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JAPANESE FINANCIAL LIBERALIZATION
— To Where Its Going —

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> "From the standpoint of the national economy, financial liberalization is constructive in that it will create a more efficient Japanese financial system, as well as ensuring the smooth allocation of financial resources.... Rapidly liberalizing the Japanese financial market, however, would confuse the credit order that is fundamental to the nation's stability. Furthermore, financial institutions would not be able to fulfill their social responsibilities." (1)

The changing economic environment of the 1970s following the First Oil Crisis and the breakdown of the Bretton Woods Accord significantly impacted on the financial systems of the major industrialized nations. In the United States, the monetary authorities' inability to cope with inflationary pressures and the disintermediation effects of Regulation Q, put pressure on the U.S. government to deregulate capital and money markets. Meanwhile, as the Japanese public authorities were forced to seek alternative ways to finance ever-increasing fiscal deficits the forces of financial liberalization were put into motion. In an earlier paper,(2) while investigating in detail the economic conditions that fostered liberalization of Japanese financial markets, it was noted that the pace of liberalization in Japan has not paralleled that of its economic counterparts despite Japan's emergence as the world's largest creditor nation. The objective of this study is two-fold: first, the paper will examine some of the more important changes that have occurred in financial markets; and second, it will investigate the factors that have hindered the further development of Japan's financial system. By doing so, it will shed light on the future course of the liberalization process.

I. Developments in the Money Market

The first step in the liberalization of Japan's financial markets took place in 1976 with the official recognition by the Ministry of Finance of the *gensaki* market for government bonds.[3] The next step occurred in 1977 when official authorization was granted to banks to sell government bonds in the secondary market. This hastened the expansion of the secondary market and as a result, shifted funds away from those markets historically characterized by interest rate and portfolio constraints. This shift in funds provided the impetus for the monetary authorities to move towards deregulating deposit rates, and in May of 1979, floating-rate certificates of deposits (CD) were introduced. Although restrictions on issue included such things as a minimum denomination of ¥500 million, maturity periods of up to six months and a ceiling of 10% of a bank's net worth, nevertheless, this freeing of deposit rates signaled the end of the strictly controlled interest rate policies of the postwar era.

Financial liberalization of the money market proceeded at a gradual, but cautious pace for the next five years with developments that included the further lifting of interest rate controls on large denomination deposits and increased access to the call and bill-discount market by previously restricted financial institutions.

One of the most significant changes that has taken place during the past decade has been the implementation of many of the measures recommended in the *Joint US-Japan Ad Hoc Group on the Yen/Dollar Exchange Rate, Finance and Capital Market Issues.* Primarily instituted to create an international role for the yen, thus pushing up its value to cope with Japan's growing trade surplus, the accord served to foster continued deregulation in the money markets.

In early 1985 interest rate controls on all large-denomination deposits were lifted by the Ministry of Finance. This was followed by both a reduction in the minimum deposit requirement and a decrease in the length of maturity on time deposits (TD) and certificates of deposits. In addition, a market for money market certificates (MMC) was newly

opened. When originally proposed the minimum deposit requirement was set at ¥50 million, but the current minimum was subsequently reduced to ¥10 million. Each deposit pays a variable rate of interest 0.75% below the current rate on CDs, and with a short-term maturity of one to six months, the MMC is, in effect, a small denomination certificate of deposit.

Further liberalization in the money market has included the relaxation of restrictions on yen-denominated banker's acceptance (BA) and commercial paper (CP) markets. Both banks and securities companies were given permission, commencing in June 1985, to formally participate in the BA market. And in December 1987 both banks and security houses were allowed to begin underwriting yen-denominated commercial paper (CP). The greatest significance of this development is that it pushes the limits on Article 65 of the Security and Exchange Law which separates the activities of banks and securities companies. Should this law be officially appealed it is expected to have a major impact on the financial markets.[4]

Along with the changes in short-term money market instruments, the Tokyo Offshore Market was opened in December 1986 to authorized foreign exchange banks. This was established to create a market in which non-Japanese investors could participate unimpeded by the restrictions imposed in the domestic market. The market, however, has not yet attained the stature of other offshore markets.[5] The Ministry of Finance, for example, has placed limitations on the movement of funds from offshore to domestic accounts to prevent a loss of control over the money supply. This, along with the imposition of corporate and local taxes on these offshore transactions has been responsible for dampening the enthusiasm of overseas investors. Most of the transactions in this market have been limited to those between Japanese banks and until these obstacles are eliminated, it is believed the participation of foreign institutions will remain minimal.[6]

The above market-opening measures notwithstanding, the money markets continue to be plagued by institutional rigidities. The yen-denominated banker's acceptance market has remained small because

of procedural complexity and the imposition of stamp duties.[7] The minimum denomination requirement on CDs, TDs, and MMCs remains beyond the reach of most small investors and progress in the deregulation of interest rates has been mixed at best. The official discount rate, prime lending rates, and government-bond issue prices (which determine the yield on these assets) continue to be fixed by the Bank of Japan or the Ministry of Finance. The interest rate on some 75% of the total sum placed in banks' time deposits is still controlled.[8]

Small-denomination Deposits

One area in which liberalization has been particularly minimal is that of small-denomination deposits. Interest rate ceilings continue to remain in effect for these deposits and future deregulation remains uncertain. The principal factor contributing to the maintenance of interest rate ceilings on small-denomination deposits is the complex regulatory aspects of the Japanese financial system.

The speed and degree of regulation is influenced by the differing goals of the various regulators; namely the Bank of Japan, the Ministry of Finance and the Ministry of Posts and Telecommunications. Each regulatory body appears to seek to protect the well-being of its constituent body resulting in a conflict among regulators.[9]

The Bank of Japan, concerned that internalization of the yen may weaken its ability to control the money supply, is hesitant to rapidly liberalize the international market. The Ministry of Finance, however, favors a more rapid liberalization, perhaps, as Cargill[10] notes, because the Ministry of Finance is more susceptible to U.S. pressure. Internal conflict exists within the Ministry of Finance as a result of the competition between the banking and Postal Savings System (PSS). While the Ministry of Finance is responsible for much of the regulation of the banking sector it is also dependent on the Postal Savings System and its large control of assets,[11] as the major source of funds for the Ministry of Finance's Trust Fund Bureau. These funds are distributed to institutions such as public corporations, local public bodies, special corporations, and a number of government financial institutions (Export-Import Bank,

Japan Development Bank, People's Finance Corporation, etc.), all of which have played an important role in the economic development of Japan.[12] Thus, the Ministry of Finance is reluctant to reduce the role of the PSS, even though at the same time it is under increasing pressure from the banking sector to do so.

The Postal Savings System, with over 22,000 branches nationwide, has been able to become extremely competitive with the banking system and has even been allowed to pay higher interest rates than the banking establishment to attract customers. Even though abolishment of the *maruyu* system in April 1988 has lowered the rate of increase in deposits, the Postal Savings System continues to enjoy widespread political and public support. The one negative effect of the abolishment of tax-free status on these accounts is that it has forced the postal savings authorities, the Ministry of Posts and Telecommunications, to resist a revision of the regulations governing fixed-amount postal deposits. However, the revision of this fixed-amount system is an absolute prerequisite to liberalization of interest rates on small deposits.[13] Ohnishi[14] notes that the ostensible reason the Ministry of Finance has given foreign bank managers for not deregulating postal rates is that some Japanese live on remote islands without access to banks and need post offices as a source of savings. But the real reason lies behind the fact that a portion of postal savings deposits are used to fund the government's debt and if interest rates were based on market rates, it would raise the cost of servicing the government's debt.

Despite the hindrances to liberalization listed above, Wright and Pauli[15] believe that a major source of pressure from within Japan for further deregulation is the Japanese consumer of financial services, who, "increasingly frustrated by low rates of return, lack of flexibility, and the very limited variety of financial instruments available, will demand a first-rate financial system to match a first-class economy."

II. Breakdown of Market Segmentation

The highly-segregated financial system that has been cited as an

important contributor to the stability of the financial system during the high growth period has also come under increasing pressure for change from both external and internal forces. The slowdown in the growth rate of the economy and increased access to the international capital markets by the corporate sector has reduced overall loan demand in the domestic market. This has spurred increased competition with the banking sector itself as the various financial institutions, particularly city banks, begin to encroach on each other's domain.

The group which has suffered the most as a result of this aggressive expansion of city banks has been the small and medium-size financial institutions. Traditionally, these firms have lent to small and medium-size firms, but now city banks account for over one-half of funding needs. Hinterhauser[(16)] speculates that for smaller institutions the worst is yet to come. He attributes this to the future deregulation of retail deposits which would severely impact on their recurring profits; and concludes that over the next five to ten years many of these institutions will be taken over by larger banks.

The commercial banking establishment (primarily city banks) has also begun to expand into the market for long-term funds. Under current law long term credit banks can issue fixed-interest five-year debentures as necessary, but city banks are limited to accepting deposits for a maximum of only three years. In reality, however, over thirty percent of city banks' loans have a maturity of more than three years.[(17)]

The city banking establishment, spurred by its recent increased involvement in long-term lending and by its desire to tap Japan's lucrative pension market, has been actively campaigning within the Finance Ministry for the liberalization of long-term fund procurement. They argue that this "mismatching" of lending and borrowing hurts the bank's profitability. Long-term credit and trust banks are adamantly opposed to any change, claming that the commercial banking sector does not have the expertise to deal in long-term financing and that any intrusion on their "territory" would harm the health of the industry.[(18)]

In response to the pressure to open up the long-term markets to city banks, the Finance Ministry's Financial Systems Research Council

released a report in December 1987 which specifically addressed the questions of 1) allowing all banks to engage in the management of Japan's pension funds, an area that is now restricted to the nine trust banks, 2) permitting city banks to participate in long-term lending, an area officially granted to long-term banks, and 3) allowing banks to engage in securities dealing and underwriting.[19]

Legislation concerning the above issues has not yet been formally enacted, and it is expected to generate a great deal of debate before anything becomes official. In particular, the third proposal above would be strongly opposed by securities firms as they are now restricted from engaging in banking activities under Article 65.

III. The Status of Foreign Firms

The one market in which liberalization has progressed at a fairly rapid pace is that of international capital transactions. In December 1980 the Foreign Exchange and Foreign Trade Control Law (FEFTCL) was completely revised in what Colin Jones termed "an all embracing and epochal reversal of policy.... Whereas previously these transactions were subject to control unless specifically deregulated, thenceforth all were deregulated unless specifically controlled."[20] The factors contributing to this internationalization of finance can be found in both the move from a fixed-exchange rate system to the floating rate system and the changing pattern of the flow of funds. First, the floating rate system encouraged the development of a sophisticated foreign exchange market dealing in spot and forward exchange transactions. This stemmed from the necessity for the business sector to hedge foreign exchange risks. As the Japanese economy joined the fellow ranks of the world's industrialized economies the demand for yen as a reserve currency grew.

Second, the end of the high growth period reduced the demand for funds by the domestic corporate sector and forced domestic financial institutions to seek alternative sources of lending. One such alternative was an expansion of yen-denominated loans abroad. This led to Japanese financial institutions expanding operations overseas and at the same

time foreign banks in Japan saw their range of activities expand and diversify.

For foreign firms, improved access to capital markets has been made on two fronts; 1) through the granting of permission for foreign banking institutions to have securities affiliates, and 2) an increase in foreign securities firms share allotment of new issues of government debt.

The first development is particularly significant in that it provides foreign banking institutions with greater access to the securities market than that afforded the Japanese banking establishment. For example, in 1985 foreign banks were granted permission to own up to fifty percent of a securities affiliate in Japan; effectively allowing foreign banking institutions to deal in both banking and securities activities. Japanese banking institutions, meanwhile, are limited to just five percent ownership and are also subject to Article 65 of the Securities and Exchange Law.

The legislation regarding increased access to the government security market is important in that it loosens the grip on this market by the syndicate of Japanese banks and securities companies. Prior to the official recognition of a secondary market for government debt in 1978, the terms of all Japanese government debt was negotiated by the government and the syndicate and, in turn, each member received a predetermined share.[21]

The method of issuing debt posed a problem for foreign firms desiring to enter this market as they were generally not part of this syndicate. This placed foreign firms at a competitive disadvantage not just in the government market itself but in other markets as well because of the important linkages between government securities and other securities.

The Ministry of Finance's decision in 1986 to issue a proportion of short and medium term bonds by auction provided the initial opportunity for foreign firms to enter the government bond market. Subsequent market-opening measures, such as increasing the share of new issues available to foreign firms and expanding the auction system to include the all-important 10-year bond, have also been forthcoming. For a long time, however, the share of Japanese government debt underwritten by

foreign firms remained slight. This is in sharp contrast to the fact that Japanese have bid for as much as half of some new U.S. Treasury issues, and that three of the 40 primary dealers in U.S. government securities are Japanese corporations.[22]

Finally, in September 1988, the Ministry of Finance took a bold step towards competition in the government bond market when it announced a four-fold increase in the proportion of government bonds that can be bid on by foreign firms. This will enable foreign firms to become major players in the underwriting syndicate and moves the government bond market towards an auction system. The market, as opposed to government forces, will then be allowed to determine the price of the bonds.

An interesting aspect of the opening up of the domestic market to cross-border capital flows was its effect on the foreign banking establishment. Prior to the new FEFTCL, domestic corporations desiring to obtain a foreign currency loan (called impact loans) were forced to turn to the foreign banking sector as the domestic financial sector was forbidden to provide these types of loans. At that time, some of the major United States' and European banks derived 40% of their income from impact loans. With the lifting of restrictions under the revised foreign exchange law, the profit and lending abilities of the foreign banking sector was dealt a severe blow from the increased competition from the domestic sector. Liberalization meant the loss of the old lucrative monopolies—impact loans—once enjoyed by the foreign banking establishment. Heighted competition and low demand for loans have made traditional banking in Japan a low profit endeavor. At the end of 1982, for example, foreign banks held 4.2% of the loan market in Japan. As of August, 1987, however, the share had shrunk to 2.2%.[23]

IV. Factors Hindering the Liberalization Process

> "Beware the Japanese bearing gifts! The liberalization of Japan's financial markets is often wrapped in the guise of concession's to foreigners, but it is shrewdly crafted to derive maximum benefits for the Japanese themselves."[24]

The internationalization of finance was just one of many important elements that ignited financial liberalization in the domestic economy.[25] And there is no doubt that without this external pressure, the pace of liberalization would have been even slower. But the primary moving forces came about from the changing economic environment within Japan, and the Japanese policymakers adjusted, in their own time, the character of the regulations to suit the prevailing needs of Japan.[26]

The continued liberalization of Japan's financial markets is generally accepted as a foregone conclusion as laws and regulations restricting the free flow of capital are becoming things of the past. However, problems regarding access to the market will remain for non-Japanese financial institutions as a result of the peculiarities in the Japanese system.

These so-called invisible barriers are made known in a number of ways ranging from language and customs to relationships within the system. Federal Reserve Bank of New York Chairman Gerald Corrigan notes that "some observers would contend that so-called invisible barriers in Japan are more of a problem than in the case of other financial institutions."[27] Nevertheless, they are an integral part of the Japanese financial system.

Main-Bank Relationship

One such peculiarity of the Japanese banking system is the phenomenon of the "main-bank relationship." This is a remnant of the highly regulated growth period where tight controls reduced the opportunities for the corporate sector to utilize the services of a number of various financial institutions. As a result, borrowing and lending decisions were based on long-term relationships instead of price competition among the financial institutions.

Some economic writers, and in particular Crum and Meerschwam,[28] have argued that, while financial liberalization progresses, the long-term relationships would be expected to breakdown as "these once profitable relationships shift to a more flexible market orientation." These market forces will then serve as the motivating factor in forcing Japanese regulators to further liberalize the financial markets in line with those of New York and London.

A study by Akiyoshi Horiuchi and Frank Packer,[29] however, shows that the data do not support this conclusion. The main bank relationship system remains strong and secure despite advances in liberalization. Defining a main bank as being the largest single lender to a company for the past three years, the authors found that nearly 100% of the companies listed on the first section of the Tokyo stock exchange had a main bank. And of those companies listed on the first section of the stock exchange between 1962 and 1967, 84 of 481 changed their main bank, or approximately 17 percent. Between 1967-1972, 15 percent; and between 1978-1983, 11 percent changed their main bank affiliation. Thus, the role of the main bank has not significantly diminished over time and remains as a stabilizing force in the financial system.

Lisa Martineau[30] states "all things being equal, the average Japanese company will bank with a Japanese bank." She attributes this to the conventional wisdom that the lending policies of the Japanese banks were responsible for the Japanese economic "miracle" of the postwar period. And for this reason, big corporations have remained loyal to their Japanese bankers, thus impeding the ability of foreign bankers to enter the market.

Languages and Customs

The differences in language and customs, long deemed responsible for the unique aspects in the Japanese system, also play a role in hindering the development of the financial markets. But there continues to be conflict concerning the extent of and the solution to the problem itself. Richard Holloway[31] attributes certain weaknesses of Japan's financial institutions to the fact that they are not internationally-minded enough. Japanese financial institutions are accused of not utilizing the talent of foreign experts and do not place foreigners in positions of responsibility. In a similar vein Japanese firms are criticized for not making extensive use of the English language even though English is the multinational medium of business people. Holloway contends that Japanese firms continue to remain inward-looking, a term which appears to be synonymous with being "too-Japanese."

On the other hand, a list of recommendations for American and other foreign financial institutions advises foreign banks and securities companies to make greater efforts at acquiring proficiency in the Japanese language, and to obtain an in-depth understanding of the Japanese financial system. Historically, however, foreign executives, particularly American, have discounted the value of learning Japanese, and this in the long run has proved to be to their detriment.

According to Ohnishi,[32] one strong reason for foreign executives to obtain fluency in the Japanese language is that almost all of the Ministry of Finance's reports and announcements are in Japanese. The necessity to have the Japanese translated into English slows the flow of information. And, "the various nuances of the Japanese language are also sometimes difficult to translate into English, creating further possibilities of misunderstanding."

V. Concluding Remarks

The extent to which the Japanese financial markets will liberalize in the future cannot be predicted with certainty. There remains a myriad of conflicts within the domestic market, and each sector will seek to protect its own interests. Regulation has long been a part of the Japanese financial markets and the deregulation process will require concessions from all parties involved. Nevertheless, if the financial markets of Japan are to take their place alongside those of London and New York, an increasing number of market-opening measures must continue to be forthcoming. Fortunately the forces of change are becoming stronger every day.

Notes

(1) Japanese Ministry of Finance, *Outlook and Guidelines for Financial Liberalization,* Tokyo, Japan, April 1984.
(2) McCornac, Dennis C., "Japanese Financial Liberalization – From Whence It Came," *Journal of Social Science (ICU),* Vol. 27 (1) October 1988.
(3) See Takagi, Shinji, "Financial Liberalization and the 'Bills-Only' Doctrine: A Causality Test of Daily Japanese Data, 1978-85," *The Economic Studies Quarterly,* Vol. 39, No. 2 June 1988, pp. 149-159.
(4) See Murphy, T., "Financial Liberalization Moving Forward," *Tokyo Business Today,* December 1987, pp. 30-35.
(5) A survey of bankers has indicated that the advantages are too slim for them to invest more than token amounts, and the market is too restrictive to take business away from London, New York, Singapore, or Hong Kong. See Jones, Colin, "Dismantling Barriers," *The Banker,* June 1987, pp. 44-49.
(6) Ohta, Takashi, "Japan's Financial Liberalization," *Banking World,* January 1987, pp. 30-31; and Murphy, T., *op. cit.,* p. 31.
(7) Jones, C., *op. cit.,* p. 46.
(8) Holloway, Nigal, "Markets Suffer From Tightly Bound Feet," *Far Eastern Economic Review,* December 17, 1987, p. 62.
(9) For an excellent discussion of the conflict and consensus in policy-making regarding Japan's financial markets see Horne, James, *Japan's Financial Markets,* George Allen and Unwin, 1987.
(10) Cargill, Thomas, "A U.S. Perspective on Japanese Financial Liberalization," *BOJ Monetary and Economic Studies,* Vol. 3 No. 1 May 1985, p. 147.
(11) The Postal Savings System accounts for approximately 20% of all savings in Japan.
(12) Cargill, T., *op. cit.,* p. 147.
(13) See "Postal Savings Accounts Face Attack from Both Depositors and Bankers," *The Japan Times,* August 10, 1988, p. 6.
(14) Ohnishi, Natalie J., *Report of the Japan Market Access Post-Action Program: The Liberalization of the Japanese Financial and Capital Markets,* The American Chamber of Commerce in Japan, August 1987, p. 10.
(15) Wright, Richard W. and Gunter A. Pauli, *The Second Wave – Japan's Global Assault on Financial Services,* Waterlow Publishers, 1987, p. 82.
(16) Hinterhauser, Gerhard, "Down Tumble the Barriers," *The Banker,* January 1987, pp. 65-67.

(17) Hinterhauser, G., *op. cit.*, p. 65.

(18) See Kimatsu, Katsuro and Nobuo Takahashi, "Finance Ministry to Tackle Outdated Bank Restrictions," *The Japan Economic Journal*, Vol. 25, No. 1288, November 27, 1987, pp. 1, 3.

(19) See "Japan to Review Finance System to Cut Barriers," *The Asian Wall Street Journal*, December 7, 1987, pp. 1, 11.

(20) Jones, C., *op. cit.*, p. 45.

(21) See Feldman, Robert Alan, *Japanese Financial Markets: Deficits, Dilemmas and Deregulation*, MIT Press, 1986, chapter 3.

(22) Corrigan, E. Gerald, "A Perspective on the Globalization of Financial Markets and Institutions," *FRBNY Quarterly Review*, Spring 1987, pp. 1-9.

(23) Hanson, Richard, "The Outsiders Find Profits are Elusive," *Far Eastern Economic Review*, December 17, 1987, p. 71.

(24) Wright, R. W. and G. A. Pauli, *op. cit.*, p. 77.

(25) Suzuki, Yoshio, *The Japanese Financial System*, Clarendon Press, 1987, p. 30.

(26) Horne, J., *op. cit.*, p. 171.

(27) Corrigan, *op. cit.*, p. 6.

(28) Crum, M. Colyer and David M. Meerschwam, "From Relationship to Price Banking; The Loss of Regulatory Control," in McCraw, Thomas, *America versus Japan*, Harvard Business School Press, 1986, pp. 261-269.

(29) This study is summarized in Packer, Frank, "Understanding the Financial System," *Guest Forum – The Japan Times*, August 9, 1987, p. 16.

(30) Martineau, Lisa, "A Long Wait for Foreign Banks," *The Banker*, January 1987, p. 77.

(31) Holloway, Richard, "Awaiting the Second Tsunami," *Far Eastern Economic Review*, December 17, 1987, pp. 59-61.

(32) Ohnishi, N., *op. cit.*, p. 49.

日本の金融自由化

――その前途――

〈要　約〉

デニス C. マコーナック

第一次石油危機とブレトン・ウッズ協定の崩壊は，1970年代の経済環境を大幅に変化させ，主要工業諸国の金融制度に大きな衝撃をあたえた。日本の場合，増大する財政赤字を埋合せるための方策を探求する必要性を課せられた当局は，金融自由化の実施をせまられることとなったのである。しかしながら，日本の金融自由化の速度は，日本が世界第一位の債権国になったにもかかわらず，その経済上の取引相手国の速度に比して遅いものであった。本研究は，金融市場に発生したより重要な変化を考察し，また日本の金融制度のいっそうの発展を阻害している要因を考察することによって，この現象を解明しようとするものである。

筆者が結論として考えているものは，日本の金融の自由化が，国内市場における無数の障害と各部門の自らの利益を守ろうとする動きによってさまたげられているというものである。規制は長く日本金融市場の特性となっており，規制の緩和がより速やかな速度で行われるためには，各方面の合意を将来においてとりつけることが必要なのである。