

THE FUTURE ROLE OF TOKYO'S
FINANCIAL MARKET

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[1. Introduction]

-- A Brief Overview of the Japanese Financial System

To begin with, as a preliminary to our discussion, I would like to explain the characteristics of the Japanese financial system. Following this introduction I will discuss the changes in the financial markets in the 80's, the evaluation of Tokyo as an international financial center, and then I will summarize the future outlook of the Japanese system.

One of the basic features of the Japanese financial system is the Securities and Exchange Law. This law is similar to the Glass-Steagall Act in the United States, which clearly separates commercial banking and investment banking.

Traditionally, Japan had a universal banking system similar to that of European countries, in which banks are involved in both commercial and investment banking. After the end of World War II, U.S. occupation forces observed carefully the Japanese financial system, but did not embrace the universal banking practice. Instead they advised the Japanese government to adopt a system with a Glass-Steagall-type framework.

Except for a few differences the American and Japanese regulations are similar. A major distinction is that commercial banks in Japan can hold common stock in their investment portfolios.

This is probably considered a wise policy because in the late 1940s economic activities started from nothing (scratch). At that time, the institutional framework of the economy had been completely destroyed and all sectors badly needed capital to spur recovery. Banks played the role of stock market.

However, under the antitrust law banks equity holdings are strictly controlled. Japan imported U.S. antitrust legal framework which embodied a strong feeling of populism against big business such as the Zaibatsu. Thus even though banks are allowed to hold equities they are not permitted to hold more than five percent of the total outstanding common shares of any company.

Speaking of Glass-Steagall, a trend has been gaining momentum recently in both the United States and Japan to review the segregation of the banking and the securities businesses. Foreign subsidiaries of U.S. banks have been to sidestep the Glass-Steagall Act. These subsidiaries have been aggressively participating in bond business as well as in stock business abroad where the Glass-Steagall Act is not applicable.

Domestically, U.S. bank holding companies through subsidiaries are allowed to engage in handling commercial papers, as well as, underwriting and dealing revenue bonds, mortgage bonds and consumer credit-related asset back securities. Thus U.S. banks even now are in a position to engage in a considerable, if not full, range of activities in the securities business -- a fact that illustrates the waning significance of the Glass-Steagall Act.

In November 1987 the financial modernization bill of 1987 was presented to Congress jointly by Senator William Proxmire, chairman of the Senate Banking Committee, and by Senator Jake Garn. This bill is intended to abolish part of the Glass-Steagall Act and allow banks and security houses to engage in business on each other's turf through holding companies. On March 2, after making some amendments the Senate Banking Committee approved the bill.

In Japan the Financial System Review-Committee, a task force formed to review the issues related to the financial system, has expressed that it is too rigid to consider the separation of banking and the securities business as an immutable rule. This is a signal that the MOF might be flexible, when the U.S. system changes.

Now, let me briefly describe the major characteristics of the Japanese banks and securities companies.

--Characteristics

(1) The Japanese Banking Industry

The total number of existing banks in Japan is relatively small, compared with that of the United States. In the U.S. the FDIC has 14,000 member banks. There are only 156 member banks in Federation of Bankers Associations of Japan, 13 of which are large city banks. Thus, the Japanese banking industry consists of a relatively small group of highly competitive players.

Historically, the banks competed within a framework of a strictly regulated interest rate structure. Thus, the traditional thrust for competition has been to quantitatively expand loan assets as well as deposits, which is a quantitative game, not a qualitative one.

However, with the advent of securitization and interest rate deregulation, signs of change have appeared in the way Japanese banks compete for expanded assets. They now have a completely different set of risk factors; in addition to the traditional credit risk, they have to cope with all kinds of market risks involved. Another important factor fueling the underlying trend is the move to establish an international standard of banks' capital adequacy ratio. In order to effectively monitor the capital adequacy ratio, you have to be much more sophisticated in controlling risks and in managing the relationship between assets and liabilities. A quality competition will become more vital than a quantity competition.

Historically, however, Japanese commercial banks worked hard to pursue a quantitative competition by greatly expanding their lending activities, particularly during the high economic growth period of the 1960s and 1970s. For Japanese corporations, external debt like bank borrowing was an important and normal source of funds under a given tax framework. During the high growth period, when the Japanese economy achieved 9% to 10% growth annually, 70% to 80% of total funds raised by business corporations came from bank borrowings. These borrowings enjoyed the advantage of tax benefits on interest payments. Japanese corporations preferred bank loans, for, among other reasons, they could easily be custom-made (a JIT product!!). That's why Japanese corporate executives enjoyed "relationships" with their bankers. And vice versa. Financial transactions were traditionally relationship-oriented rather than price-oriented.

The oil crisis of 1973 marked a new era for the Japanese economy: it moved from a high growth period into a slow or stable growth period, resulting in diminished corporate demand for funds. Japan's economic growth rate since 1974 has averaged 3-4% a year, and bank borrowings as a share of the total funds raised by corporations has recently dropped to about 25% instead of the previous 70-80%. Furthermore, corporate needs for financial services has become highly complex. As a result, it has become necessary for banks to perform not only commercial banking but also investment banking services in order to adequately serve corporate customer needs.

In this regard, some argue that, in keeping up with the ongoing change in banking functions, Japanese banks will see a shift from relationship banking, the traditional practice, to price banking. I disagree. Maintaining a close relationship with clients is the basis of Japanese banks' activities. Not only are good and reliable banks dependable business information providers, they also provide information for risk management. Given this tradition, it is unlikely that even with the rising importance of the securitization business, relationship banking will easily change to price banking.

(2) Japanese Securities Companies

There are about 250 securities houses. The Big Four virtually monopolize about 80% of equity underwritings and about 70% of bond underwritings. Commissions paid on securities transactions are fixed and have not been deregulated. Furthermore, new entrants have been restricted. (The current annual pre-tax profit of Nomura Securities Co. is the equivalent of 2 billion dollars -- much larger than the corresponding figure of the largest bank.)

Soon, the division between the commercial banking business and the securities business will be partially mitigated in Japan. Japanese bankers were interested in the verdict of the U.S. court case regarding commercial paper placement by Bankers Trust. Last June, the Federal Appeals Court ruled that the private placement of commercial paper should not be interpreted as "underwriting", and therefore bankers were allowed to proceed in this business. The Supreme Court concurred with this decision.

Thus the U.S. banking industry will legally be able to step into the securities business or investment banking in a decisive manner even within the Glass-Steagall framework. And it seems to me that bank regulatory authorities in the United States are increasingly in favor of this.

The U.S. environment should eventually affect the Japanese environment. It should be a typical example of "ideology transfer". Even though both the U.S. and Japan Glass-Steagall frameworks may endure for a few more years, the policy climate of financial authorities will be substantially liberalized in both countries.

[2. Changes in the Tokyo Financial Markets in the 1980s]

Now let us look at the changes taking place in the Tokyo financial markets in the '80s. The liberalization and internationalization of the Tokyo financial markets has been remarkable since the early 1980s. These moves were triggered by the 1980 revision of the Foreign Exchange Control Act and the 1982 revision of the Banking Law. The inprinciple liberalization of capital transactions, implemented with the revision of the Foreign Exchange Control Act, had a particularly strong impact. The agreement reached in 1984 by the Japan-U.S. Yen-Dollar Ad Hoc Committee, Financial and Capital Market Issues, further spurred the trend toward financial liberalization.

The liberalization and internationalization of the Tokyo financial markets can be divided into four categories of action: (1) deregulation of interest rates, (2) liberalization of domestic financial markets, (3) opening up of the Tokyo markets to foreign financial institutions, and (4) internationalization of the yen.

(1) Liberalizaion of Interest Rates on Deposits

Interest rate deregulation is being implemented in steps, to avoid pushing the domestic markets into disarray. Deregulation began in 1985 with large-denomination time deposits of Y1 billion and over, followed by incremental lowering of the deposits' denominations. Interest rate on Y100 million and over time deposits are the most recently deregulated. In April 1988, interest rates on time deposits of Y50 million and over are scheduled to be deregulated.

(2) Liberalization of Domestic Financial Markets

Now the liberalization of domestic financial markets has occurred in the form of diversification of financial instruments and services. On the financial instrument front, certificate of deposit issues were liberalized in 1979, ushering in the age of market liberalizaion, and in 1987 domestic commercial paper issues were liberalized. The commercial paper market was worth about Y2 trillion at the end of last January, reaching this size only three months after its inauguration. Indeed, except for short-term government bonds, the Tokyo financial markets today can match those in the U.S. and Western Europe in a variety of short-term financial instruments.

Measures have also been taken to deregulate yen-denominated loans to foreign borrowers and to relax rules governing the issuance of yen-denominated bonds.

As the result, the yen's share of the international financial market during the first seven months of 1987 was about 13%, compared with almost 40% share by the U.S. dollar. And utilization of Yen denominated financing actually exceeds that of the D mark's 8% share. Therefore, the appetite for Yen is gradually growing. But, the U.S. dollar remains, of course, the key currency in the global capital market. International investors' portfolios are obviously based on U.S. dollar.

[3. Evaluation of Tokyo as an International Financial Center]

As financial globalization is progressing, New York, Tokyo and London are becoming the major international finance centers. As a matter of fact, Tokyo is now really gaining momentum to grow as the third nucleus. This contrasts sharply with Tokyo's historical image as only a local market as compared with the central markets in New York and London.

I would like to show you the comparative size of the Tokyo financial markets in four different categories: (1) money market, (2) debt markets (bank credit + bond issues), (3) equity market, and (4) foreign exchange market.

The outstanding value of Tokyo's short-term money market instruments at the end of last September was about \$520 billion. This is about one-third New York's volume (NY is of course the largest market). However, Tokyo is about five times the size of the London market.

How about the debt market? Tokyo's bank credit outstandings are about \$1 trillion which is higher than New York's market. Of course, New York is the market leader for bond issuance (the real flower of capitalism) with \$4.5 trillion outstanding. Tokyo's bond issuance market is at \$1.5 trillion and thus it is roughly one-third the size of the New York market.

Indeed, the magnitude of the New York market is best portrayed by the capitalization value of the New York Stock Exchange (\$2.2 trillion). However, today, the market capitalization of Tokyo is bigger than that of the NYSE.

Speaking of the volume of foreign exchange transactions, London is primarily known as enjoying the highest status, which is actually at \$90 billion a day, and is double that of both New York and Tokyo.

How can the comparisons of these markets be characterized? London can be described as a "graceful old matron", with fancy Forex attire; while New York is definitely a "Gulliver", with flexing short term money market muscles and a strong body, made up of an equity and a debt market. Tokyo can best be described as an "unexpected beauty", her money market muscles still young but developing, her bank credit eyes are very big and shining, while her "securities" hair is unexpectedly gorgeous.

To further illustrate the perception of Tokyo's expected growth I would like to cite interesting results of the Japan Center for International Finance surveys. JCIF asked representatives of foreign financial institutions in Tokyo to rate the Tokyo markets in comparison to London and New York. The survey taken in 1984 ranked the London market as top of the three. However, when a similar survey was conducted in 1987, assuming London was 100 Tokyo's index rose to 62 and New York's was up to 115. In the 1987 survey, the respondents were also asked to forecast the future importance of the three markets in 1992. Tokyo was placed ahead of London, and just behind New York. As stated before these perceptions are those of "foreign" bankers and financial experts doing business in Tokyo.

One reason for Tokyo's high rating is the successful liberalization and internationalization of the Japanese financial markets. Another important reason is, of course, the growing accumulation of Japanese dollars, which is eventually destined to be recycled abroad. This implies enormous business opportunities.

If you look at past statistics, Japanese real GNP growth rate during the golden years of the '60s was 10%. This growth was taken for granted. The current growth rate in the '80s has dropped to 4%, which has become our cruising speed. While experiencing these rough changes, Japanese industries have continuously raised productivity and remained competitive through active renovation of manufacturing facilities.

As a matter of fact, if you look back to the '50s and '60s, Japan's industries depended on the expansion of domestic markets; this phenomenon was widely misunderstood by foreign Japanologists, many of whom still believe that export-led expansion is part of Japan's indigenous culture.

Second, with the establishment of an offshore market and with preparations under way to create a financial futures market, Tokyo is becoming fully equipped as an international financial center. Cash market and futures market are indeed indispensable wheels to roll on any financial center. So far, only a government bond futures market exists, but preparations are being made to start a comprehensive financial futures market. A market where a wide variety of instruments will be traded, including interest rate and currency futures, currency options, stock price index futures, and U.S. Treasury bond futures. Another important vehicle in Japan's financial center is the Japan Offshore Market(JOM), modeled after the New York IBF, created in 1986.

Thirdly, Tokyo's geographical position is important. Tokyo is located between New York and London(!). When the New York market closes in the evening, the San Francisco market is still open for another 3 hours. Four o'clock in San Francisco is 9 o'clock in Tokyo. When Tokyo closes at 5 in the evening, it is 9 in Brussels and Zurich and 8 in the morning in London.

Therefore, financial markets in New York, Tokyo and London are ideally located for 24-hour transactions.

Also, Tokyo is supplied with well-trained human resources as well as high-tech communications devices, and the level of information is high in both quantity and quality. This "financial infrastructure" is the key to the success of any international financial center. Of course, we are also well equipped with an "entertainment infrastructure". Not only do we have Ginza & Akasaka, but we also attract such productions as Chorus Line, Cats and now Phantom of the Opera. Today, Harold Prince is busy in Tokyo.

Tokyo is expected to perform its part as one of the three financial centers of the world and at the same time to function as the key station in Asia. The increase in the importance of New York, Tokyo, and London as international financial center does not mean that financial activities concentrate in New York, Tokyo and London; what it means is that each of these three financial centers functions as the key station for its region. This means that satellite markets develop around each financial center. In the case of Tokyo, it will be called on to fulfill its role as the center of the Asian galaxy.

The Japanese economy has already started a sound movement toward a positive restructuring by means of expanding domestic markets. We need careful policy coordination. If the United States fails to seriously address the issue of readjusting its twin deficits in order to put its economy on a healthy path, uneasiness may erode confidence in the dollar and also undermine the future role of the Tokyo financial markets, hindering their function as a stable supply base of funds. The U.S. financial market now depends on Japan for one-third of all long term funds flowing in from overseas. The future role of Tokyo depends on a healthy management of the U.S. economic policy. We have to know that we are all on the same boat. And we must avoid any kind of future crisis due to the lack of policy coordination.