

JAPAN'S FINANCIAL POWER

Akio Mikuni

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Akio Mikuni
President, Mikuni & Co., Ltd.

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by Akio Mikuni

President, Mikuni & Co., Ltd.

It is a great pleasure to give a speech on "Japan's Financial Power" as a Distinguished Lecturer Series speaker.

If you see a recent league table of Euromarket bond underwriters, you may find many Japanese brokers and bankers high in the list. Various bank asset rankings indicate Japanese banks almost monopolize the top five banks in the world. When a US Treasury auction takes place, the degree of enthusiasm of Japanese investors decide the level of interest rates. These news certainly indicate Japan's financial power which has emerged only in recent few years. Our substantial current surplus, net creditor position and overseas investments are accountable for the emergence of Japan as the World banker.

The current spectacular phenomena appears to me of temporary nature. Firstly, the thrust of our long-term capital outflow comes from acquisitions of long dated bonds, especially US Treasury bonds, triggered by rapid expansion of current surplus. Since the net long-term capital outflow by far exceeds the current surplus, the difference is financed by net short-term international borrowings in the approximate amount of \$250 billion. The reliance on short-term funding could be justified

as our long-term assets largely consist of highly liquid US Treasury bonds. Furthermore, Japan's gigantic international presence in terms of securities investments should be curtailed significantly when the current surplus should be reduced substantially in the future. Such sign has been discernible already in recent past. Secondly, our banks' assets have increased due to two reasons. The sharp yen appreciation in the past four years has doubled their dollar translated domestic assets. In addition, their overseas assets have risen sharply from less than 10% of the total assets to 40% or more in the past six years. It is important to note that their equity to total domestic assets has remained more or less stable for the past decade. This might mean that the rapid build up of overseas assets by Japanese banks has not, by and large, been commensurate with growth in overseas earnings. Suffice it to say that banking assets have to be supported by reasonable earnings, especially in the light of fluctuating interest rates. Having said that, Japan's somewhat exaggerated financial power is likely to disappear in the not too distant future as the trade imbalance should be corrected by one way or another. However, our aggressive investments in R&D efforts as well as production capacities, the very reasons that have brought forth our international competitiveness, will continue to improve the terms of international trade in Japan's favor. Accordingly, our

intrinsic trade surplus will gradually enable our industries to build up production facilities in overseas markets. It should be noted that Japan's manufacturing industries will be in a position to control flow of goods in and out of Japan in most cases. Our productivity gains vis-à-vis other nations will enable us to produce goods competitively and sufficiently even in the light of rapidly aging population. It is worth mentioning that our direct investments will rise rapidly while our trade surplus are on the wane. This will cause our manufacturing industries will rely increasingly on overseas long-term financing both in terms of debt and equity. Furthermore, our overseas investments will be paid back only if they will increase positively productivities in the local markets. Having said that, our financial power will become more invisible and will depend upon its contributions to the world economy, or supports by overseas consumers and investors, or market forces.

Now, I would like to review our economy and finance in order to assess realistically our financial power. I believe that our economic and financial system is still unchanged from the one that has more than encouraged or literally forced our people to carry out savings, investments and exports for the purpose of catching up with the Western civilizations since the start of the Meiji era. Our industrial success has increased tremendously productivity of manufacturing. The excessive production

capabilities are used to increase exports and are not made available for raising standards of living of the general public so far. Of course, our exports in relation to GNP or sales during the past three years have been cut almost in half, not because our export unit volume has declined, but because yen proceeds of export sales have been cut in half due to the drastic yen appreciation.

I believe that we have not gone through a real economic adjustment in our economic structure. Instead, what we have done, so far, is stimulating domestic consumption and investments by means of easy money and public construction works. Our exports in dollar terms are running currently somewhere around 15% above last year. And also, our resilient unit export volume has enabled our manufacturing industries to operate at near full capacity, and to boost their earnings despite the higher yen.

Imports are rising rapidly as our domestic economy needs more raw materials related to active construction expenditures. In addition, imported manufactured products in relation to total imports are rising very rapidly. However, we do not see real penetration of imports yet. The automobile trade is the most important in terms of export value, or representing one third of our total exports. We import this year about 130,000 units of Mercedes-Benz, BMW, Volvo, Porche and some expensive models of American cars, as compared to export units of 6.6 million. If we

are looking forward to a practical solution to close a trade gap, we should be importing millions of automobiles, and reduce exports also by millions. These changes in exports as well as in imports should drastically reduce our automobile production from the current level of 14 million to below 10 million, which should reduce our trade surplus dramatically.

As I look into the trade picture in Japan, I have not seen such real solution to have taken place yet. What we are facing in Japan is that we have to choose what industries or which companies will be allowed to exist, as we inevitably reduce our trade surplus significantly either by means of a US economic slowdown or higher yen or more protectionism. Then, the most important issue will be "how" to do it.

Here, we have the most difficult problem to be solved. As you know perhaps well, when our industries faced a rapid yen appreciation, our monetary authorities created excessive liquidity in the market to drive up asset prices. Many hard hit industries have been greatly helped by selling assets and realizing capital gains. Our financial as well as economic system is playing a role of shifting resources from one sector to another to foster and help our industrialization. We still have a coal industry which has not internationally competitive. The way we had helped it was not so clear to the outsider including ourselves. The Japanese electric utility still now and steel

industries until recently buy or bought coal at much higher prices than international prices. These two industries pass those high costs onto their customers, their prices are either regulated or fixed unofficially. Here, we try to eliminate market forces to play a role but let "visible hands" to keep our any existing industries intact.

Since this "manipulating" system works well, we are keeping our exports still largely intact, and also rule out significant inroads of imports at bay. As I see our trade surplus to resurge again, we will see in the not distant future a real adjustment coming, which has been long overdue. I do think such adjustment will result in not because of our policy change but because of the market forces which cannot be controled by the government due to the following reasons.

Firstly, the US will not politically and economically tolerate the persistent trade imbalance. With the strong yen plus some forms of protectionism, especially, the anti-dumping charges or its fears on the part of Japanese manufacturers, the production shift from Japan to the US of many items will be accelerated rapidly. Our industries will make overseas investments in order to protect their markets. This cannot be our governmental policy because it will certainly create hollowing effects in our industries. Therefore, our government will not play a positive role and let industries to decide their overseas investments.

Secondly, imports of various manufactured products should rise rapidly, given the wide price differences between Japan and abroad in many items. There exist many, both formal and informal, barriers to protect domestic producers. However, the wide price gaps will create a huge profit opportunity to attract imports. Because of multi-layers of walls and moats, it may take a longer time but it will come, especially, when the overseas supply exceeds demand and finds capacity to export.

Thirdly, our consumers are more knowledgeable than before. Our consumers are allocating their purchasing power to their likings. This has created wide differences in profitability among producers of consumer goods in the same industry. If foreign products offer more value for price, our consumers are willing to buy them regardless of their origins.

Fourthly, our important function of the domestic banking will be undergoing a rapid change, in my opinion. As mentioned earlier, our banking industry has created huge liquidity by expanding credit in the domestic market which has caused stock prices and real estate to appreciate sharply. These high asset prices naturally attract money as well as attention from public at large.

During the past few years, we have seen an interesting topic "insider information" which has not been discussed widely in Japan heretofore. The public started to be alerted when we saw

Tateho Chemical got into financial difficulties last year after it speculated in the government bond future market and its losses wiped out its equity practically. Maybe, some explanation is needed to illustrate a degree of speculation. In the fiscal year ended March 1987, its sales were about \$46 million with working capital and fixed investments in the amount of \$29 million at the year-end. It increased its equity excessively to \$135 million by selling new shares in order to earn financial income by employing "no cost" equity money. However, its annual dividend payments increased to \$5 million. Considering tax burdens at about 60% of income, Tateho needed \$12-13 million or 25% or more on its sales to service dividends. When higher yen reduced its operating profits to nil, Tateho had to earn financial income at least to cover dividends. According to newspapers, it went as far as to expose itself in the government future market in the maximum amount of \$3,500 million or over 70 times its sales. This illustrates how our excessive liquidity has been exploited in an extreme case.

The case in point is that Tateho, after the huge losses in the future market and amidst such rumors, asked its bankers to come to the meeting. One bank sold a big block of shares upon such notice. This caused a big surprise and resentments among public at large. If, in the past, banks were notified any important news, they were supposed to help client companies without paying

any attention to their own interests. After this incident, our securities law was revised for the purpose of tightening insider trading regulations and will be put into effect next spring.

Several months ago, shares of Sankyo Seiki, a manufacturer of precision equipment, went up sharply just before the announcement of Nippon Steel's acquisition of a minority stake in the company. As the rumor of insider trading spreaded out, TSE and MOF were forced to investigate and announce the findings. Although no criminal prosecution procedures were taken, this incident has illustrated that insider trading could be considered immoral and criminal, finally in Japan. There are two important observations from this. Firstly, Nippon Steel, which is the bluest of blue chip companies, is getting into a new business in order to diversify. It has been devoting its time, efforts and money to produce best steel in the world so that our automobile and all other assembly manufacturers can compete internationally. The fact that it has decided to diversify its business indicates that it will not be considered as a special protégé of MITI any longer as it competes with anybody else. Secondly, on the insider information, several officials at both companies bought Sankyo Seiki shares before the announcement of the equity participation. People were shocked that staffs of Nippon Steel, super elites by any standard, even demean themselves by making money illegally. These two factors created sharp criticism

against such insider trading. I am convinced that this incidence does indicate that close working relationship between the government and Nippon Steel may have ended, if not too apparently. Unlike the period of catching up, private interests do not coincide with national interests.

Fifthly, as our overseas investments are increasing rapidly, we will face many important issues. So far, we have made significant overseas investments in Southeast Asia for the purpose of outsourcing labor intensive components and products. However, trade surplus between Japan and these countries is rising. In the U.S., trade friction has made our automobile and electronics industries to shift production from Japan to the U.S. by building local factories from the scratch. Also, many larger companies are buying big companies here such as CBS, Firestone, and Intercontinental Hotels. In these major acquisitions, just like our Treasury bond purchases and real estate acquisitions, it is curious to find that these acquisitions do not lead to reduction of exports from Japan. Unless we see acquisitions to replace Japanese exports, our direct investments through acquisitions are quite different from the solution to the trade problem. If we are going to make real investments to replace our exports, there are two important factors to be considered.

Firstly, our investments in the manufacturing sector in the U.S. and elsewhere should improve dramatically productivity of local

manufacturing and produce good profits, part of which can be repatriated to Japan.

Secondly, Japan's economic system has to be yielding to market forces, departing from the past practices of helping industries at any costs. Japan's industry has outgrown its government. It is inconceivable that the government is telling the industry how to cope with international competition. If the government intervenes the industry from now on, it has to be from the view point of protecting consumers or public investors. In order to help industries against overseas competition, always, public or consumers have picked up tabs without knowing the fact or even willingly as they know they can benefit by the stronger industries. But, since our industries are shifting production from Japan to abroad, the government cannot foster such trend as it creates domestic redundancies, and, neither can discourage such trend as it is vital in the interest of industries to preserve their markets. The government has to retreat from a position of a playing manager in our industries to a position of an impartial referee.

To sum up, I believe that our economy moves toward more market oriented system and this will help our economy prosper together with the rest of the world economy. Our younger generations are more honest and realistic what they like as compared to our generations or older who have been imbrued with the old values to

keep Japan's catch-up with the West as priority, ahead of individual needs. This will lead to reduce our current financial power but will eventually build up direct investments which will be supported by local markets and, therefore, their dividends will be paid to Japan to support our consumption.