

# Liberalization of Japan's Financial Markets and Banking Sector

*Interview with Ichiro Isoda, chairman of the Board of the Sumitomo Bank by Kenjiro Horikawa*

In the following interview, Ichiro Isoda, chairman of the Board of the Sumitomo Bank, gives his views on the liberalization of Japan's capital and money markets—an issue currently attracting hot debate both in Japan and overseas.

While he cautions that the interests of investors must be protected, Isoda sees such opening up as a natural and desirable development. He cites the liberalization of interest rates of large-denomination deposits and the activities of financial institutions as two obvious steps in such a process.

Isoda also touches on the future role of Japanese banks, and their strengths and weaknesses compared to American banks.

As Board chairman of the number one Japanese financial institution in terms of net profit as well as recipient of *Institutional Investor's* "Banker of the Year" award, Isoda lastly explains his banking strategy and management philosophy.

**Question:** *Lately, the United States and some other countries have begun to strongly request that Japan open up its capital and money markets. How do you view such requests?*

**ISODA:** The United States is pressing not only Japan but other countries too, such as Britain and South Korea, to liberalize and internationalize their financial markets. Citicorp has bought a stake in a British securities company and is attempting to enter the international stockbroking business. And, reportedly, the United States is asking South Korea to allow U.S. banks to expand their branch network in that country and to approve the establishment of U.S. life insurance companies there.

For the promotion of economic activities, government regulation and protection should be kept to the minimum. This is understood to some extent even in the Communist countries; in fact, controls are gradually being eased in China and the Soviet Union.

There is a growing trend on a worldwide scale toward deregulation, and I believe that the foreign and domestic demand for the liberalization



Ichiro Isoda,  
chairman of the Board  
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of Japan's financial markets is a quite natural development. During the 1960s, the demand came from abroad for the liberalization of trade and during the 1970s for the liberalization of capital flows, and now it seems the demand has finally come regarding the capital and money sector.

**Q:** *I agree with you that the liberalization of financing and banking is the current of the times. In Japan's case, however, the liberalization of the financial markets would have substantial effects on the management of financial institutions. So, the issue here is the pace of liberalization, isn't it?*

**ISODA:** Regarding the liberalization of Japan's financial markets, there are a group urging caution and another urging positive action, and the former seems to be in the majority. Those representing the first view point out that, even in the United States, liberalization took a decade, so it is unreasonable to push it so suddenly in Japan. Take CDs (certificates of deposit); in the United States, the interest rate on the large-denomination CDs was liberalized in 1970, but in Japan, it was not until 1979 that the buying and selling of CDs was finally approved. Because we are so far behind the U.S., it is pointed out that liberalization in one sweep, either this year or the next, is unreasonable.

I feel, however, that liberalization is "a river of no return." Moreover, we have already crossed it, so we should go forward as rapidly as possible.

I, personally, have grave doubts about protectionism itself. For example, we liberalized the import of grapefruit in 1971. As a result, Japanese farmers, through tremendous efforts, developed very delicious, inexpensive oranges, and the consumers began to buy these fruits in greater quantities. I believe that increased productivity in agriculture results principally from technological innovation such as improvement of plants and, in this sense, farming is basically "an advanced-country-type" industry. There still remain various obstacles to the liberalization of farm products in Japan, and Japan's agricultural sector is now relatively unproductive and uncompetitive against foreign products. Honestly speaking, I do not think that the Japanese financial industry should follow suit.

**Q:** *Wouldn't the management of medium and small financial institutions become unstable with the shock of liberalization? And, wouldn't depositors need protection?*

**ISODA:** I am an advocate of positive liberalization. However, I believe that the following basic principles must be upheld: first the conditions of liberalization must be in accord with international common sense; second, the minimum necessary regulation must be retained to insure the soundness of the financial system and protect the interests of depositors and investors.

It is likely that Japan's financial institutions will receive a great shock from liberalization. To absorb this shock, a scenario must be prepared for the consolidation of these institutions. However, if you were to ask whether the smaller financial institutions are necessarily the weaker, the reply would be no. Some are very efficient. This holds true in the U.S. as well. It is true that the stalemate in the management of some of the



Headquarters of the Sumitomo Bank in Tokyo

smaller U.S. banks has become an issue, but this does not stem from liberalization or a rise in interest rates. Management error is the principal cause.

In the U.S., deregulation is rapidly gaining force in three basic industries, namely finance, telecommunications and transportation. Bankruptcies have increased in these fields, but so have the number of new enterprises. As a result, various fees have been lowered with great benefits to the consumer. Finance, communications and transportation could be described as the infrastructure of the economy, and deregulation in these fields has stabilized consumer prices and has revitalized the entire economy. Japan should follow suit.

**Q:** *What should the first step be in the liberalization of our financial markets?*

**ISODA:** Two possible spheres are interest rates and widening the scope of permissible activities. With regard to interest rates, it is clear from the examples of the United States and West Germany that it makes sense to extend the liberalization from large- to small-denomination deposits.

As for the interest rate on small-denomination deposits, I think it would be impossible to liberalize it in the near future because of the existence of the postal savings system in Japan, which does not require profit management on a commercial base, and the difficulty of revamping this system.

Therefore, we should begin with liberalization of the interest rate on large-denomination deposits. The U.S. banks would in fact find it extremely difficult to collect small-denomination deposits in Japan; hence, the liberalization of the interest rate on large-denomination deposits alone should be sufficiently beneficial.

**Q:** *Speaking of large-denomination deposits, how about lowering the minimum denomination of CDs, which is now ¥300 million (\$1.25 million), and thus increasing the range of financial instruments without interest rate ceilings?*

**ISODA:** Yes. At the outset, minimum denomination CDs should be lowered, the constraint on their maturities removed, the ceiling on CD issues enlarged, and so forth.

**Q:** *How should activities be liberalized?*

**ISODA:** Since World War II, three fields of financial business have been separated from com-

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P R O F I L E

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mercial banking in Japan: securities business, trust business, and long-term credit banking.

In the U.S. and in Western Europe, such regulation does not exist, or has been almost entirely abolished. In international finance, Japanese banks and securities companies often encroach into each other's fields. There is no doubt that their domestic activities should be liberalized as well.

**Q:** *What has been described as "the first round of the U.S. financial and banking revolution" ended last year with complete liberalization of interest rates on deposits. Now the second round has begun whereby the barriers are being removed between the various types of financial institutions; they are becoming homogeneous as they begin to operate in fields that hitherto had been outside their sphere. When one realizes that Japanese financial institutions will also be treading the same path, the question arises: What will happen to the banks' indirect financing role that has supported the country's postwar economic growth? Will it lead to the disappearance of the "main bank" system of Japanese business enterprises?*

**ISODA:** The issue could be settled if, no matter how earnestly the banks try to explain that "having a 'main bank' is helpful," the enterprises would say, "We do not need a 'main bank.'" It is not something that the banks could demand. It is a matter of the businessman's managerial philosophy.

However, when removing barriers to the activities of financial institutions, care must be taken to retain the good aspects of the Japanese system, that is, protection for the depositors and the investors. It must be remembered that when Ataka & Co. and Toyo Kogyo Co. faced managerial difficulties, turmoil was avoided because the Sumitomo Bank acted as the "main bank." If the two companies had been financed entirely through the capital markets, they both might have gone bankrupt immediately.

When considering the removal of barriers between the spheres of operation, liberalization of the stock and securities field also should not be forgotten. For instance, an agreement currently exists whereby both domestic and foreign securities companies could obtain membership in the Tokyo Stock Exchange. However, in practice, the membership quota is full and not a single foreign securities company has gained entry. Also, the fact that the price of the membership is extremely high is another barrier to foreign membership.

**Q:** *There are two lines of thought regarding the opening up of Japan's financial markets. One is the reciprocity advocated by countries such as the U.S. and the other is the national treatment formula, that is, to treat foreign financial institutions just like domestic ones. Which do you favor?*

**ISODA:** Liberalization should perhaps be advanced on the basis of reciprocity, in line with international common sense, but it cannot be denied that Japan has its own unique environment and tradition. Hence, everything approved in the U.S. cannot automatically be permitted in Japan. On the other hand, national treatment does not mean a passive attitude toward liber-

alization, because if the regulations binding Japanese financial institutions are gradually removed, the nature of national treatment would change.

**Q:** *How do you view the future of Japanese banks?*

**ISODA:** I am rather optimistic. While U.S. banks are superior in terms of overall size, such as net worth, Japanese banks are not inferior in terms of managerial efficiency. For example, Japanese banks operate with far smaller staff. Hereafter, electronics will probably be the key to management success in the financial field as well; this involves the application of technology, a field in which the Japanese excel.

But we cannot expand as long as we confine ourselves to the traditional fields of deposit taking and lending. I believe that we must develop a broad range of services, including information services capable of responding swiftly to the various needs of customers, both foreign and domestic.

**Q:** *How do you view the future of the Japanese economy?*

**ISODA:** During the past year or so, U.S. growth has been higher than that of Japan, but the U.S. growth is measured against the low level recorded following the second oil crisis. When it comes to latent growth potential over the mid-term, I think Japan is superior. And, regarding the strength of individual enterprises, Japan might rank considerably below the U.S. in some aspects, but it could strengthen its enterprises hereafter through reductions in corporate and investment taxes.

**Q:** *The Sumitomo Bank has consistently come out top among Japanese financial institutions in terms of net profit. With this in mind, what do you consider to be most important in managing a bank?*

**ISODA:** One can establish a company or set up an organization, but it is the staff that must operate them. Consequently, the most important factor is cultivating capable personnel. For centuries, the precept of the Sumitomo family has been: "The people make the enterprise." I have come to believe in the philosophy quite thoroughly.

In management, I place great stress on profitability. When CDs were introduced in Japan five years ago, I anticipated that all corporate deposits would be CDs, and I believed that when the interest rate ceiling is liberalized, management would be able to survive only by raising business efficiency. My belief is turning out to be true.

**Q:** *In the summer of 1982 you were selected the "Banker of the Year" by "Institutional Investor" magazine and in January 1983 as "Asia's Banker of the Year" by "Asian Finance." How do you personally evaluate your work performance?*

**ISODA:** Before I became president, we were faced with the problem of Ataka & Co.'s failure. Since the Sumitomo Bank suffered a precipitous drop in earnings at that time, its recovery must have attracted attention. It is difficult to attain spectacular results. Our decline was so big that our recovery must have appeared big. If anything, my drastic action in revamping the internal organization of the bank proved successful.