, the backbone of the entire economy of the country.

Despite of their contribution to the society, it has been long argued that small firms appear to have more serious difficulty in obtaining loans than large firms. Consequently, governments (and sometimes trade associations) have often intervened in credit markets by taking on the role of guarantor of loans that financial institutions advance to SMEs. This form of intervention, called a credit (or loan) guarantee scheme are currently implemented in more than 170 countries, usually with the goal of facilitating formation and growth of SMEs by easing access to debt capital (Levitsky, 1997; Llisteri, 1997).

By far, the most active loan guarantee program in the world is the Japanese Credit Supplementation System. Yet, it does not appear that the enormous scale of the Credit Supplementation System in Japan has translated into entrepreneurial activity. Therefore, this paper investigates the efficacy of the Japanese scheme by comparing it with loan guarantee programs in other countries and by reviewing data on the scheme from secondary sources. This study seeks: to identify strengths and weaknesses of the Japanese approach by comparing it with loan guarantee schemes in other countries; to determine the role the Japanese Credit Supplementation System does play; and to explain the discrepancy between the high level of activity in the Credit Supplementation System and the low level of entrepreneurship activity in Japan.

To study the role of the Japanese Credit Supplementation System, the most active loan guarantee scheme in the world, is interesting in itself. As well, identifying certain unique characteristics of the scheme that explain the discrepancy between the high level of the scheme's activity and the low level of entrepreneurship activity in that country, yields a yet better understanding of the mechanisms required to facilitate SME growth.

Literature Review: Credit and Entrepreneurship

The low level of entrepreneurial activity in Japan is well known (Reynolds et al., 2001; Black & Gilson, 1998; Milhaupt, 1997; Department of the Small and Medium Sized Enterprises, 2001). For example, one in every 100 adults in Japan is currently starting a business, compared with 1 in 8 in Brazil, 1 in 10 in the US, and 1 in 17 in Canada (Reynolds et al., 2001). Moreover, the business start-up rate is the lowest among 21 countries and has been decreasing over the last decade to the extent that it is now lower than the business failure rate.

Several researchers have sought to explain the relatively low level of entrepreneurial activity in Japan (Black & Gilson, 1998; Milhaupt, 1997; Ooghe & Bekaet & van den Bossche, 1989). They have identified reasons that include: a bank-centered capital market; a scarcity of venture capital; highly illiquid markets for human capital; and cultural obstacles.¹ In stark contrast to the relatively low level of Japanese entrepreneurship activity, the Japanese Credit Supplementation System is highly active. As noted by Christensen and his colleagues (1999), the Japanese Credit Supplementation System guarantees more loans, and for a higher value, than the guarantee schemes of all other countries combined.

In general, loan guarantee schemes have been established to assist SMEs with respect to gaining access to debt capital. Table 1 identifies the officially-articulated reasons for the establishment of loan guarantees in several countries. A review of these objectives reveals that the goals of loan guarantee schemes are invariably stated in terms of improving access to debt capital so as to stimulate business growth and innovation among *viable* SMEs.

Conceptual rationales for the existence of such initiatives have usually been vested in theories of credit rationing (Akerlof, 1968; Stiglitz and Weiss, 1981; Bester,

¹ Traditionally Japanese people are highly risk averse and successful entrepreneurs are less admired than top business managers in large companies. Moreover, Reynolds, Bygrave, Camp, and Autio (2000) reported differences in two social/cultural factors, the extent to which “fear of failure” acts as a deterrent to starting a new firms and respect for those starting new firms, between countries with high level of entrepreneurship activity and counties where entrepreneurship is not an integral feature of everyday life

1985; and others). Even though it is a widely-held understanding that SMEs face particular difficulty with access debt capital, it remains uncertain whether this is simply the outcome of banks' "correct" assessment of businesses, or whether SMEs are more naturally victims of credit rationing. Moreover, it is not clear that capital rationing actually occurs (Berger and Udell, 1990, 1992) and, if it does, whether or not loan guarantee schemes are a suitable remedy for capital rationing (Vogel and Adams, 1997).

It remains, however, that loan guarantee programs are widely used to facilitate SMEs' access to debt capital. Given the resources at stake, and the potential costs to society, it is essential to understand the linkages between the design of such programs and the level of entrepreneurial activity. Based on the *prima facie* evidence from the Japanese experience, it might seem that the level of entrepreneurial activity is not fostered even by widespread reliance on loan guarantees. Conversely, perhaps the level

Country	Objectives
France	"guaranteeing the financial operations of SMEs" "the scheme is especially geared towards <u>new firms and take-overs</u> " "to support businesses which are in the most vulnerable stages of development, i.e., creation and transfer of ownership" "to strengthen the financial structure of firms and support investments made by SMEs. Particularly those businesses producing <u>highly innovative products</u> "
Germany	"to strengthen small and medium sized companies in economy" "to target small businesses with <u>viable</u> business projects, who lack the adequate security necessary to obtain finance"
Netherlands	"to grant loans to SMEs who have ' <u>satisfactory future prospects</u> ' but are unable to receive a conventional loan due to a lack of collateral"
UK	"to facilitate the supply of finance to <u>viable</u> small firms where conventional loans are not available, possibly due to lack of security or track record" "to give the lender experience of lending to businesses which have a viable proposal but do not satisfy normal banking security criteria, the objective being to encourage more emphasis on the appraisal of business projects"
Canada	"to increase the availability of loans for the purpose of the <u>establishment, expansion, modernization and improvement</u> of small business enterprises" (SBLA, 1991. P.2). "to bridge the gap between small, new firms and the type of secured lending traditionally sought from institutions" "to encourage lenders to provide debt financing to SMEs that the lenders would otherwise consider too small or risky"
US	"to increase the access of small businesses to credit and in so doing to stimulate <u>growth</u> in the small business sector"
Japan	"to contribute to the smooth flow of funds for SMEs by guaranteeing loans that advanced to SME by banks or other financial institutions (the Credit Guarantee Corporation Act: 1953, No. 196)." "to discover SMEs that are seeds of <u>growing</u> businesses and build bridges between those SMEs and private financial institutions"

of entrepreneurial activity depends critically on the design and implementation of the loan guarantee scheme. This study examines this question.

Table 1: Objectives of Loan Guarantee Schemes

(Source: Christensen et al., 1999)

Research Questions, Data Sources and Methodology

This study examines why it does not appear that the enormous scale of the Credit Supplementation System in Japan has translated into entrepreneurial activity. More specifically, three research questions are posed:

1. What are the characteristics, including strengths and weaknesses, of the Japanese Credit Supplementation System compared with loan guarantee schemes in other countries?
2. What role, in reality, does the Japanese Credit Supplementation System play?
3. What factors explain the discrepancy between the high level of activity in the Credit Supplementation System and the low level of entrepreneurship activity in Japan?

Data were obtained from secondary sources. These sources included Japanese government publications, listings of economic statistics, and comparisons published by Christensen and his colleagues (1999) and the Japanese National Federation of Credit Guarantee Corporations (1996). The methodology employed for the comparison is essentially a re-analysis and epiclesis of the findings reported in the two data sources identified above.

Research Findings

Characteristics of the Japanese Credit Supplementation System

This section reports on a comparison of the major characteristics of the Japanese Credit Supplementation System with those of guarantee schemes in France, Germany,

Netherlands, UK, Canada, and the US (Christensen *et al.*,1999). Key parameters of mechanisms of the seven countries’ guarantee scheme are compared in Table 2.

Table 2: Comparison in Key Features of Seven Loan Guarantee Schemes

(Source: Christensen *et al.*, 1999).

	France	Germany	Holland	UK	US	Canada	J
Overall Financial Structure	Bank-centered	Bank-centered	Capital market centered	Capital market centered	Capital market centered	Capital market centered	Bank
Year Established.	1982	1953	1989	1981	1953	1961	1937
Participating Organizations	SOFARIS, banks	16 Burschafts-banken, the federal and state governments, lenders	The Ministry of Economic Affairs, banks.	Department of Trade and Industry, banks	SBA, banks	Industry Canada, banks	52CC, NFC, JAS
Lenders’ Degree of Discretion	Relatively low.	Low	High	Relatively high	relatively low. ²	High	No di
Specific Eligibility of Borrowers	No specific criterion	No specific criterion	No specific criterion	Firms that have tried and failed to obtain loans.	Firms that have tried and failed to obtain loans.	No specific criterion	No sp criterion
Use of Proceeds		Not for refinancing		Allow for working capital	Allow for working capital and refinancing.	Not for working capital, share acquisition, intangibles, refinancing.	Allow work capital refina

² Besides its regular program, the US scheme has two special programs, the Certifies Lenders Programs and the preferred Lender program in which the scheme give lenders higher discretion in guarantee loan approve procedure.

Size of Loan (max. US\$)	\$666,700 ³	\$681,800	\$80,000	\$178,570 (established), \$71,400 (new and existing firms). ⁴	\$750,000	\$156,250	usual per p (but r one p can b simul used firm)
Term of Loan (years)	2-15	Max 15	6	2-10	Max. 25 (7 for working capital)	Max. 10	7-10, work capita
Guarantee %	Up to 50% 70% for start-ups	50-80%	45% (66% for start-ups)	85% for established, 70% for new or existing firms.	75- 80% (depends on loan size)	85%	90%
Default Rate	N/A	3%	Average 2.5%	Average 15%	2.8% (1990)	Average 6%	2.2%
Value of average loan	\$111,760	\$216,140	\$109,090	Euro 65,340	\$220,450	\$46,590	\$93,7
Share of loans = start-ups	23%	49%	31%	27%	N/A	60%	N/A
No. of new Commitment (1998)	36.000	7.000	3.900	10.000	45.000	30.000	2,235
Take-up rate	20% (firm/firms) 40% (of loans to start-ups)	N/A	3-4% (guaranteed loan/total loan in 1991)	N/A	1% (volume)	N/A	N/A

The Japanese scheme appears to differ from most schemes in several respects. The first difference lies in terms of its administrative structure. The Japanese Credit Supplementation System consists of two interrelated subsystems: the Credit Guarantee

³ \$1,333,300 for ownership transfer or qualified investment programs.

⁴ New = start-up businesses, existing = businesses trading for less than 2 years, established = businesses trading for 2 years or more at the date of application.

System (CGS) in which 52 regional Credit Guarantee Corporations (CGCs) guarantee loans advanced to SMEs; and the Credit Insurance System (CIS) in which the Japan Small and Medium Sized Enterprise Corporation (JASMEC) re-insures a portion of default losses incurred by CGCs. While such two-tiered re-insurance programs are not the norm, other countries that do use such an approach include Germany, Korea, Malaysia, and Indonesia. The Appendix to this paper illustrates international differences in the administrative structures of loan guarantee schemes.

A second characteristic unique to Japan is that, for the sake of extensive supply of its service, the Japanese scheme locates fifty-two Credit Guarantee Corporations (CGCs) throughout Japan, each responsible for the everyday operation of the scheme in each prefecture or city (e.g., assessing, processing and approving guaranteed loan applications from SMEs). CGCs are independent public institutions but under the direction of the National Federation of Credit Guarantee Corporations (NFCGC) that unifies the standards of services provided by the CGCs. The guaranteed loan applications can be submitted either through a bank or directory to a CGC. While the German scheme locate 16 guarantee agencies in each Lander, the other five schemes maintain only one guarantee agency for everyday operations. All six schemes (including that in Germany) utilize the geographical networks of private financial institutions as delivery agents.

Third, the Japanese scheme is available to much larger firms than are those in other countries. Firms with total capitalization of less than or equal to \$2.3m US, or with fewer than or equal to 300 employees (figures differ by industries)” are eligible for applying guaranteed loans in Japan. Hence, eligibility of SMEs for the Japanese scheme would cover a larger group of firms than those for the other countries’ schemes.

Fourth, other countries’ schemes give lenders some degree of discretion in approval of guaranteed loans; however, the Japanese scheme does not give banks any authority in that procedure at all. Staff in the credit guarantee corporations (CGCs) have full responsibility in business assessment and full discretion in guaranteed loan approval.

The fifth difference pertains to the use of proceeds. The Japanese scheme limits the use of proceeds to plant/equipment investment or working capital financing. Such limitations, however, are not unusual. For example, the Canadian scheme is even more

restrictive and prohibits use of proceeds for financing working capital and such constraints may be reasonable.⁵

Sixth, the maximum loan size for the Japanese scheme (in the case of using the regular program) is much higher than for other schemes. In addition, the Japanese scheme offers numerous special programs. Borrowers can potentially avail themselves of both the regular program (\$1.6 million US maximum loan size) as well as special programs (maximum loan sizes differ by program within the range of \$77,000 US to \$2 million US).

Finally, the Japanese scheme sets the highest level of guarantee, at 90%. In comparison, the Dutch scheme, one that gives lenders full discretion in guaranteed loan approval, sets a low guarantee level (45% for loans advanced to existing firms and 66% for loans to start-ups). Since banks in Japan have no discretion in guaranteed loan approval procedure, there is no danger that such a high level of guarantee induces banks' moral hazard resulting in high default rate.⁶ Since the major part of default losses (70%-

⁵ Since financing short-term assets with long-term liabilities is likely to lead to financial distress, the Canadian approach seems more reasonable considering that most schemes arrange relatively long maximum terms of loans (10 years for the Canadian's, 5-7 years for the Japanese in case of working capital financing). Pleda (1992), who evaluated the UK scheme, found that defaults were more common amongst those firms that use the loan to finance working capital.

⁶ However, during the period from 1998 to 2000 the Japanese scheme offered a special program called "the Special Guarantee System for the Financial Stabilization of SMEs". To apply to this program, SMEs were required to submit a certificate from the bank that the conditions of their loans had become worse from the previous year. This means that the program gave banks some degree of authority in guaranteed loan application procedure (SMEs could not apply without the bank's approval to issue the certificate). In spite of that, the Japanese scheme kept 90% of the guarantee level for this program, thus the introduction of this program induced banks' serious moral hazard. For example, banks required SMEs switch existing non-guaranteed loans into guaranteed one under this program in exchange for providing the certificate.

80%) is re-guaranteed by the JASMEC, high default rates resulting from CGCs' assessments of applicant firms would not harm the CGCs.

According to Pineda (1994) and Riding and Haines (2001), the two parameters in the Japanese scheme might result in its high default rates. The first is the availability of loans for working capital financing, and the second one is prominently large maximum size of loans available to a firm. However, a remarkably high default rate was not observed in the Japanese scheme (2.2% in 1998).

One explanation for the enormous supply of guaranteed loans by the Japanese scheme could be that the Japanese scheme deals with a wider market than do other schemes (the eligibility criteria of SMEs for the Japanese scheme would cover a larger group of firms than those for the other countries' schemes). However, this explanation does not solve the fundamental puzzle in the Japanese scheme: why the enormous scale of the Japanese scheme has not translated into entrepreneurial activity. To unravel this puzzle, the following section investigates the roles played by the Japanese scheme.

Role of the Japanese Credit Supplementation System

The second hypothesis this study posts is that an explanation for the discrepancy between enormous scale of the Japanese scheme and low level of entrepreneurial activity might be found in the role actually played by the Japanese scheme. Thus, this section investigates the actual roles played by the Japanese scheme.

As had been shown in Table 1, all seven countries focus on "the growth of SMEs" and target "viable businesses". At first glance, the Japanese scheme does not appear to be an exception. The National Federation of Credit Guarantee Corporations (NFCGC, 1996) defines the role of CGCs as "to discover SMEs that are seeds of growing businesses and build bridges between those SMEs and private financial institutions (p.2)". Subsequently, however, NFCGC gives a more detailed description on the roles played by the Japanese scheme. In that description, a role unique to Japan scheme can be identified. That is (p.12; translated by the author of this study),

"The primary role of the Credit Guarantee Corporations is to foster a healthy growth for SMEs in Japan. It is a forward-looking role to recognize SMEs for their viability and contribute to their development by financially backing them up. This notion of a "forward-looking" role is

not inconsistent with guaranteeing loans to SMEs that need bailing out, such as those affected by disasters or related companies' bankruptcy”.

Thus, in contrast to other countries schemes the Japanese scheme includes not only support for the growth of viable firms but also the rescue SMEs in difficult situations.

This is further evidenced by a review of the special programs offered within the Japanese scheme. Besides its regular program, the Japanese scheme has offered in its history approximately 50 special programs; each sets its specific objective (those are either permanently or temporary offered). Using the data on all programs offered during the period from 1958 to 2000 with annual number and volume of loans approved under each program, this section tries to identify some tendencies in role played by the Japanese scheme.⁷

To do so, all regular and special programs offered during 1958-2000 were categorized into four groups:

1. 19 “creation/expansion” programs (4 premanent), specifically meant to facilitate new business creation or expansion. During the 47 years for which these programs have been in effect, 227,228 loans (with a volume of 446 billion yen/\$3.4 billion US⁸) have been approved these programs;
2. four “disaster” programs: specifically meant to rescue SMEs affected by natural disasters;

⁷ This data was provided by the JASMEC, the institution responsible for the Credit Insurance System; the information contained there is about loans re-guaranteed by JASMEC. Since all loans guaranteed by the Credit Guarantee Corporations (CGCs) are automatically re-guaranteed by JASMEC, the number of loans re-guaranteed is the same as that guaranteed by the CGCs. However, since JASMEC re-guarantees 70-80% of loans, the volume of loans re-guaranteed by JASMEC is 70-80% of that guaranteed by the CGCs.

⁸ Dollar denominated figures may not indicate the exact volume of loans due to the frustration of US dollar/yen exchange rate.

3. seven “economic change” programs: specifically meant to rescue SMEs affected by changes in business/economic situation (in the following, the expression “rescue programs” refers to the combination of groups two and three); and,
4. 19 “other” programs established from time to time.

While four of the expansion programs were permanent initiatives, all eleven “rescue” programs were offered within specific limited time periods. However, 1,923,824 loans with a volume of 31 trillion yen (\$237 billion US) have been accepted under various “rescue” programs (of those, 1,810,240 loans with the volume of 30 trillion yen/\$230 billion US are under “rescue from economic change programs”). The number of loans under “rescue” programs are eight times those under “creation/expansion” programs, and the volume of loans under “rescue” programs are sixty-nine times those under “creation/expansion” programs. These data speak to the true goals of the Japanese scheme.

Moreover, the coal-mining industry program (of the “economic change” programs) shows the Japanese scheme’s intention to support SMEs in obsolescent industries, the “international economy” program shows its willingness to salvage SMEs damaged by yen appreciation, and the management stabilization II program indicates its attitudes to bail out SMEs affected by a parent company’s downsizing.⁹

It is beyond the scope of this study to investigate whether it was worthwhile to spend 3 trillion yen for rescuing and retaining SMEs. Nevertheless, it could be said that the introduction of this program displayed the Japanese government’s (and scheme’s) tendency to put emphasis on retention of existing SMEs. If entrepreneurship is fostered by “creative destruction”, it would seem that efforts to rescue distressed and obsolete enterprises would limit entrepreneurial activity.

⁹ It can be, again, argued that viable SMEs exists among those eligible for these three programs.

Over its history, the Japanese scheme has constantly rescued SMEs when significant changes in economic situation natural disasters occurred. For example, the volume of loans approved under “economic change” programs rose to around 5% during 1974-1975 when the oil crisis affected the Japanese economy. Also it increased to approximately 2% in 1986 when “the Plaza Agreement” triggered yen appreciation against US dollar. Moreover, it surged up to 40-55% during 1998-2000 when the Japanese government assumed a credit crunch affected SMEs and undertook a large scale “economic change” program: “the Special Guarantee System for SMEs’ Financial Stabilization Program”. As for the “disaster programs”, the volume of loans approved under those programs rose to 5.1% in 1959 when a violent typhoon swept over Japan, and increased to 4.4% in 1995 when the Kobe earthquake occurred.

Compared to the Japanese scheme’s active support to distressed SMEs (when the necessity is recognized), its support to start-ups and expansion is weak. The proportion of loans approved under “creation/expansion” programs was below 0.01% between 1958-1987. Though it has slightly increased from 0.04% to 0.53% during 1988-2000, but during the entire period of 1958-2000 it has never reached to above 1% (in volume).

These figures suggest that the Japanese scheme tends to put more emphasis on rescue and retention of existing (though distressed) SMEs than on support to start-ups or expansion. This bias could, at least partially, explain the discrepancy between the enormous scale of the Japanese scheme activity and the low level of the entrepreneurship activity in Japan.

“Other” Programs within the CGS Approach

The previous section compared the number and volume of loans under “rescue” programs and those under “creation/expansion” programs”, and identified that the Japanese scheme tends to focus on “rescue” rather than “creation” activities. This section examines the large volume of loans approved under other programs. Approximately one million loans are approved under these “other” programs every year. Most were approved under “the regular” or “no-collateral” or “special small sum” programs, for which any SMEs could be eligible. It is instructive to determine the purposes for which these loans were used to determine whether they fostered growth or were used to redress losses

A substantial increase in the number of loans under “other” programs occurred when the Japanese economy moved from its prosperous era into a stagnation era (1989-1993). The increase occurred when firms were likely to experience slow growth, sales reduction, and reductions in expansion-oriented investment. During the 1990’s, plan/equipment investment in manufacturing sector was decreasing. Thus, this circumstantial evidence suggests that the increased portion of loans under “other” programs were not used for growth-oriented purposes.

The Credit Supplementation System as a Permanent Supply of Capital

Figure 1 shows a comparison in take-up rate (number of SMEs using guaranteed loans divided by number of SMEs) among guarantee schemes in 11 countries. Figure 2 displays changes in take-up rates for the Japanese scheme between 1985 and 2000. In Figure 2, three measures of take-up rates are displayed: case take-up rate (number of outstanding guaranteed loans divided by number of SMEs); firm take-up rate (the same rate used in Figure 1); loan take-up rate (volume of outstanding guaranteed loans divided by volume of all outstanding loans advanced to SMEs). The Japanese scheme displays unusually high take-up rates: four times that in the US, the country considered the most active in terms of entrepreneurship. Essentially, one out of three SMEs used at least one guaranteed loan. Moreover, between 1985 and 2000 the case take-up rate doubled from 33.5 to 72.5% (72.5% as a case take up rate means that if a firm were allowed to receive only one guaranteed loan, more than seven out of 10 SMEs receive loans). Moreover, “loan take-up rate” almost tripled from 4.5% to 12.9% during the period.

Figure 1: International Comparison in Take up Rate (1998)

(Source: Christensen et al., 1999).

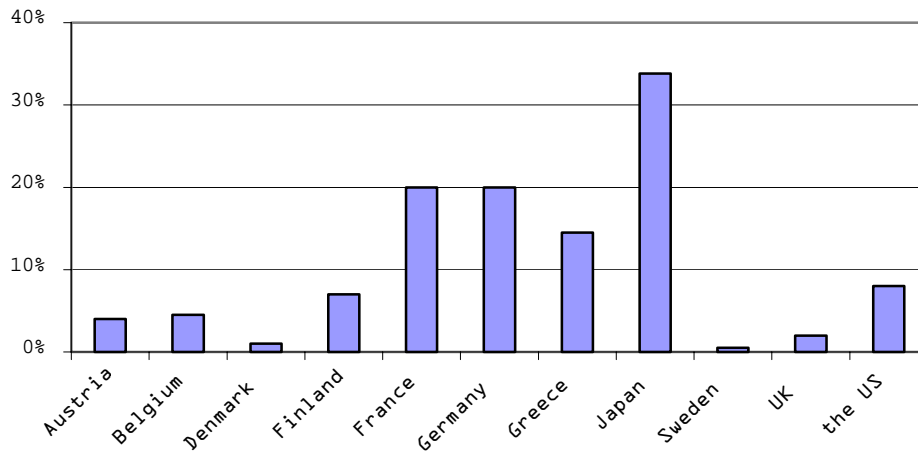
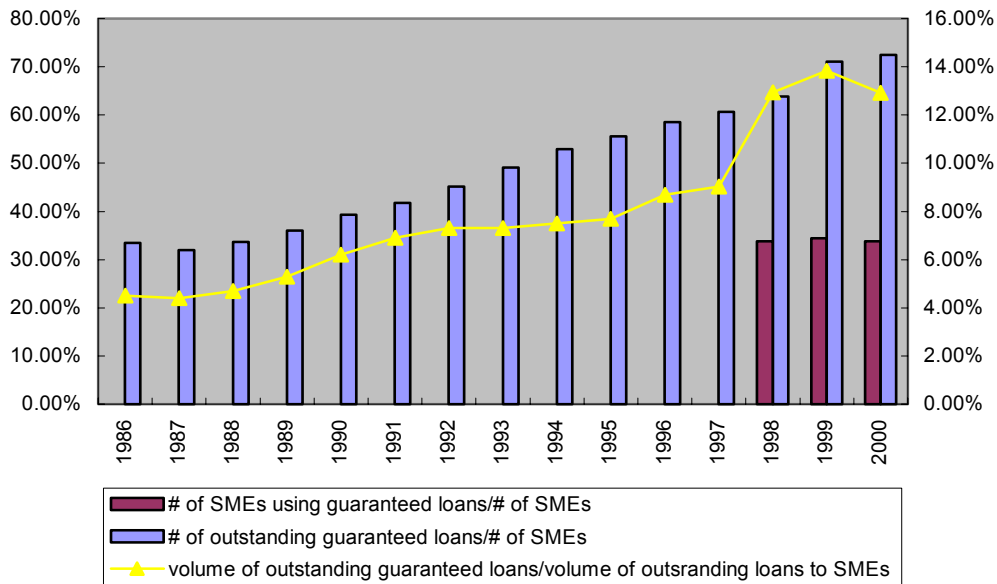


Figure 2: Change in Take up Rate for the Japanese Scheme



In most countries, loan guarantee schemes are intended to help banks and other private financial institutions to improve SMEs' access to debt capital. Thus, only loans

that would not be otherwise granted (without the guarantee scheme) should be guaranteed; consequently we speak of “additionality” (the additional loans that would not have been approved, had the scheme not existed) as one indicator, among others, of the scheme’s contribution. In this regard, the high take-up rates of the Japanese scheme can be interpreted in two ways. One interpretation is that all loans guaranteed by the scheme are “additional”. This would imply that Japanese banks’ and financial institutions’ high degree of rationing starves one-third (33.8%) of Japanese SMEs. Alternatively, a large portion of loans guaranteed by the Japanese scheme is not “additional”.

In this context, the data also show that during 1979-2000 an average of 88.5% of guaranteed loans were renewals. The Japanese scheme identifies SMEs’ lack of creditworthiness (due to lack of collateral and/or track records) as the major reason for presumed difficulty in accessing bank loans.

Thus the CGS defines as its role to recognize SMEs’ viability and to contribute to their development through financial support. If the scheme properly plays this role, SMEs should “graduate” away from guaranteed loans. Through initial loans through the CGS SMEs should have been able to build track records or rapport with banks, or to grow and become capable of securing loans themselves. Thus high renewal rates should not be observed; that they are observed suggests that the scheme does not function properly. Either CGS continuously guarantees loans to SMEs that have become capable of obtaining funds themselves or it guarantees loans to SMEs that are not growth-oriented. In the first case CGS loans are not additional and the scheme is essentially an SME banking institution. In the second case, many of the firms are viable over a long term and provide ongoing employment and other social benefits; however, it is not clear why they require loans from the CGS. Other firms among this latter group are, in fact, weak firms. Moreover, during the 1976 to 2000 period the majority (77.9%) of guaranteed loans were used to support working capital. To the extent guaranteed loans are being advanced to weak enterprises as permanent financing, these artificially-supported firms are then able to compete with more efficient businesses.

In summary, the Japanese scheme’s high take-up rate, high renewal rate, and high proportion of loans used for working capital suggest two possibilities, both of which may

hold: that a very high proportion of guaranteed loans are not “additional”; or that a high proportion of loans are not in support of growth or start-up.

If some guaranteed loans are not “additional”, this implies that some portion of costs is wasted. Moreover, prevalence of “non-additional” guaranteed loans might enhance banks’ indisposition to grant loans to SMEs when loans are not guaranteed. It therefore increases banks’ hesitance toward small business financing rather than removing it. If some loans are granted non-growing firms, the scheme does not contribute the “development” of SMEs. Moreover, though a permanent source of capital for not growing SMEs’ working capital financing is necessary, there is no reason why such loans must be guaranteed. These findings again suggest that the Japanese scheme does not work towards its stated objective (to contribute to SMEs’ development) and helps explain why the guarantee scheme has not translated into entrepreneurship activity in Japan.

Finally, it is also worth noting that default and loss rates under the Japanese scheme’s are relatively low compared to those for other countries, ranging from 0.5% to 3% (see Appendix). This can be explained by the high renewal rate: since the majority of guarantee loan users are repeaters, the scheme has enough information on borrowers to avoid high default/loss rate.

Summary and Conclusions

This study seeks possible explanations for the discrepancy between the high scale of the Japanese loan guarantee program and the low level of the entrepreneurship activity in Japan. To do so, it investigates the characteristics, mechanism, the actual roles played by, and performance of the Japanese Credit Supplementation System. The central finding of this investigation is that the de facto activity under the program is much more targeted to averting the failure of weak firms and much less focused on new and growing firms.

Consequently, considerable societal resources are expended in efforts of prop up firms in distress and provide non-incremental, perhaps even permanent, guaranteed financing. This means that the process of “creative destruction” is stifled. Moreover, weak firms artificially supported by the program are able to compete on a state-subsidized basis with efficient enterprises that may be seeking to grow.

Several questions arise from these findings. The first one is whether using the scheme for rescue/retention of distressed SMEs can generate greater social welfare benefit than using it for support SMEs' growth. Proponents might argue that this may benefit society through the retention of employment and maintenance of social stability. However, but there is also a danger that this approach harms society. In keeping SMEs artificially alive, the scheme may well pose an obstacle moving the Japanese economy to a new era. Moreover, there is a likelihood that the scheme's effort to retain SMEs does not actually result in the desired outcome that distressed SMEs simply overcome a difficult period and regain prosperity, but simply postpones bankruptcy. The OECD Economic Survey (2001) suggests this possibility as it points out the significant decrease in number of bankruptcies in 1998 and 1999 (when the large scale rescue program, the Special Guarantee System for SMEs' Financial Stabilization Program) was introduced, and the significant increase in 2000 after the program's introduction. In order for the Japanese scheme's role to rescue SMEs to be justified, it is necessary to study the social benefits generated by such a role. This challenging task remains to be undertaken.

A second question is what kind of benefit the society receives from the guarantee scheme when the scheme functions as a permanent device for non-growing SMEs to obtain financing for working capital. A "non-growing firm" does not mean a firm that may fail: many firms that do not grow maintain a sound operation of their businesses. When such SMEs cannot obtain loans, there might be a necessity of a government intervention to provide them loans. However, such loans need not be guaranteed. It remains to be determined whether social welfare benefits are generated by guaranteeing loans to not-growing SMEs.

Third, given the experiences of other countries, it seems that the two-tier, double guarantee mechanism characteristic of the Japanese and German schemes is advisable. On the one hand, the National Federation of Credit Guarantee Corporations in Japan points out two advantages of the two-tier mechanism: to make the scheme to reflect both local and federal level's concern, and to allow the guarantee corporations to more actively supply guaranteed loans by reducing loan recovery costs incurred by the corporations. However, a two-tier guarantee mechanism may induce moral hazard within

the CGSs and lead to approval of guaranteed loans without sufficiently rigorous assessment of applicant SMEs (this is because since increased default losses resulted from such negligence does not harm the corporations). In addition, involvement of an additional institution implies additional costs of operation of the scheme. Investigating which mechanism is likely to generate greater social benefit scheme, one-tier or two-tiers, is an interesting area of further study.

Fourth, it is necessary to study further the linkages between the guarantee agency and lenders. The Japanese approach is one by which guarantee corporations cooperate less with banks. While the Japanese approach keeps the scheme's sovereignty and avoids conflicts between the guarantor's and lenders' interests (e.g., lenders' moral hazard), the scheme's operation more costly, requiring 52 local guarantee corporations.

Finally, a limitation of this study is noted. This study suggested three possibilities: the Japanese scheme puts more emphasis on retention of exiting SMEs; it guarantees loans to non-growing firms; and it has low additionality. All can explain the discrepancy between an enormous scale of the guarantee scheme activity and the low level of entrepreneurship activity in Japan. However, the certainty of those possibilities has not been proven. Much of the evidence presented here is circumstantial and inferential. Therefore, further investigations are needed.

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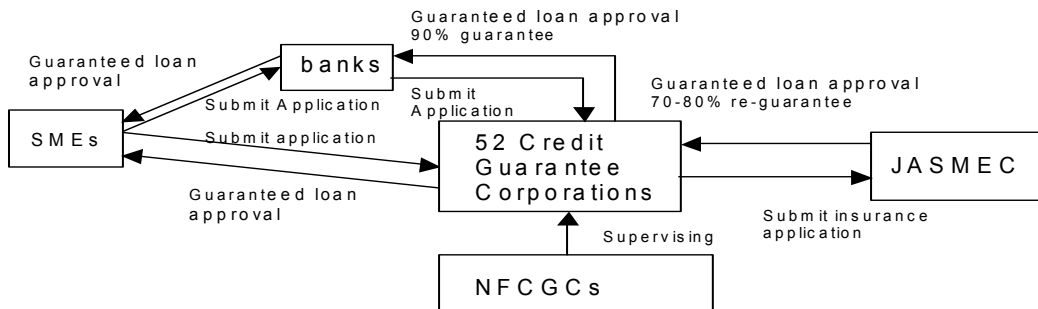
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Appendix

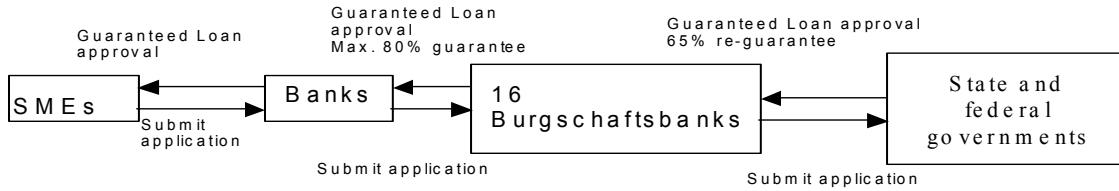
The following figures summarize the difference in basic administrative structures in the Japanese scheme, the German scheme, and other five European & North American schemes.

Basic Administrative Structure of Guarantee Schemes

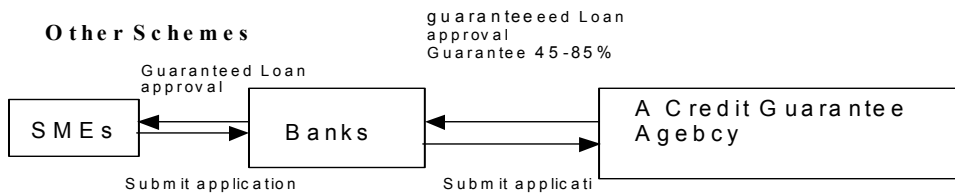
Japanese Scheme



German Scheme



Other Schemes



About the Authors:

Author: Miwako Nitani, PhD Student

Company or Institution: Carleton University, Eric Sprott School of Business

Canadian Council for Small Business and Entrepreneurship

Country: Canada

Author: Allan Riding

Email: al_riding@carleton.ca

Company or Institution: Carleton University, Eric Sprott School of Business

Canadian Council for Small Business and Entrepreneurship

Country: Canada