Corporate Finance in Japan: Changes with Deregulation

By Nobuyoshi Namiki

In the United States, deregulation and liberalization of tertiary industry started in the 1970s, and by the 1980s had begun to impact on the Japanese economy.

Deregulation of the American transport business, from trucking to railway services, maritime transport and aviation, triggered moves in Japan to develop an intermodal transportation system. Whereas the U.S. placed railway passenger services under a public corporation, Japan is now pushing the privatization and dismemberment of the Japanese National Railways (JNR).

American deregulation of the information and communication industries triggered the privatization of NTT (Nippon Telegraph and Telephone Public Corporation) and the establishment of private-sector telecommunications companies.

The inefficiency of government and public hospitals led in the U.S. to the development of private trustee associations to undertake hospital management. In Japan the response to similar problems has been the appearance of elite membership hospitals.

But of all the series of deregulation and liberalization steps taken in American tertiary industry, the ones which have attracted the greatest attention in Japan are those related to finance. Because Japan and the U.S. differ in economic environment, historical background and tradition, the reaction of the Japanese financial world to deregulation and liberalization has not been as striking as in the United States. But even so, a number of noteworthy changes has begun to reshape the world of Japanese corporate finance.

Not all of these changes have been directly due to liberalization and deregulation. For instance, slowing demand for funds due to slower economic growth, and the consequent rise in the ratio of funds raised internally to those raised externally, are, in theory at least, unconnected with financial liberalization and deregulation. However, liberalization has widened and diversified the corporate avenues for fund procurement and fund operation. To this extent, it can be said to have changed corporate financial practices.

In other words, while Japanese companies' net dependence on outside funds has lessened, their gross dependence on outside funds has risen in the form of procuring low-interest funds and operating them for higher yields. The lessening of net dependence and the rise in gross dependence are not incompatible.

What, then, is the connection between American and Japanese financial deregulation and liberalization?

Financial deregulation in the U.S. was prompted by three factors: political and social pressures toward deregulation; the need to cope with high interest rates and convulsions in the interest rate system caused by unprecedentedly high inflation; and the speedy transmission of huge amounts of information made possible by progress in microelectronics.

The domestic motivations for financial liberalization in Japan differed in detail from those in the U.S. While they included the need to deregulate interest rates because of massive government bond issues, there was no inflation-led convulsion of the interest rate system. The microelectronics revolution affected both countries equally.

The pace of deregulatory financial legislation in the U.S. has slowed as inflation has subsided and moves to reduce the federal budget deficit and reform the tax system have come to the fore. In actual practice, although more progress may yet be made in lowering barriers between banks and securities companies, in allowing interstate banking, and in opening the way for financial institutions to advance into other industries, it is unlikely there will be much more radical change. If moves toward deregulation slow down in the U.S., the pace of progress in Japan is also likely to slow. Nonetheless, the institutional deficiencies in corporate finance will gradually be rectified in coming years.

Shrinking corporate fund shortage

An overarching reality of Japanese corporate finance today is the shift from a shortage to a surfeit of funds. The tendency away from the shortages that characterized postwar corporate finance was already evident before the oil crises of the 1970s. It has significantly upped the ratio of funds raised internally and lowered that of funds procured externally, and will probably continue to do so in the future.

Change has also occurred in the composition of funds procured from outside sources. Companies are increasingly raising funds in foreign currencies. The ratio of borrowed funds has fallen, while that of funds raised through the issue of corporate bonds and stock, particularly the former, has risen markedly. Today there are more corporate bond issues overseas than on the domestic bond market, and convertible bond issues have outpaced straight bond issues. In short, Japanese companies are seeking funds at lower cost.

The third big change has been in the way corporations operate the funds they have. Japanese companies are shedding their conventional fixation on stable interest rates in favor of operating their funds in higher-yield, if riskier, uncon-

Nobuyoshi Namiki, a director and the chief economist at the Japan Economic Research Center, is a leading expert on Japan's industrial structure. He concurrently serves as an editorial writer for the Nihon Keizai Shimbun.

trolled-interest products, such as certificates of deposit (CDs) and foreign currency deposits.

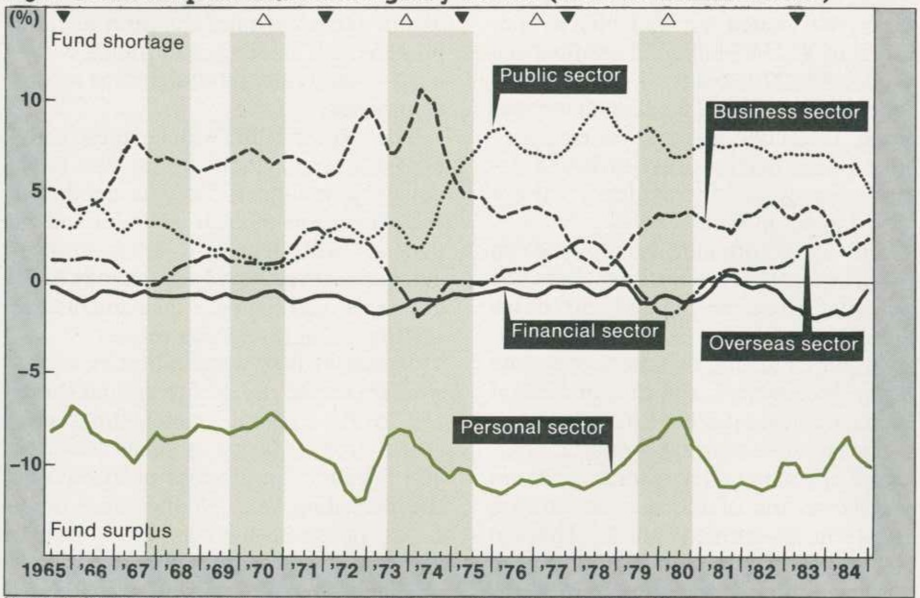
The shrinking corporate fund shortage shows up clearly in calculations by the System of National Accounting (Fig. 1). The fund shortage in the corporate sector improved markedly in the period before and after the oil crises. What caused this change?

The main factor was a drop in the economic growth rate. As growth slowed, investment in plant and equipment and in inventory also decelerated, shrinking demand for funds. At the same time, depreciation increased steadily year by year, as did retained profit, despite some year-to-year fluctuations.

According to the Finance Ministry's Quarterly Statistics of Corporate Businesses, corporate savings (depreciation + retained profit) in 1972 on the eve of the first oil crisis totaled some ¥1 trillion, while investment (plant and equipment investment + inventory investment) was roughly ¥3 trillion. In other words, investment was roughly three times as much as available savings, leaving a fund shortage twice as large as the funds companies had on hand.

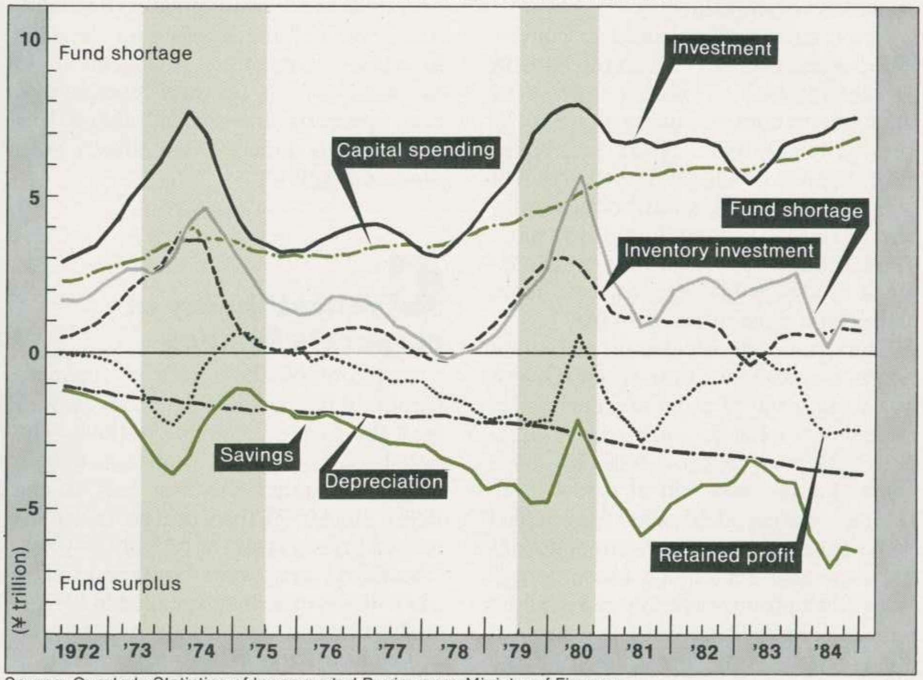
But by 1984, corporate savings had reached ¥6.2 trillion, closing in on total investments of ¥7.5 trillion. With investment running at only 1.2 times savings, the fund shortage had shrunk from 200% to 20%. During this period the growth rate of depreciation was actually greater than that of fixed investment (Fig. 2). Inventory investment and retained profit fluctuated considerably in line with swings in the business cycle. However, if the shifts are averaged out, and if inventory investment is added to fixed investment and retained profit to depreciation, it is clear that savings grew faster than investment. This trend is expected to continue.

Fig. 1 Fund Surplus and Shortage by Sector (ratio to nominal GNP)



Notes: 1. Seasonally adjusted, three-quarter weighted moving average (weight 1:2:1)
2. Shadowed parts represent tight-money periods (same in Fig. 2).
3. White triangles show peaks of economic activity while black triangles show troughs (survey by Economic Planning Agency).

Fig. 2 Savings-Investment Balance of Business Sector



Source: Quarterly Statistics of Incorporated Businesses, Ministry of Finance
Note: Seasonally adjusted, three-quarter weighted moving average (weight 1:2:1)

Bank borrowings down, bond issues up

The Bank of Japan's Flow of Funds Analysis does not touch on internal flows. However, a recent MITI (Ministry of International Trade and Industry) survey on component ratios of the source of funds for plant and equipment investment found that in fiscal 1973, 62.0% came from corporations' own capital (of which 46.5% was depreciation), 20.6% from borrowings, 11.8% from corporate bond issues and 5.6% from stock issues. In fiscal 1984, the component ratios were own capital 79.3% (62.1% depreciation), borrowings 6.9%, corporate bonds 11.0% (7.8% foreign bonds) and stock 2.8%.

The component ratios vary according to economic conditions. The fiscal 1973 component ratios can be considered typical of the high-growth period before the effects of the oil crisis made themselves felt, and those in fiscal 1984 representative of the period after the effects of the oil crisis had worked through the economy. Fund procurement plans for fiscal 1985 were not much different from those for fiscal 1984.

These component ratios clearly reveal a declining dependence on outside funds. The decrease in borrowings from banks and other financial institutions is most striking, while the proportion of corporate bond issues increased greatly among external procurements.

A detailed study of corporate bond issues reveals that domestic issues in fiscal 1984 totaled ¥2,334.5 billion, including ¥720 billion in nonfinancial bonds, ¥1,611.5 billion in convertible debentures and ¥3 billion in warrant bonds. Corporate bond issues overseas in fiscal 1984 totaled ¥2,795.1 billion, consisting of ¥1,134.5 billion in nonfinancial bonds, ¥1,227.1 billion in convertible debentures and ¥433.5 billion in warrant bonds. Fiscal 1983 was the year corporate bond issues overseas first exceeded domestic issues, and the tendency was observed again in fiscal 1985.

The brisk corporate bond issues in overseas markets are attributable to the fact that issue procedures are much simpler abroad, that no material collateral is required, and that the coupon rate is low. Moreover, in the case of straight bonds, interest rates have been lower on overseas issues than on domestic offerings. The coupon rate on domestic issues is 0.3% on top of the interest rate on long-term government bonds. Thus, in 1985 the coupon rate on AA bonds (see p. 18) was 7.1%. At the same time, it was possible to issue straight bonds in Switzerland with interest rates of 5.4–5.7%. The low issue cost was one of the reasons straight bond issues overseas exceeded domestic issues.

The interest rate on five-year convertible bonds issued by Sumitomo Bank in Switzerland was 1.375%, far lower than the standard domestic interest rate of 4%. Yet, the total number of overseas issues of convertible bonds was less than that of domestic issues. This was because overseas investors convert into stock more quickly than do Japanese investors, making it relatively less expensive to issue convertible debentures at home.

The true aim of issuing corporate bonds overseas at a time when the yen was weak vis-à-vis other currencies was to realize exchange gains as the Japanese currency appreciated. In 1985, when the yen was still at a low level, several leading Japanese commercial banks issued ¥30 billion worth of debentures overseas separately. These debentures alone produced profits of ¥8 billion for each bank. The subsequent narrowing of interest rate disparities and the appreciation of the yen should have eliminated for the time being the merits of issuing bonds abroad.

According to Bank of Japan trial calculations, 92.2% of the funds procured by big Japanese companies from outside sources between fiscal 1975 and 1979 were in yen, versus 7.8% in foreign currency. Between fiscal 1980 and 1983, the figures were 77.3% and 22.7%, respectively, and in 1984, 66.2% and 33.8%. In fiscal 1985, 73.2% of planned procurement was in yen and 26.8% in foreign currency. Because fund procurement in foreign currency will be affected by the narrowing interest rate differential and the revision of the exchange rate, the ratio of fund procurement in foreign currency is unlikely to continue the straight-line ascent of the past.

The change in the way Japanese companies operate their funds has been equally pronounced. They have reduced the proportion of cash on hand and in deposits with regulated interest rates, and have moved heavily into bonds, CDs and high-yield financial instruments denominated in foreign currencies.

Trends in 1984 were indicative of the whole. Despite the declining fund shortage in the corporate sector, funds procured from outside sources reached ¥24.5 trillion, an increase of 10.9% over the preceding year. At the same time, funds operated by companies leaped 34.3% to ¥16.6 trillion. This ¥16.6 trillion included ¥3.6 trillion invested in foreign securities. The net increase in overseas bond issues was ¥1.4 trillion. In short, in 1984 Japanese companies vigorously raised funds in overseas markets and operated them with greater flexibility than ever before. It was also the year Japanese companies' involvement in overseas markets for fund procurement and operation intensified, although a trend in this direction had already been observed in 1983.

Cyclical theory of corporate finance

In plumbing the future of Japanese corporate finance, it is necessary to start with the future economic outlook. The world economy will probably remain sluggish through the first half of the 1990s. Since 1790, the world economy has moved in long cycles of roughly 50 years. The fourth long wave bottomed out in the 1940–45 trough and peaked in 1973. It seems that the world economy is now on a downward course toward a trough in 1990–95. Close study clearly shows how difficult it would be for even the new wave of technological innovation spurred by high technology or the coming of an information-based society to deflect the downward sweep of this long wave.

Japan cannot remain outside this worldwide trend. With the future of the cumulative debts of developing countries as unpredictable as it is, economic growth is likely to remain low for years to come.

Accordingly, capital and inventory investment cannot be expected to show new life; rather it seems probable that Japanese companies' dependence on outside funds will lessen even further. A troubled profit picture will limit any increase in retained profit, although depreciation will continue to swell for the time being.

The economic situation being such, how will corporate finance develop?

Liquidity of funds in institutional terms will inevitably increase through operations in domestic and overseas markets. Procedures and terms of issue for corporate bonds in Japan will be simplified to the level of other countries. The interest rate differential will tend toward narrowing rather than widening, as there is no prospect in any country of inflation severe enough to cause money rates to climb. Conversely, that means no expansion of demand vigorous enough to cause inflation.

Exchange rate adjustments will be all but completed during 1986, and there should be no big fluctuations either way. This being so, how can Japanese corporations be expected to procure funds from outside sources and operate the money they raise?

First, in terms of external procurement, overseas bond issues will increase overall, reflecting a belief among Japanese companies that the yen is likely to remain high over the medium and long term. Among funds procured domestically from outside sources, the proportion of convertible bond offerings will probably increase. Demand for such bonds should expand because no change is likely in the basic tendency for stock prices to rise, even during an economic slump (when surplus corporate funds made available due to sluggish capital spending tend to be invested in the stock market); higher stocks should encourage conversion of convertible bonds into stock and thus boost demand for such bonds rather than straight bonds. Corporations, meanwhile, will reschedule their low-interest short-term loans so repeatedly that the effect will be the same as long-term loans. Banks will have to switch their emphasis from corporate loans to lending money to small- and medium-sized enterprises, real estate investment and consumer financing.

As the number of companies with hefty surplus funds increases, fund operations will naturally become more vigorous. Companies will select the most profitable instruments available, whether in domestic or overseas markets. The problem in operating funds overseas will be how to hedge against exchange risk. Within Japan, treasury bills (TBs) will become a new target of investment as the financial market matures. ●