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Consultation, Competition, and Control

The Realities of Financial Liberalization in Japan

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Delivered before the Japan Society, New York, July 9, 1985.

IF voluntarism in Western societies worked, Moses would have descended from Mount Sinai with 10 guidelines instead of 10 commandments. As you know, that ethic—commandments—is not native to Japan. The fact is, guidelines work in Japan, and like commandments, they are subject to revision, particularly by competing adults. Japan is now revising its guidelines about who can perform what kind of services at what cost and through which type of instruments for the various participants in the financial marketplace. It calls that process liberalization, an ambivalent term in the best of circumstances. Liberalization fundamentally is a Western concept. It presupposes several things: liberals on one side, conservatives on the other; a reduction in government intervention; and, of course, in economic terms, an increase of welfare benefits from letting market forces run free.

In fact, over time, liberalization has come to be used in quite a paradoxical way. It became synonymous with, simply, the welfare of citizens. In Western societies, liberals in politics came to be understood as those who sought government intervention and programs in order to prevent the abuses of either extreme of market competition or market allocation.

But Western concepts are not easily transferrable to Japan. For in Japan, as we know, it is consensus rather than "loyal opposition" that is relied on for societal progress. And change must never come in a disjunctive way. In Japan, the relationship of government to society is not so much the working out of specific areas of permissible intervention, carefully circumscribed by law, as it is an unwritten code of consultation, competition, and control between government and those who have power—who are, in turn, trusted by the body politic.

The question of liberalization of the financial markets arises in that context. The players are important, are well capitalized, have entrenched interests, and derive influence and power not just by dint of official mandate. The major institutions are mature, are not immune from competition from outsiders, and play a fundamental role as intermediaries of savings, both in yen and other currencies.

The participants in the financial marketplace have derived their influence—their status—from an unstable financial world. Over the last decade, financial institutions in Japan and elsewhere learned to cope with the following:

—Volatile exchange rates.
—Volatile interest rates.
—Uncertain access to funds.
—Changes in world volume and patterns of savings.
—Increased government borrowings.
—Restrictions on flows of capital.
—Capital flight.
—Increasing competition among intermediaries for funds.
—Shifts in the current account balance due to significant oil price changes.
—A debt crisis in the less developed countries.
—Increased communications.

In the context of so much uncertainty and competition, governments ceded control. We became comfortable with floating exchange rates, the growth of the Eurodollar market, the defensive shift from long-term fixed-rate funds into money market instruments, and deficit financing. And, of course, we made easier and more efficient the export of capital as a counterpart to large trade surpluses. We call that whole process liberalization. We turn necessity into a virtue.

The process, not incidentally, has a major impact on the allocation of profits among financial intermediaries. Thus, for this reason alone, there is a great deal of material generated in the financial press. Liberalization fosters the ultimate in financial voyeurism as readers and tombstone watchers

are interested in the profits and conflicts between and among the financial players.

In Japan, the subject of liberalization deals with the extent and scope of short-term money market instruments that are permissible in a society; whether rates should be set by government or the market; whether nonresidents can borrow yen and, if so, from whom; what the competitive relationships between banks, securities firms, and long-term credit institutions should be; where and under what circumstances foreign institutions can compete and whether their activities should be subject to the same or different proscriptions as Japanese counterparts; whether the liabilities of commercial banks should be subject to market volatility; to what extent pension funds should be managed in a competitive, market-measured environment; what should be disclosed about the strength of financial institutions; what the accounting and disclosure implications of a more open and competitive financial environment are; how competing financial institutions should be permitted to fund themselves and from what sources and at what costs; to whom they should be permitted to lend; how corporations and the government should finance themselves and with what kinds of instruments.

"Liberalization fundamentally is a Western concept."

These are the subject matters of liberalization. The subject is not the opening of the Euroyen market or the internationalization of the yen. These are the vehicles or labels, which do little to identify the complexity of these subjects. It is not possible here to set out even the barest outline of the controversies surrounding these matters and hardly less difficult to describe the implications for macroeconomic policy, exchange rates, and the profitability of participants. One thing is clear, however: Individuals and institutions will pursue what is in their best interest. The matter will test consensus decision making in Japan as not before. For this is not a game with only winners—profits may shrink, and even a growing pie may not have enough slices to satisfy all the guests at the table. There will be winners and losers.

There is also a political dimension to the so-called liberalization process. Faced with a burgeoning budget deficit that was to be financed abroad and an explosion of the U.S. trade deficit, there was a political need in the United States to appear to do something. Much to the U.S. government's credit, and often with courage, an effort was and is being made to resist protectionist pressures and, specifically, restrictions on Japanese imports. Instead, the U.S. administration portrayed itself as being in intense negotiations to get the Japanese to liberalize their capital markets as the quid pro quo of their benefits from a liberal U.S. trade policy.

Let me not be misunderstood. The negotiations were in good faith, tough, and intense on both sides. And in the end, the Japanese agreed to certain measures, possibly sooner and certainly with more fanfare than would usually be the case in that consensual, careful, evolutionary political system. But at another level, it served the political interests of both sides to make the discussions seem to be more pivotal and adversarial than careful scrutiny might belie. And it served the interests of Japan, with a trade surplus, against the United States, with a budget deficit, to have some area to thrash out negotiated agreements, which would both provide for a diversion from protectionism in real goods and facilitate, over the long term, the orderly investment of dollars earned from exports to finance those who wanted to, or had to, borrow dollars. But the link, which by definition had to occur, was cloaked with arcane discussions about exchange rates, freeing up markets, and the like.

And the subject, irrespective of the political overtones, opened up a host of contentious issues on the matters I have just alluded to.

The fact is, however, that Japan has been pretty open for some time. For years, Japan has had a trade surplus and slowly but surely facilitated capital outflows. Over the last decade, Japan has had as open a financial market as virtually any other country in the world. What are the various tests of the openness of a financial market? First, access to the market: Japan has provided access to yen to scores of sovereign borrowers, international institutions, and corporations. That is rare. Most countries in Western Europe even today have not opened their capital markets to foreign or nonresident borrowers to the extent of the Japanese fixed-rate capital market in the last decade.

A second test of liberalization is the freedom to export capital. Japan certainly, in the last 10 to 15 years, has permitted its citizens to export capital through a variety of methods—equity investment, real estate investment, dollars, deutsche marks, and Swiss francs—in amounts that make trivial, in comparison, the export of capital from many other industrialized countries. In virtually all countries in Western Europe, the restrictions on export of capital are more extensive than those that exist in Japan.

Another test of the so-called liberalization of financial markets is the extent to which interest rates are set by market forces rather than by government regulation or control. Most countries—even the United States, which is clearly the most open financial market in the world—continue to set important interest rates by regulation or law. There are, in fact, ceilings on interest rates in U.S. dollars in checking accounts in U.S. banks. There are ceilings set on passbook savings accounts in the United States, and until the mid-1970s there were even ceilings set on the interest rates for large certificates of deposit with commercial banks. In virtually every country of the world, there are interventions by central banks to maintain interest rates at various levels. So that, even in the single area where it is said Japan exercises considerable control through government authority, Japan does not behave all that differently from most industrialized countries of the world.

Another test of the liberalization of a currency or market is its use as a reserve currency. Is it held by other central banks? The yen is, in fact, held by other central banks, just as they also hold the Swiss franc and deutsche mark as diversification from U.S. dollars but hold virtually no other currencies.

"In Japan, the relationship of government to society...is an unwritten code of consultation, competition, and control between government and those who have power..."

Another test is the availability and existence of a short-term money market instrument. While short-term securities are not yet a significant part of the Japanese market, bank deposits—short-term funding—are significant. Thus, if a short-term market is meant to describe a liquid secondary market made up of certificates of deposit, banker's acceptances, and repurchase agreements, then it is true that Japan does not have a liquid market in short-term maturities. But the only country in the world that has a viable liquid secondary market for short-term instruments is, in fact, the United States. Such a market does not exist in Italy or France or Belgium or Holland or Germany.

The negotiations between the United States and Japan, however, seemed premised on a view that Japan had to be pressed into opening up a closed market—closed more than other countries'. From Japan's point of view, it was prepared to be

somewhat "reluctant" in its negotiations with the United States and agreeable, publicly at least, to being viewed as a financial market more regulated than others. Otherwise, the international political value of further change would be diminished. Besides, there were powerful domestic forces to be reckoned with, and they were and are truly concerned. Thus, external pressure also helped to set the stage for a domestic dialogue. It was, in short, in Japan's best interest to internationalize the issue. There were real needs to be addressed. Perhaps I might talk about those needs.

Why was Japan prepared to liberalize even more? Because it was in its best interest to do so. First, there were already strains in the allocation of business among insurance companies, city banks, long-term credit banks, and issuers and savers. There was champing at the restrictions on banks in underwriting securities, lending yen to nonresidents, and managing pension funds. The liberalization program would provide a forum to address these issues and grievances.

"Over the last decade, Japan has had as open a financial market as virtually any other country in the world."

Further, as many of you know, real changes in the mid-1970s, in the wake of the oil price crisis, required a far more flexible financial market. Major aspects of liberalization were a natural evolution of a financial market responding to the oil price rise in 1974 and the contraction in the economy. Hardest hit was the Japanese government, which moved from being a supplier of credit to a major debtor by 1975. Self-interest required the development of more flexible market instruments. As the lead-in of one article put it, "Slower economic growth, changing corporate and household financial behavior, technological innovation, and the maturing of government bonds are all helping to create more open markets."

Japan had to finance its debt in the mid-1970s. Its economy slowed down. That debt had to be issued and now has to be refinanced. Short-term instruments with little risk of capital loss will be required to attract funds for financing as investors increasingly demand shorter-term investments either to protect themselves against capital loss, to provide liquidity in the event they wish to switch to another currency, or to respond to concern about potential future changes in an accounting system that may require them to disclose losses on their long-term bond portfolios.

Self-interest also means that, given the huge increase in assets managed by pension funds, it may be wise to introduce competition so as to increase the rates of return and the quality of performance measurement. Self-interest also means that the creation of short-term instruments will provide, over time, a quick and easy vehicle for diversification into and out of Japanese yen and permit exchange markets to reflect the market perception of the weakness or strength of the yen. Self-interest also means that it may be wise to create a range of alternative investments in your own currency so as to make them attractive as an alternative to a free and unfettered outflow into other currencies. Self-interest also means that it may be wiser and appropriate for savers to earn market rates of interest rather than distort the flow of savings into investments that are unregulated, perhaps more risky, or less productive, merely because those rates of return are free from administrative guidance. And it may be the better part of virtue to permit Japanese banks to lend yen to nonresidents in the face of shrinking domestic corporate demand.

Permit me to go back to the subject of competitiveness among financial intermediaries. There is

intense competition in Japan between those who can make long-term loans and those who can make short-term loans. Their cost structure is quite different. In addition, banks want to compete with securities firms in underwriting securities. The Japanese counterpart of the Glass-Steagall Act blocks them from such activity. While trust banks compete with securities firms in managing pension funds and trust accounts, commercial banks are not permitted to engage in that activity. Nonbank competition for lending by credit companies and consumer finance companies was and is increasing. Insurance companies wish to deal directly with issuers rather than through other financial intermediaries. Each of the major financial intermediaries—insurance companies, banks, securities firms, and long-term credit institutions—has support in the Ministry of Finance, which at various times in the past, to a lesser or greater degree, has either insulated them from competition or provided them with some protected niche. That subject needed and still requires scrutiny in the face of competitive pressures inside and outside Japan.

In short, the need for the government to attract funds, the increased sophistication and experience gained in the Euromarkets, the increased competition, and the increased demand for dollar assets created opportunities and requirements and inevitably raised highly contentious and difficult problems that went well beyond the scope of the discussions and protocols set out between Japan and the United States.

There is a host of problems relating to the timing of the "reforms," which are likely to cause considerable market distortions if not handled carefully. For example, one cannot leave large-denomination deposits set at market rates while virtually all rates on small deposits are strictly regulated.

There is also concern about the implications of deregulating the liability side of commercial banks, and thereby increasing their costs in a competitive environment, without permitting similar deregulation on the asset side; otherwise, there will be interest rate and maturity mismatches with resultant financial risks. Liberalization, if it means anything at all, means that banks will have to pay more for money. They will have more competition from new intermediaries. In Japan, one still seeks market share possibly to the detriment of capital-to-debt ratios.

"Most countries...continue to set important interest rates by regulation or law."

Losses in portfolio asset value have been obscured by nontransparent accounting conventions. Currently, there is minimal disclosure. Spreads, already narrow, will be under further pressure from new forms of competition. Risk will increase.

All this suggests that there will be increased regulation, not less control, by the government. United Kingdom, after 200 years of a sophisticated, diverse system of allocation of markets, functions, and roles, is only now sorting out changes—liberalizing—after great debate and study. In the United States, the process is about 20 years old and is still highly contentious and controversial. Japan's financial market is mature, with great potential demand for yen and dollars. But it is also new. The changes cannot and will not occur overnight, anymore so than in the United States or the United Kingdom. They have hardly started elsewhere in the world. I personally do not believe the implications can yet be thought through. I hope and expect that the Japanese penchant for doing things slowly and carefully, particularly given their enormous savings, potential for investment, and importance in world trade, will be followed here too.

EUGENE H. ROTBERG

Born in Philadelphia, Pennsylvania, in 1930, Eugene H. Rotberg earned a B.S. in economics and political science from Temple University in 1951 and an LL.B. from the University of Pennsylvania in 1954. A professorial lecturer in law at George Washington University Law School from 1965 to 1975, Mr. Rotberg was associate director of the U.S. Securities and Exchange Commission's Division of Trading and Markets from 1966 to 1968. He became treasurer of the International Bank for Reconstruction and Development—the World Bank—in 1968 and has served as vice president and treasurer of the Bank since 1977. Mr. Rotberg has received the U.S. Government Distinguished Service Award and has been named a Distinguished Scholar by Hofstra University and Alumnus of the Year by Temple University.

But all of this is what happens when a financial system is opened up. Opportunities increase. So does risk. Care must be taken. We are not dealing with some minor changes in the role of financial intermediaries. Permit me to use other examples.

Most societies are frightened by inflation, particularly when the only instruments of investment are fixed-rate and long-term and illiquid. That fear diminishes when instruments are available to offset or index the ravages of cost increases, that is, short-term instruments whose rates change in reference to market forces and a decline in budget discipline. It's almost as if the existence of the palliative destroys the incentive to avoid the disease.

Though economic regulation and allocation is deep-seated and diverse in Japan, competition is endemic in Japan among the financial intermediaries in a particular sector. What we are talking about now in Japan is a breaking down of some of the financial compartments, that is, lifting the barriers to competition across different types of financial intermediaries.

"Japan's financial market is...new. The changes cannot and will not occur overnight..."

There are other kinds of protections. Most companies do not report changes in asset value, and comparative performance data are not meaningful or comparable; unrealized losses on portfolios are hidden; banks act as a trustee for bondholders, watching over collateralized assets, though issuers can avoid the control by borrowing "outside" Japan or swapping into yen without having borrowed it directly. All this is likely to become transparent as liberalization proceeds. Liberalization means competition; competition requires disclosure. Managers will be measured and held accountable. Risk will increase.

Fortunately, not all matters dealing with liberalization are fraught with controversy. Some of it just involves common sense. As you may know, soon Japan will permit the first "Tokyo dollar" issue, that is, a dollar-denominated bond issue domiciled in and sold in Tokyo. It will be highly publicized and treated as a matter of great consequence and proof of liberalization. But it is simply the result of the fact that, since Japanese insurance companies and other institutional investors want to buy dollar-denominated bonds, it makes little sense to have those purchases intermediated through the branches of financial institutions, Japanese or otherwise, in New York or London. There is better control in Tokyo, better monitoring, and more profit. Therefore, it is logical to domicile the transaction in Tokyo and let the syndicates be controlled by Japanese firms, rather than having them perform as surrogates—with lesser influence and lesser compensation than their New York or London competitors.

After all, it is Japanese citizens who are buying bonds. If the buyers are Japanese and the intermediaries are Japanese, why not bring the issue out in Japan? Besides, it is a convenient way to permit "foreign" banks to participate in return for reciprocity in their markets offered to Japanese firms. Japanese investors want to invest in dollars because of the higher yield, currency diversification, the perceived strength of the dollar, and the falloff in yen-denominated borrowings by Japanese corporations. What better way to support the U.S. deficit, increase profitability of financial intermediaries, make political friends, increase control, and satisfy investors than to permit a Tokyo dollar bond issue—and call it liberalization?

Permit me to conclude with some decidedly oversimplified generalizations and predictions:

—The subject of competition in markets between financial intermediaries in Japan will be debated and unresolved 20 years from now.

—In the interim, there will be mergers and acquisitions, and some institutions will need official support because of increased competition and risk taking, narrow spreads, and higher costs.
—There will be more volatility and less certainty on the future level of yen interest rates.
—There will be as much, or more, government intervention and concern over the affairs of financial intermediaries than in the past, not less.
—Japanese investors will shift the maturity structure of their holdings and the currency of their investments, often quickly, and generally in the same direction, making more complex the control of money supply and the predictability of interest and exchange rates.
—The activities of insurance companies and securities firms will merge—if the firms do not.
—The Euroyen bond market will exist only to the extent required as a means for tax avoidance, as a means of avoiding the necessity to collateralize assets, or because of market restrictions on access to the domestic yen market. It will be a useful testing ground for the authorities.
—Japanese banks will make long-term floating rate loans based on their cost of funds, which will be well below the costs of other non-deposit-taking financial institutions.
—Administrative guidance will be less effective in response to the increased complexity and size of the Japanese market.

In short, the Western concept of commandments might well be resorted to, perhaps in response—but I hope not—to a major, publicized, unhappy financial event. But even then, the tablets will not be handed down from the mouth of God to the hand of Moses, or from the Ministry of Finance by one-way messenger. Liberalization in Japan instead will be managed through the uniquely Japanese process of consensus—through the delicate balance of consultation, competition, and control. □

(The title of this speech was provided by the editor.)