

Financial Market Liberalization

By Koei Narusawa

Financial deregulation based upon the Japanese government's declared policy of complete liberalization of the nation's money and capital markets has proceeded rapidly as well as successfully over the past year and a half.

First came the gradual deregulation of interest rates on bank deposits subject to ceilings set by the authorities (similar to Regulation Q in the United States). Bank deposits with a denomination of ¥1 billion or above (about \$4.88 million) were freed from restriction effective October 1, 1985. The threshold amount is now scheduled to be lowered in stages to ¥100 million by spring 1987 at the latest, and it is generally assumed the timetable is more likely to be advanced than delayed.

This move is tremendously significant for foreign banking institutions operating in Japan. Heretofore they have obviously been at a disadvantage relative to their domestic competitors because of an extremely limited deposit base consisting mainly of relatively low-cost funds garnered from the general public. Now that bank deposits are becoming more subject to market forces appearing in the form of interest rates, the relative competitive position of foreign banks is bound to improve.

Second has been the progress toward a more sophisticated Japanese money market through the introduction of new high-quality financial instruments. A bankers acceptance market has been in operation since June 1985, even though it still remains modest in size due mainly to the relatively high cost of financing for customers. A far more important issue still in the pipeline, however, is a freely functioning market in short-term government securities, most notably treasury bills. The significance of establishing a free market in treasury bills is twofold. On the one hand, freely tradable treasury bills will doubtless be the centerpiece of open market operations by the central bank, operations which are bound to become the most important tool for monetary control as the opening of the nation's domestic financial markets continues.

On the other hand, treasury bills, once

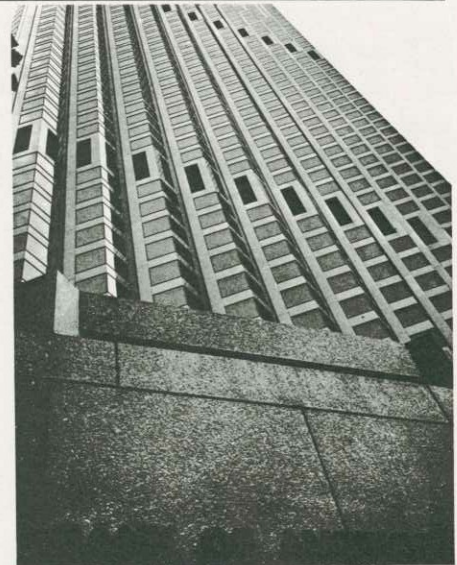
made freely accessible, will be by far the most attractive short-term financial asset with high liquidity for would-be holders of the yen overseas. This in turn will encourage greater inflows of foreign capital into Japan, thus underpinning the value of the yen.

A third major development was the admittance of foreign credit institutions into areas other than commercial banking. The most outstanding example was the opening of the door to trust businesses. In October, three of nine American banks licensed to enter this new market started operations, Bankers Trust, Morgan Guaranty and Chase Manhattan.

Another move equally worth noting was the admittance for the first time ever into the Tokyo Stock Exchange (TSE) of six foreign brokerage houses in October. The six foreign firms that won the long-awaited TSE membership were Merrill Lynch International Bank Inc.; Goldman Sachs International Corp.; and Morgan Stanley International Ltd. of the U.S. and Jardine Fleming (Securities) Ltd.; Vickers da Costa Holdings Ltd.; and S.G. Warburg, Rowe and Pitman, Akroyd (Japan) Inc. of Britain.

Last but not least, foreign commercial banks already maintaining branch offices in Japan are expected to be permitted to establish subsidiaries dealing in securities. Entry will be granted on the proviso that the entity to be set up in Japan be owned by a subsidiary of the parent bank in which the latter has a stake of less than 50%. This rather cumbersome restriction was deemed indispensable in light of existing regulations which prohibit even domestic banks from entering the securities business and underwriting private bonds and equities. German and Swiss banks as well as British banks are expected to take advantage of this new opportunity.

Fourth, in the area of financial innovation, two developments seem to stand out: the establishment of a financial futures market in the Tokyo Stock Exchange last October 19, and the move toward introducing an off-shore financial market similar to the International Bank-



Foreign banks are becoming more competitive in the Japanese market.

ing Facilities already operating in the United States since 1981. For the time being, the financial futures market is confined to dealing in a standardized abstract type of government bond with a coupon rate of 6% and a life of 10 years. The off-shore banking facilities, meanwhile, are expected to be christened sometime in 1986. According to a draft already made public, authorized foreign exchange banks, domestic as well as foreign, will be able to establish segregated accounts in their books exclusively for conducting off-shore banking business, such as lending non-resident deposits to non-resident borrowers. Three preconditions are considered indispensable if the facilities are to be worthwhile to would-be users: complete freedom in quoting interest rates on off-shore deposits, exemption from Japan's reserve requirement on off-shore deposits, and remission of withholding tax on interest paid to off-shore depositors. It may also be worth considering providing incentives in conjunction with this operation to make it more attractive to would-be entrants.

Today it is taken for granted that the nation's monetary authorities are committed to enhancing the international role of the Tokyo financial and capital market. Their goal is to help it develop eventually into one of the key financial centers of the world, comparable to the markets in New York and London. Tokyo's time zone already gives it a crucial role to play in completing a ring of international markets round the globe for 24-hour trading. With the rising tide of financial liberalization, Tokyo's place in the sun is not far off. ●

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