

FOREWORD

THE JAPANESE CAPITAL MARKETS

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The Japanese capital market, particularly in terms of the role played by debt instruments, has been for most of its history a relatively minor element in a financial system dominated by banks. The capital market has, however, been gaining importance in Japan over the past decade. The market is becoming broader and deeper — increasingly able to absorb larger and more innovative transactions.

There is still a long way to go before the Japanese market is as flexible and varied as the U.S. or British capital markets. But it seems inevitable that we will see a continuation of the ongoing process of structural change that is making the Japanese market more like other major markets. For example, asset-backed instruments for a long time were not even construed as securities for purposes of Japanese law and were thus in a regulatory and trading limbo. Today, a full-fledged local market may be on the verge of developing in Tokyo.

The Japanese capital market has been gaining in vigor and breadth largely in response to domestic economic changes within Japan, changes that have been inextricably linked with a growing international role for the Japanese economy and financial system. The changes in capital market structure to date — and many prospective changes — have been the necessary by-product of the successful adaptation of the Japanese economy to fundamental domestic and global economic forces.

The process of liberalizing and integrating the Japanese capital market with world markets has not occurred because the Japanese economy is notably dependent on, or exposed to, international trade. Insofar as the value of international trade in goods and services in relation to the size of its economy is concerned, Japan is in about the same position as the United States. During the late 1980s both countries'

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exports or imports were in a range no higher than seven to eleven percent of the nations' gross national product (GNP), much less than for other major countries.

Paradoxically, the liberalization process is rooted in the emergence of a large export surplus within the Japanese international balance of payments. In the 1980s, mainly because of changes within the Japanese economy that brought about a large excess of domestic saving over investment, Japan developed a huge surplus on international current account transactions. Exports of goods and services came to exceed imports of goods and services by historically large amounts — rising to almost 4 ½ percent of GNP in 1986, before falling back to around two percent by the end of the decade. By way of contrast, from the mid-1960's through the 1970's, the international current account surplus had averaged less than one percent of GNP.

The huge current account surplus was financed by the net outflow of surplus domestic saving to foreign countries. The United States was the largest recipient of that saving because its markets were the broadest, most liquid, and safest in the world. At the same time, Japan also developed a large bilateral current account surplus with the United States because it was the lowest cost producer of goods demanded by U.S. consumers and businesses during the boom years of the 1980s, when U.S. spending outpaced domestic production and when U.S. domestic saving fell short.

The huge outflow of Japanese saving accelerated the modernization of Japanese capital markets by establishing a close connection between Japanese and other major markets and necessitating certain related adaptations in the Japanese market. Prior to that, however, the Japanese financial system had already begun to shift away from a bank-dominated one, with most interest rates set by regulation or administratively, toward one with a greater role for markets and market-determined rates.

In Japan, the oil price shocks of the latter half of the 1970s led to a reduction in business capital spending and to the emergence of large government deficits. These deficits helped sustain the economy in face of a slowing in business spending but of course led to a very large rise in government debt. In earlier years the debt had been placed mainly in the banking system. By the late 1970s, however, debt growth had become so large that sustained inflation would have resulted if the banking system (including the central bank) had continued to finance the great bulk of the debt.

To avoid rampant inflation, more and more debt was placed outside the banking system, first with securities firms and ultimately

with individual and corporate investors. A secondary market in government debt soon developed, bringing with it a short-term money market to help finance debt holdings and secondary market trading, all at free market interest rates.

Since corporations could shift short-term funds out of banks and earn more by financing dealer positions in securities, the broadening of markets to finance government debt also made it necessary for banks to be permitted to issue competitive instruments, such as large certificates of deposit (CDs) at market rates. The process of deregulating deposit interest rates at banks was thereby begun — though the process gathered steam only later in the 1980s in response both to further domestic pressures and pressures from abroad to place the Japanese banking system on an equal competitive footing with banks of other major countries.

As the budgetary deficit in Japan became ever greater, countervailing forces emerged in the political process. The potential tax burden loomed increasingly large, particularly if account was taken of the aging of the population and the accompanying burst in social security payments expected late in this century and early in the next. It soon became governmental policy to reduce budgetary deficits.

The policy was quite successful, and the central government's deficit dropped from more than five percent of GNP at the beginning of the 1980's to less than one percent early in the current decade. But so sharp a decline in the deficit threatened to have serious contractionary effects on the economy unless offset by expansion elsewhere. Domestic saving remained very high; unless the surplus saving that was no longer absorbed by the budget deficit could be put to active use, the economy would weaken.

In the event, the surplus domestic saving was absorbed through a rapid expansion in Japanese net exports, which became the engine of economic growth through the first several years of the 1980s. Later, domestic spending replaced net exports as the principal catalyst to economic expansion.

The need to finance the export surplus greatly accelerated the process of financial liberalization in Japan and the broadening of the capital market. There was a spectacular rise in the outflow of long-term capital from Japan, mainly into foreign bonds, but also into equities. Domestic financial institutions — insurance companies, banks, trust accounts — rapidly increased the percentage of foreign securities in their portfolios. As time went on, an increasing amount of the capital outflow took the form of direct investment either into foreign companies abroad or into the establishment of foreign subsidiaries of Japanese

companies.

As these funds poured into foreign countries, primarily the United States, Japanese securities firms and banks followed their customers and became more active abroad. At the same time, foreign securities firms also sought to enlarge their business in the Japanese market. It became clear in practice that if Japanese firms were to be active abroad, foreign firms would have to be permitted to be more active in Japan.

A broadening and liberalizing of the Japanese capital market became necessary to provide the type of opportunities for borrowers and lenders at home that were now available to them on a global basis. Greater flexibility and competitiveness also gave foreign firms some opportunity to secure a foothold in Japan that would help make the international playing field more level and equitable.

Resistance to change always has to be overcome. It often appears to take longer in Japan because of the consensual decision-making process. In addition, though, the Japanese financial system had, and has, unique aspects whereby competitive forces are contained and in a sense muted through long-standing domestic relationships. There is competition across these relationships, but the competition is not as intense as in the United States. In such a context, an external influence may be a useful force to hasten change.

Changes in the Japanese securities market were partly the product of negotiations with the United States through the Working Group on Yen/Dollar Exchange Rate Issues, which issued a report in 1984 and in one guise or another has been meeting to discuss mutual problems ever since. A number of changes were introduced to make the yen more attractive to global investors — in effect to internationalize the yen.

From the viewpoint of U.S. and Japanese macro-economic policies at the time, the internationalization of the Japanese currency served a short-run practical purpose of increasing demand for the yen. A stronger yen was desirable because it helped encourage reductions in Japan's excessive trade surplus and the United States' excessive trade deficit that had developed partly in consequence of an undervalued yen (and overvalued dollar) in the early part of the decade. From the viewpoint of needed structural changes in Japanese markets, the policies to help internationalize the yen served as a wedge toward greater liberalization of Japanese securities and also banking markets.

Some transactions were permitted outside Japan in the Euro-yen market that could not be undertaken readily or that were not cost effective in the home market. These restrictions in turn exerted pressure to liberalize the home market for competitive reasons. A market in Euro-

yen CDs and short-term loans was established outside Japan in 1984; some three years later a domestic commercial paper market was established within the country. The corporate bond market within Japan is still rather moribund — largely because of high commissions and fees and collateral requirements — but pressure for change has intensified in part because of the successful establishment of yen issues in the Euro-bond market.

The equity market in Japan has to date always been the more active part of the capital market. It became the focus of world attention in the past decade when the price-earnings ratio became spectacularly high as compared with the U.S. market. From the mid-1970s to the mid-1980s the average Japanese p/e ratio was generally a little more than double that of the United States. In the second half of the 1980s, however, the ratio rose to three to four times the U.S. ratio, as a sharp rise in the foreign exchange value of the yen laid the basis for continuous reductions in domestic interest rates in Japan and, in combination with an accommodative monetary policy, for a large, persisting upward revaluation in capital assets. Following the crash in the Japanese stock market in the early months of 1990, caused in part by a tightening of monetary policy and rising domestic interest rates, the p/e ratio in Japan has returned to about twice the U.S. level.

One lesson from the rise and fall of Japanese p/e ratios is that the Japanese equity market is not immune from the forces — free flow of international capital, modern technology and communications, homogenization of attitudes — now making major capital markets more and more interdependent. Reactions of one market to another may be delayed for various reasons, including national macro-economic policy differences or less sensitivity to events abroad because of sheer market size or remaining cultural differences, but sooner or later, and in one degree or another, major capital markets impinge on each other.

The globalization of markets affects not only security prices and interest rates, but also the particular instruments markets need to make available in order to maintain their position. Thus, in Japan, while the equity market had been relatively well developed as compared with the domestic bond market, it lagged other major equity markets in the availability of derivative instruments. As derivative instruments became increasingly popular abroad, as it became technically more feasible to trade instruments denominated in any currency outside of home markets, and as globalization increased the awareness of Japanese investors, the development of derivative instruments in Japanese equity markets was given great impetus. Futures on stock indexes are the most popular, although options on a market index are also traded. Thus far,

participants are mostly securities firms, but as the learning curve is lengthened and as markets compete for business it can be expected that major institutional investors and individuals will be increasingly drawn into the market.

The development of money and bond markets and the expansion of the equity market into derivative instruments are important aspects of the modernization, liberalization, and indeed globalization of the Japanese capital market. This trend has forced securities firms in Japan to learn new ways of doing business, in addition to their traditional function as market-makers and distributors particularly in the equity area. It has also forced the Japanese authorities to rethink the role of banks in the capital market. This response is somewhat similar to the United States' experience with the declining role for traditional banking in today's world.

Similar to the United States, Japan has attempted to separate the banking and securities business — the only two major countries that now do so. This distinction has become increasingly untenable in practice. Deliberations have been under way within Japan for the past several years about how to redivide the financial services pie. As of this writing, it is not known how the debate will finally be resolved in Japan, though it seems clear that banks will be given further securities power (they are now in the government securities business and make long-term loans through the long-term credit banks) and that securities firms may be able to extend their reach into areas currently reserved to banks (such as market-making in foreign exchange with customers or the banking trust business).

As in the United States at this time, though, both banks and securities firms in Japan are going through a period of reduced profits, and the capital position of banks is under pressure. These business difficulties tend to make the process of structural change more delicate since each institution becomes more loathe to give up sole rights to profitable areas, and the authorities become fearful of setting off a scramble for business that could threaten to disrupt further (at least during a transition period) an already delicate situation.

Further changes along the lines of the past few years appear inevitable in Japan, however, though it is hard to predict the pace. The globalization of Japanese markets, catalyzed by the large international current account surpluses and excess domestic saving of the past decades, makes continued change inevitable. At some point Japan will inevitably not run so large an international surplus. The present surplus is already substantially diminished relative to GNP. As time goes on, and if the high domestic saving rates fall as the population ages, the

country conceivably could become a net international borrower from time to time.

Nonetheless, even when the net flow of funds between Japan and the rest of the world reverts to historically more normal proportions, the process by which Japanese markets become more like other major markets will continue — though they will never be exactly the same because of lingering differences in culture, institutions, and business practices. The period of large excess domestic saving has established linkages between Japanese and foreign markets that will not be sundered, short of a very unlikely return to financial autarky around the world.