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Financial Reform: Japan Style

Any financial system is ultimately shaped by the economy it serves. Thus, economic changes often lead to adaptations in financial structure. In the U.S., the growth of money market funds, the decline of the thrift industry, and other changes stemming in large part from our inflation have graphically demonstrated this relation. So it should not be surprising, given the exceptionally severe *worldwide* economic shocks of recent years, that even more far-reaching transformations have been occurring in many financial systems abroad.

Virtually every aspect of Japan's financial system has changed dramatically over the last decade. The main forces spurring these changes—oil, inflation, prolonged recession, fluctuating exchange rates—are similar to those causing financial change in the U.S. and elsewhere. But the direction Japan's system has taken in response has been critically shaped by its historical characteristics, causing changes there to differ in some ways from our own.

Origins

Traditionally, formal and informal regulation of Japan's financial system has been extraordinarily pervasive by U.S. standards. As late as 1970, most key interest rates were constrained by government regulation to some degree. As in the U.S., deposit interest rates were fixed at artificially low levels, and allowed to vary only sporadically. The short-run flexibility of bank lending and most other short-term interest rates were severely restricted. Regulation even extended to the capital markets, where yields on newly issued bonds generally were kept below those on the secondary market.

The *activities* of financial institutions have been regulated no less severely. Until recently, banks were forbidden to purchase funds from the public by issuing certificates of deposit or similar instruments (a common practice of banks in the U.S.), to act as dealers in the securities markets, and even, in most cases, to open new branches. Controls on financial flows between Japan and other countries have been especially severe, with virtually every transaction subject to quotas, prior approval, and other forms of scrutiny. Foreign banks and other foreign financial institutions have been prevented from gaining more than a "toehold" in Japan's markets.

Not surprisingly, this extensive regulation distorted Japan's financial system. Interest rate controls led to widespread credit rationing. Money and capital markets remain comparatively underdeveloped (only about ten percent of funds typically flow through such markets in Japan, considerably less than here). Regulation also largely accounts for the historical dearth of consumer credit, and the restricted availability of mortgages. Capital controls had virtually "walled-off" Japan's financial system from those abroad and prevented many Japanese institutions from fully using international capital markets.

Why then have the authorities regulated the financial system so heavily? In large part, financial regulation attempted to alleviate perceived problems in Japan's economy. For example, deposit interest rates were held down partly to encourage corporate investment by lowering the cost of bank loans. (Whether this policy succeeded is another matter.) Capital controls were used partly to conserve scarce foreign exchange reserves. Japan's authorities have also been more willing than officials here to "cushion" private institutions against unusually large shocks, a policy that often entails some control over their activities lest such "free insurance" induce them to assume excessively large risks.

Changing times

Still, Japan's authorities have long been aware of the drawbacks of such regulatory

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"solutions," as evidenced by their limited moves to increase interest rate flexibility during the 1960s. The economic upheavals of the next decade drastically accelerated reform, though, by fundamentally altering the economic basis of regulatory policy.

In contrast to the U.S., inflation has played a comparatively modest role in these changes, not least because Japan's authorities have been more successful in containing inflation. More important have been the effects of slower real growth and changes in industrial structure seen since 1973.

Slower growth has undermined the traditional basis for monetary policy—corporations' heavy dependence on bank loans—by lowering business investment demand and, hence, its need for external funds. Monetary policy now has to rely more heavily on regulating the *cost* of credit, making more interest rate flexibility necessary. Difficulties in funding recent massive government deficits (incurred to spur growth) have underscored the advantage of well-developed financial markets which Japan lacked.

By altering traditional financing patterns, these factors probably made it considerably more difficult for Japan's regulated system to allocate savings *efficiently*. A financial system based on rationing relies heavily on information available to lenders in allocating credit. This reliance works adequately only when economic structures, and therefore financing needs, have been stable long enough for lenders to learn of them. With economic conditions changing rapidly, though, lenders' information alone will be inadequate to channel savings to their most productive uses.

By contrast, in a free financial system, credit flows depend upon the knowledge of both lenders *and* borrowers. Such a system can use, or "pool," considerably more information than any one group of participants possesses, and is therefore essential for efficiency in a changing economy.

Finally, the breakdown of fixed exchange rates among the major currencies has also spurred reform, particularly in Japan's financial relations with other countries. Generally, countries have pursued more divergent macroeconomic policies under floating exchange rate systems, so pressures for capital flows have tended to be greater than under the fixed rate system. This has probably made the task of controlling these flows through capital controls more difficult. Moreover, controls on capital flows can *add* to currency instability that arises from temporary fluctuations in the balance of payments, and are therefore less desirable. For example, a currency depreciation resulting from a temporary fall in exports encourages an offsetting capital inflow—to take advantage of the appreciation expected when the shortfall ends—helping to stabilize the balance of payments and the exchange rate. Controls would impede such "stabilizing" capital flows. Freer capital flows are also needed to facilitate Japan's lending to foreigners when domestic savings exceed the domestic demand for them, by business and government, a frequent condition in recent years.

...and reform

These pressures have led to numerous steps toward financial liberalization over the last decade aimed at increasing interest rate flexibility, improving the money and capital markets, and strengthening links between Japan's financial system and those abroad.

By 1980, virtually all controls on interest rates in the call and commercial bills markets in Japan had been removed. Money market yields were left free to respond to forces of supply and demand. In May 1979, banks were allowed to issue certificates of deposit (with some limitations), a step which has since significantly enhanced their funding base. Japan's banks were authorized to deal in government securities (with some limitations) in last April's major overhaul of the country's banking laws, the first major reform since World War II.

Most radical of all in recent years have been reforms affecting financial flows between Japan and other countries. In 1979, the short-term repurchase ("Gensaki") market was opened to foreigners, linking Japan's money markets with those abroad. In December 1980, a new foreign exchange law dramatically relaxed many capital controls, reversing the old principle of "prohibited where not explicitly authorized" to "permitted except where explicitly forbidden." These changes were followed by the removal of overt discrimination against foreign banks in Japan and by steps making it easier for foreigners to borrow in Japan's capital markets. In addition, the government has actively encouraged U.S. finance and insurance companies to open offices in Japan, partly in hopes that they will spur development of more consumer-oriented financial facilities.

In sum, financial reform in Japan has been much more far-reaching than reform here largely because past regulation had made Japan's system less adaptable to changing economic conditions than our own. Financial change in Japan has most often been the result of government actions; in the U.S., change has more often been the work of the private sector outside the control of authorities. The reason for this difference is that Japan's traditionally heavy regulation prevented spontaneous financial innovation by its private sector. In contrast, the much freer U.S. system allowed, indeed even encouraged, such innovation.

Where now?

Japan's style of financial reform has pushed its financial system closer to complete liberalization, but the process is yet unfinished. The reforms have been limited and future changes will be subject to political and economic conflicts familiar to observers of financial reform in the U.S.

Bank deposit rates remain controlled (although less so than in the past) in part because complete deregulation could divert funds from the postal savings system—the chief source of funds for government lending institutions. Official desires to minimize interest costs on government debt may help explain why yields on newly issued bonds are still restricted.

Progress toward "internationalizing" the yen—promoting its use by foreigners as well as Japanese citizens—illustrates the pressures for and resistances to change. Internationalization is an avowed long-term goal of Japanese authorities, but the authorities have to date been unwilling to take one widely desired first step toward this goal—the establishment of an international banking center (in Tokyo) free of regulations applied to domestic institutions. They continue to fear, in part, that it might interfere with domestic monetary policy. Historical experience, however, strongly suggests that the yen will not be used internationally unless Japan's financial system becomes substantially freer and better developed than at present.

Japan's progress toward a liberal financial system is not complete, but the process of reform itself has generated pressures for further changes. As U.S. experience demonstrates, the freer a financial system becomes, the harder it becomes to maintain any remaining controls. So, although it remains unclear where Japan's financial reform will end, that it will continue seems almost certain.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/22/82	Change from 9/15/82	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	162,084	– 17	10,306	6.8
Loans (gross, adjusted) — total#	142,198	4	11,372	8.7
Commercial and industrial	45,600	– 163	6,316	16.1
Real estate	57,562	123	3,032	5.6
Loans to individuals	23,470	– 58	366	1.6
Securities loans	2,751	209	1,217	79.3
U.S. Treasury securities*	6,543	– 13	818	14.3
Other securities*	13,343	– 8	– 1,884	– 12.4
Demand deposits — total#	38,842	–3,314	38	0.1
Demand deposits — adjusted	27,454	– 452	545	2.0
Savings deposits — total	30,991	– 433	1,616	5.5
Time deposits — total#	100,313	1,271	14,835	17.4
Individuals, part. & corp.	90,369	1,178	13,013	16.8
(Large negotiable CD's)	37,929	919	4,011	11.8

Weekly Averages of Daily Figures	Week ended 9/22/82	Week ended 9/15/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	81	100	58
Borrowings	10	142	53
Net free reserves (+)/Net borrowed(–)	71	– 42	5

* Excludes trading account securities.
\# Includes items not shown separately.

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