Freedom In Japanese Financial Markets

By Takashi Hosomi

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The liberalization and internationalization of financial services in Japan have progressed synchronically over the past several years. But though both trends tend to be discussed as if they constitute one and the same question, they clearly should be considered separately. Similarly, the view that financial liberalization and internationalization resulted from "external pressure" is one-sided. It should not be forgotten that they were in large part prompted by the unavoidable domestic circumstances of Japan's financial industry.

Factors behind liberalization

Massive government bond issues

One of the key factors contributing to financial liberalization was the sale of large quantities of government bonds beginning in fiscal 1975. Following the rampant inflation and economic recession caused by the first oil crisis in the autumn of 1973, the Japanese government adopted a vigorous deficit spending policy, issuing large volumes of bonds to help pay for projects designed to reflate domestic demand. The total value of bonds outstanding exceeded ¥100 trillion in June 1983 and reached ¥133 trillion (about $740 billion at the rate of $1/¥180) by March 31, 1986, the end of fiscal 1985. Some of these debt certificates came due after ten years, but because of the still large budget deficit, refinancing bonds had to be issued to meet the obligations.

To facilitate the sale of such vast volumes of bonds, the Finance Ministry had to make them attractive to a broader segment of the investing public by linking them to market interest rates. The sale of new government bonds began over the counters of not only securities companies but also of banks in April 1983. And in June 1984, old public bonds went on sale at 34 banks. This so-called "bank dealing" paved the way for the extensive entry of banks into the securities business.

At the same time a variety of competitive new financial instruments were put on the market, expanding investors' range of options. The public was able to choose freely among various instruments linked to prevailing market interest rates, rather than just use conventional instruments restricted by regulated interest rates. This brought market functions into play in the financial arena, creating conditions conducive to liberalization.

Liberalization and internationalization of capital transactions

Both inward and outward capital transactions were liberalized in principle with the revision of the Foreign Exchange Control Law in December 1982. Thereafter, surplus Japanese funds flowed increasingly into foreign markets in search of higher interest rates. Domestic enterprises, discouraged by stringent regulations at home, began raising low-cost funds abroad in the form of foreign bonds. With foreign investors also demanding easier access to the Japanese financial and capital markets, it became increasingly difficult for the Japanese financial industry to maintain traditional practices on the grounds of the nation's "special" historical background and domestic situation. The internationalization of the Japanese economy inevitably necessitated the internationalization of the domestic financial and capital markets, causing a tidal wave of financial liberalization.

One of the first moves in financial internationalization in Japan as elsewhere was the establishment of overseas bases by domestic financial institutions to expand their operations more freely. Today, on average, half the profits of Japanese banks are said to originate from operations abroad. This could not but attract the attention of foreign banks and securities companies, and predictably, they have demanded that they be given the same freedom in Japan—where family savings rates are remarkably high and corporations have vast surplus funds—that Japanese financial institutions enjoy in their own markets. In short, they are calling for complete deregulation.

Japan-U.S. Yen-Dollar Committee

The Japan-U.S. Yen-Dollar Committee, established under an agreement reached during U.S. President Ronald Reagan's visit to Japan in November 1983, held nearly ten sessions attended by officials of the Japanese Finance Ministry and the U.S. Treasury Department in just six months. The intensive discussions led to the publication of a "Yen-Dollar Committee Report" at the end of May 1984. In that report the United States made demands that would shake Japan's postwar financial system to its foundations. They included liberalization of borrowings of Euroyen (yen deposited with overseas banks), granting Tokyo Stock Exchange (TSE) membership to foreign securities companies and entry of foreign banks into the trust business in Japan. The most stringent demand, however, was that the Japanese government abolish regulations on interest rates, which U.S. officials maintained obstructed free capital movements. Moreover, the United States requested that Japan's domestic markets be further liberalized to allow Japanese and foreign financial institutions to compete freely on the basis of market principles.

In the end, the Finance Ministry issued a statement entitled "Financial Liberalization—Current Situation and Future Prospects." This blueprint, along with the Yen-Dollar Committee Report, has since served as a guideline for financial liberalization in Japan. Rapid progress has been made in this direction, in terms of both institutional liberalization and interest rate deregulation.

Progress in computer and communications technology

Financial liberalization in Japan was also prompted by the development of efficient computers, sophisticated financial software and advanced communications technologies. Originally, financial institutions introduced computers and telecommunications systems to increase efficiency. But now these systems are also widely used for developing new financial instruments and services and for providing customers with information on profit opportunities. Computers are indispensable for the sale of financial instruments which require complex interest rate computations. Thus progress in computerization has contributed significantly to financial liberalization.

Liberalization schedule

Deregulation of deposit interest rates

This is one of the keys to financial liberalization. But interest rates on Japan's massive bank and postal savings deposits cannot be deregulated in a single stroke because they consist largely of small deposits held by individuals. Instead, deregulation began with large deposits. In October 1985, interest rates on time deposits of ¥1 billion or over were deregulated. In April this year, the minimum amount was reduced to ¥500 million. It is to be further reduced to ¥300 million in September and to ¥100 million in the spring of 1987.

Negotiable certificates of deposit (NCDs or CDs) were issued in Japan for the first time in May 1979. Generally speaking, ordinary certificates of time deposits, the receipts issued by banks to depositors, are not negotiable. But CDs are made negotiable by endorsement or other means. CD interest rates are sensitive to market changes. At first the mini-

mum CD unit issued was ¥500 million, but this was reduced to ¥100 million in April 1985 to encourage sales. The total value of CDs outstanding at the end of March 1985 stood at ¥8,129 billion, and it has continued to increase. The reduction in CD units came in response to requests from foreign banks in Japan, which are at a disadvantage vis-à-vis Japanese banks because their small branch networks result in higher fund-raising costs.

The sale of money market certificates (MMCs), floating-rate deposit certificates introduced in the United States in 1978, did not start in Japan until March 1985. Japan's MMCs have a minimum unit of ¥50 million, with interest rates not to exceed a level 0.75% lower than the average interest on CDs. MMC rates remain unchanged until maturity.

The maturities of CDs and MMCs were extended in April this year to be "longer than one month and shorter than one year" instead of "shorter than six months" as previously. The Finance Ministry plans to liberalize interest rates on small deposits in stages, through the introduction of small-denomination MMCs. Initially, their minimum unit of deposit will likely be lowered to ¥3 million, with an interest rate ceiling 1% lower than the average rate on already liberalized large-unit deposit rates or CDs.

The sale by banks of CDs and MMCs has already resulted in the flight of large-unit funds from the "medium-term national bond funds" introduced by securities companies several years ago as a new financial instrument for attracting investors. To meet the competition, securities companies last August initiated the sale of "free financial funds." The rapid progress in liberalizing large deposit interest rates has clearly led to the expansion of free rate markets.

The Finance Ministry is expected to study deregulating small deposit interest rates after interest rates on large deposits have been liberalized. The staggered schedule reflects a desire on the part of the financial authorities to protect small depositors (including holders of postal savings deposits) against the effects of sharp interest rate fluctuations.

Wide-ranging liberalization

Various other measures have been taken to promote financial liberalization and internationalization. These include the creation of a yen-based BA (banker's acceptance) market, issuance of short-term government bonds with maturities not exceeding one year, entry of foreign banks into the trust business, granting TSE memberships to foreign securities companies and relaxation of restrictions on the issuance of nonresident Euroyen bonds, Euroyen lending and banks' issues of convertible bonds denominated in foreign currency. It is clear to all that liberalization has progressed rapidly. But these very changes have created so-called *gyosai mondai,* or cross-business problems, which cut across the traditional boundaries of finance in Japan.

Cross-business problems

Article 65 of the Securities and Exchange Law of 1948 prohibits Japanese banks and trust companies from engaging in the securities business. The decision to prevent banks from dealing in stocks and bonds was based on the American experience, where the business of banks was separated from that of securities companies following the Great Depression of the 1930s. Yet, as shown by the bank dealings mentioned earlier, Japanese banks recently have expanded into the securities business, while securities firms are doing business traditionally undertaken by banks. For example, securities companies initiated the sale of medium-term national bond funds which can be withdrawn any time after a month-long deposit period, making them similar in character to bank deposits. Securities companies have also marketed a variety of new financial instruments in cooperation with banks. With banks making inroads into the securities business and securities companies operating increasingly like banks, the longstanding business boundaries between the two are in danger of crumbling.

Cross-business problems have cropped up not only between banks and securities companies but also among banks themselves. Under the traditional system of regulated interest rates, there were clear distinctions between long-term and short-term institutions. The former group is represented by the Industrial Bank of Japan, the Long-Term Credit Bank of Japan, the Nippon Credit Bank and seven specialized trust banks (Daiwa Bank, a commercial bank also engaged in the trust business, is an exception). Representing the latter group are 13 commercial banks, 64 local banks and numerous other financial institutions. The former raise funds by issuing bonds, the latter by accepting deposits. This separation, based as it is on Japan's distinctive financial climate, has long been taken for granted. But now these boundaries are beginning to disappear amid the rapid progress in financial liberalization and internationalization.

In the past Japanese banks were accustomed to the protective administration of the financial authorities, which was often referred to as a "convoy system" for the way no one was allowed to drop out or, even more unimaginable, sink altogether. But while banks resisted moves toward liberalization, it was impossible to check the tide. Interbank competition intensified as demand slumped for both long- and short-term funds, a development reflecting the shift of the Japanese economy to slower growth. Meanwhile, business corporations, now with wider options in the capital market, began raising their own funds by issuing foreign bonds. At home, they avoided borrowing at the higher long-term prime rate and shifted to loans at the lower short-term prime rate. In short, they tried, and succeeded, to bring down the interest rates they had to pay.

Today both long-term and short-term banks are responding to the challenge by raising the proportion of funds procured in the form of free-interest deposits such as CDs and MMCs. This, however, has made it increasingly unrealistic to set clearcut differentials for lending rates. In other words, the practical advantages of differentiating long- and short-term banking are being lost.

Nonbanks and consumer credit

Another notable trend in recent years has been the entry into banking of nonbank institutions such as credit card companies, credit sales companies and department stores. According to figures released by the Japan Credit Information Association, the volume of new credit granted by the consumer credit industry increased from ¥9,800 billion in 1975 to ¥31,600 billion in 1984, for an average annual growth of about 14%. In the case of sales credit, the volume of new credit expanded in the same period from ¥5,800 billion to ¥16,900 billion, an annual average rate of about 13%. The consumer credit industry is expected to enjoy further growth in the future and could soon pose a threat to established financial institutions.

Changes in both law and thinking

Financial decontrol has progressed rapidly in Japan and is likely to continue at an accelerated pace in the years ahead. The fact remains, however, that the Japanese financial industry has yet to completely free itself from old restrictions.

Take, for example, the rule that corporate bonds cannot be issued unless they are secured. This principle was established in 1933 in recognition of the lessons of the financial panic in the 1930s. Normally bonds are issued under detailed procedures requiring selection of a commissioned bank and a lead manager bank. This rule, however, makes it difficult for corporations like trading companies, without ready collateral in the form of real estate or plant and equipment, to issue bonds. What is actually important today is not whether the issuer can provide security in kind, but rather whether it has the essential attributes of a viable commercial enterprise, such as profit-making power, financial standing and growth potential. Changing this traditional "secured bond principle" necessitates a basic change in public thinking. What is also required is further development of Japan's still young credit rating system. And even then a prohibition on the issuance of commercial paper—unsecured promissory notes—will leave Japanese businesses laboring under a financial handicap.

With today's rapid progress in financial liberalization, Japan's banks, securities companies and other financial institutions are all bound to face growing competition both at home and abroad. Nor will it be long before foreign institutions are allowed free entry into the Japanese market. What is happening now in the world of finance is the advent of free competition, which only the fittest will survive. Only those businesses which work hard and successfully at research and other essential preparations will be able to win the new game.

One clear sign of the times is the pending proposal to create a Tokyo offshore banking center. The Committee on Foreign Exchange and Other Transactions, an advisory body to the finance minister, has been deliberating on this author's proposal of January 1983, which calls for the establishment of an international banking facility (IBF) separated from the domestic financial and capital markets. This IBF-type offshore market would allow nonresidents to conduct free transactions in fund procurement and operate with minimum restrictions on finance, taxes, foreign exchange and so forth. Certain handicaps, such as Japan's still underdeveloped short-term money market and circulation market, remain. But despite these disadvantages, the creation of a free banking market would make Tokyo one of the largest financial centers in the world, comparable to the markets in London and New York. ●