Finance Ministry Announces Major Reform of Financial System

By Sakamoto Sakae

In mid-June, the Ministry of Finance made public a complete picture of the major reform plan of the Japanese financial system (known as the Japanese "Big Bang" initiative). The five key changes outlined in the wide-ranging plan are to 1) allow banks to sell securities and insurance products, 2) allow securities brokerages to introduce "comprehensive securities accounts" that function as deposit accounts, 3) liberalize brokerage commissions, 4) allow banks and securities brokerages to establish holding companies under which financial subsidiaries could be placed and 5) abolish the current rules that limit securities transactions to official markets and allow off-market action such as electronic transactions. The Minister of Finance also announced a clear timetable for reform, pledging "implementation by 2001."

Each of the above key changes is part of a drastic plan that will turn the current Japanese financial order upside down. Through this package of measures, the Ministry of Finance aims to revitalize the Tokyo financial market, which lags behind other major world markets such as New York and London.

The recent reform proposals were put together by three advisory panels to the Minister of Finance: the Securities and Exchange Council (covering securities), the Financial Systems Research Council (banking) and the Insurance Council (insurance). Reform proposals were released earlier by the Committee on Foreign Exchange and Other Transactions, which reviews international financial matters, and the Business Accounting Council, which reviews disclosure and other issues. (These reports included plans for the introduction of global standards.) These five reports make up the official blueprint for the Japanese "Big Bang" financial reform.

From indirect to direct financing

A joint statement issued by the five advisory panels on June 13 details the goals of the "Big Bang:"

"Structural reform of the Japanese socio-economic system is necessary if her economy is to maintain its vitality as Japan becomes an aging society in the 21st century. The financial system, upon which the economy is founded, must be rebuilt into a strong base for supporting the Japanese economy in the 21st century.

As innovations in data communication technology and financial technology have advanced and international competition between markets has intensified, the Japanese financial market has fallen behind the markets of Europe and the United States in terms of convenience. The vitalization of market functions is an urgent task in order to forestall the hollowing out of the Japanese financial market, or shifting of transactions abroad."

The statement also indicated the three key points behind the basic philosophy of Japanese "Big Bang" reform. First is "the realization

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The "Big Bang" conceived: Five advisory panels agreed on the liberalization scheme of a free and competitive global market." The statement read: "Japan must seek the optimal distribution of resources by boldly moving forward on the liberalization of business activities, products, prices and the structures of various organizations and creating an open market in which market principles are freely at work." If this goal can be achieved, the financial service industry in the 21st century will see a "relative drop in the scale of its traditional savings and loan business and it will provide more sophisticated and diverse services extending beyond the framework of traditional business areas, making free use of various financial technologies and data production functions." In other words, Japan's financial system must shift from a model centered on indirect financing (banking) to a model centered on direct financing (securities).

The second key point is "formation of fair and transparent rules." "The provision of fair and transparent rules and disclosures to support market functions is necessary, as is the provision of clear penalties for violations," the statement reports. To put it another way, the existing Japanese financial system is lacking in the areas of information disclosure and penalties, a factor behind the bad credit problems of financial institutions and the succession of scandals in the banking and securities industries. Japan must free itself of the vague and toothless rules—so typical of the country—that now govern the market, in order to realize a financial system that emphasizes market functions.

Shifting to a financial administration with high degree of transparency

The third key point is a "shift to a financial administration with a high degree of transparency based on rules."

"A clear prerequisite for having a market where market disciplines and fair and transparent rules function is for the financial administration to fulfill the role of augmenting market functions and for there to be a swift shift from the previous discretionary pre-adjustment system to a highly transparent administration based on rules."

This statement can be read as a criticism of the former "escort-fleet style financial administration" or "closed-door politics-style financial administration." Assuming that the five councils' press statement was ghost-written by an official of the Ministry of Finance, this can be read as self-criticism.

A university professor who participated on several of these advisory bodies has a different view of the importance of "Big Bang" reform. The point, he says, is system fatigue in the post-war Japanese financial order.

"Japan's financial system originated from the economic environment immediately after World War II," he says. "In short, the system reflects the special conditions of the national economy at a time when the industrial sector was suffering from a constant shortage of capital, and the banks—the lenders—were in the dominant position. However, in the 50 years since then (particularly in the last 20 years), the economic structure has undergone a sea change, into a money-rich economy dominated by borrowers. Despite such a change, the financial system has been maintained in its post-war framework. In other words, the Japanese- German central bank model (where the banks, which run indirect financing, check up on the corporations to which they lend money) has already ceased to function and it has become necessary to switch to the British-U.S. model (where the financial and capital markets check up on the corporations, which take in capital). In short, Japan has to move from a system based on the banks to a system based on the capital market."

Foreign banks and foreign securities brokerages preparing for liberalization

When the manufacturing sector, which has traditionally carried the Japanese economy, is being hollowed out under the impact of the strong yen and other circumstances, a system that can promote the creation of new industries is needed. Furthermore, now that the Japanese economy has entered the stage of British-style maturity, the financial service industry, as a new key industry, must be developed into a major employer. Of course, it is preferable if Japanese banks and securities brokerages become sources of employment, but under the worst scenario, Japan must be prepared to surrender the Tokyo market to foreign banks and brokerages, as happened in London in the wake of the London "Big Bang."

In advance of the Japan "Big Bang," foreign banks and securities brokerages are steadily setting up in Tokyo. Chemical Bank of the U.S. is strengthening its remittance and capital management services targeted at Japanese corporations. With its eyes on personal financial assets, the giant U.S. securities brokerage Merrill Lynch is moving into the investment trust business, while at the same time it is seeking an opportunity to purchase a Japanese securities brokerage. Credit Suisse established the first derivatives bank in Japan in April, and the U.S. investment bank J.P. Morgan is also moving aggressively into the derivatives field. A leading U.S. hedge fund, targeting Japanese institutional investors and the wealthy individuals, is said to be moving to establish a base in Tokyo.

The Industrial Capital Section of the Industrial Structure Council, an advisory panel to the Minister of International Trade and Industry, has analyzed the economic effect of the "Big Bang" reform. According to their predictions, if the "Big Bang" is implemented, the GDP of the financial industry will reach ¥36.5 trillion in 2005 (in 1995, ¥24 trillion). If the reforms are not implemented, on the other hand, the GDP will fall to ¥22.6 trillion. Furthermore, if the reforms go through, employment in the financial sector will top 2.31 million (2.09 million in 1995). Without the reforms, employment will fall, they predict, to 1.84 million.

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