FRBSF Weekly Letter

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A Tale of Two Financial Reforms

The U.S. and Japan are both in the process of changing the structure of their financial institutions and markets. In the U.S. the process is referred to as "deregulation", while in Japan the appropriate term is "financial liberalization." Other countries also are undergoing financial reform, but the U.S. and Japan deserve special attention because they are the two largest economies in the free world in terms of the level of their Gross Domestic Products and because there exist important relationships between their economies and the rest of the world in the conduct of international trade and finance.

Financial systems prior to current reforms

The U.S. and Japanese financial systems both before and during the current reform efforts differ in terms of the structure of markets and institutions, the extent of open securities markets, the extent of government-supplied credit in the total flow of intermediation finance, and the structure and objectives of financial regulation. Yet despite these differences, both systems shared a common characteristic prior to the current financial reform period.

In both systems, a variety of regulations restricted the portfolio choices of institutions and other market participants, imposed interest rate ceilings on deposits and loans, and attempted to allocate credit by explicit and implicit controls. In Japan's case, financial regulations also restricted international capital movements and isolated the domestic financial system from international forces. These restrictions limited competition and the role of market forces in transferring funds between lenders and borrowers.

Among the differences between the two systems, two stand out. First, financial regulation in Japan restricted market forces to a greater extent than in the U.S. For example, almost all interest rates in Japan were regulated whereas in the U.S., interest rate restrictions applied only to deposits and selected types of lending.

Second, financial regulation in each country did not always share the same set of objectives. In the U.S., much of the financial regulation emerged from the Great Depression period and was designed to limit what were perceived at the time to be unsound banking practices thought to encourage the adoption of risky loan and investment strategies. In the view of many analysts, the effect of these restrictions was to limit competition and the influence of market forces. In addition, regulation was also used as an instrument to encourage a greater flow of credit into housing in the hope of making homeownership possible for all American households. In Japan, financial regulation was designed to encourage industrialization, export-led economic growth, international isolation of domestic finance, and a high household savings rate.

During much of the post-WW II period, both financial systems appeared to function in a satisfactory manner and accommodated rapid economic growth. Starting in the late 1960s and early 1970s, however, the economic environment changed in each country and rendered existing financial arrangements inefficient. The basic problem emerged from a conflict between a financial structure that limited flexibility and a changing economic environment that demanded greater flexibility. The new environment was characterized by oil-price shocks, inflation, high and unstable interest rates, changes in established flow of funds patterns, advances in computer and telecommunications technology, and a shift from a fixed to a floating exchange rate system.

In response, both the market system and the regulators in the U.S. and Japan embarked on a process of reform designed to give market forces more freedom in allocating funds between lenders and borrowers. The private market in the two countries played an important role in this process by innovating to circumvent the more binding constraints, thereby pressuring the regulators to change the structure of the system and often indicating the type of financial reform that would most benefit the public. (The reader may want to refer to two previous *Letters* on the U.S., March 22, 1985, and Japan, May 10, 1985, for background information.)

Catalyst for financial reform

In the U.S., financial reform emerged as a result of the conflict between the existing structure of fi-

nancial regulation and the failure to contain inflationary pressures during the 1970s and especially after 1978. Overly expansionary monetary policy combined with oil and other commodity price shocks during the 1970s produced successively more serious bursts of inflation as the decade progressed. Interest rates increased to historically high levels as a result and made much of the existing financial regulation, especially Regulation Q deposit ceilings, increasingly burdensome. At the same time, high and volatile interest rates exposed depository institutions, especially thrifts, to new and unexpected risks that had not been present in the low-inflation period.

By the late 1970s, the Federal Reserve had recognized the need to restrain monetary growth to bring inflation under control. Its task, however, was complicated by the growth of money market mutual funds and the new financial instruments and services introduced by depository institutions to circumvent binding regulation. These tensions in the monetary sector of the economy constituted the catalyst for financial reform in the U.S.

In Japan, the situation was quite different. The primary catalyst for financial reform emerged in the "real" sector of the economy. The sudden end of fast economic growth in 1973 with the first oil-price shocks and the effect this had on the market for credit were the principal causes. In particular, the public sector began to run large deficits after 1975. The ensuing large volume of government debt caused mounting market resistance to the policy of requiring financial institutions to absorb the debt at below-market yields. As a result, the government was forced to make a number of concessions and, increasingly, government debt practices came to reflect market forces.

At the same time, Japanese banks became advocates of new powers to restore their market share in the financial system lost when corporations—which had relied almost exclusively on banks for funding—began to borrow less than before. In addition, corporations urged that new types of financial assets be created to provide them with profit opportunities to replace those lost because of slower economic growth. Similarly, households, which continued to provide a large volume of savings, no longer were willing to invest those savings in a limited set of financial assets at below-market regulated interest rates. Unlike the past, fast real income growth no longer compensated for the limited choice of financial assets and services.

Process of financial reform

There are three differences between U.S. and Japanese regulatory responses to the forces of financial reform. First, Japan's financial regulation is defined and enforced by administrative decree rather than by explicit law or the codification of regulations as is characteristic of U.S. financial regulation. As such, Japan has not embodied its reforms in major legislative actions such as the U.S. Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982. Japan's reform process is administratively directed and conducted by the Ministry of Finance and the Bank of Japan. As a result, it is much more difficult for an outside observer to determine the content of the reforms compared to the situation in the U.S.

Second, significant regulatory reforms often occur only in a crisis environment where there is a pressing and obvious need for change. A review of U.S. financial history suggests that this is especially true in this country. The two most significant periods of reform in the U.S., the 1930s and the 1980s, followed a period of crisis in the financial and monetary structure. This crisis-reaction scenario does not easily fit Japan's case. The one major instance of intense incompatibility between the structure of financial regulation and the economic environment in Japan, caused by the high inflation rate of 1973–74, was overcome by slower monetary growth. In the absence of a crisis environment, Japanese liberalization has proceeded in a more continuous and less dynamic form than U.S. reform. It has allowed Japan to adopt a gradual approach that would be difficult to achieve in the U.S. environment.

The third difference between the U.S. and Japanese processes of regulatory change concerns how the regulatory structure itself influences the type of regulation, the type of regulator response to pressures, and the degree of market-regulator inter-

action. The U.S. scene is characterized by a multiplicity of regulators at the federal level and a dualistic regulatory structure in which depository institutions operate under either a state or national charter. These characteristics widen the range for financial innovation as market participants "shop" for the most favorable set of regulations.

Japan does not possess a multiplicity of regulators nor does it possess a dualistic regulatory structure. Its more unified regulatory structure and its cultural emphasis on group behavior make it less likely that market participants in Japan would be willing to create financial assets and services that circumvent the intent of regulation. One might say that the market participant in the U.S. assumes an action is permissible if it is not explicitly prohibited by legislation, whereas the Japanese market participant assumes the action is not permitted unless administratively authorized.

Constraints on reform

Reforms that expose the system to new competitive forces threaten established groups that have benefited from past regulations. Both Japan and the U.S. face resistance to financial reform, but from different groups.

In the U.S., the social commitment to encourage mortgage lending has been weakened by deregulation but not broken. Although adjustable rate mortgages are now common and thrifts have been given powers to diversify to enable them to become less dependent on mortgages, maintaining a large flow of funds into housing remains an important policy objective. Current regulations for thrifts, for example, restrict the amount of nonmortgage loans they can hold in their portfolios, and tax breaks provide a strong disincentive to diversify away from real estate lending. Continuing such credit allocation policies interferes with the deregulation efforts aimed at establishing a more efficient, adaptable, and stable financial system.

In Japan, the large role of government financial institutions in the lending and borrowing market constrains the move toward a liberated system. In 1982, government financial institutions provided 29.2 percent of the total flow of funds to final borrowers, and this involvement had been steadily increasing throughout the 1970s. The increase in government intermediation has been primarily the result of the rapid growth of the Postal Savings System (PSS) in Japan, one of the world's largest financial institutions by any standard. In 1983, PSS deposits represented over 30 percent of total household deposits in Japan. Favorable regulation and tax treatment of interest income earned from PSS deposits compared to other depository institutions account for their rapid growth. The pressure to maintain favorable treatment is strong since the Ministry of Finance is the recipient of PSS funds for lending operations conducted through its Trust Fund Bureau, a large number of entities depend on funds from the Trust Fund Bureau, and the PSS has a network of almost 23,000 post offices throughout Japan that render the system politically powerful.

Conclusion

The U.S. and Japan share a unique historical, cultural, and economic relationship, and they play an important role in the world economy. Both countries are restructuring their financial institutions and markets to provide their financial systems with the flexibility needed to adapt to the economic environment of the 1980s. Their experiences differ as to the catalysts for reform, the process of reform, and the constraints on reform. However, both reform processes seem to be converging on a new financial system that is more flexible and more open to market forces.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 05/01/85	Change from 04/24/85	Change from 05/02/84 Dollar	Change from 05/02/84 Percent[7]
Loans, Leases and Investments[1] [2]	190,767	1,186	10,748	5.9
Loans and Leases[1] [6]	172,648	991	12,048	7.5
Commercial and Industrial	52,166	184	3,182	6.4
Real estate	62,854	39	2,812	4.6
Loans to Individuals	33,927	160	6,264	22.6
Leases	5,370	20	356	7.1
U.S. Treasury and Agency Securities[2]	11,181	176	– 886	– 7.3
Other Securities[2]	6,938	20	– 413	– 5.6
Total Deposits	195,979	2,743	8,568	4.5
Demand Deposits	48,020	3,954	2,241	4.8
Demand Deposits Adjusted[3]	29,897	– 251	787	2.7
Other Transaction Balances[4]	13,199	– 384	936	7.6
Total Non-Transaction Balances[6]	134,760	– 827	5,391	4.1
Money Market Deposit Accounts—Total	42,866	– 444	3,558	9.0
Time Deposits in Amounts of $100,000 or more	38,235	– 464	– 228	– 0.5
Other Liabilities for Borrowed Money[5]	23,361	407	1,552	7.1

Two Week Averages of Daily Figures	Period ended 04/22/85	Period ended 04/08/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	88	– 32
Borrowings	24	123
Net free reserves (+)/Net borrowed(–)	64	– 155

[1] Includes loss reserves, unearned income, excludes interbank loans
[2] Excludes trading account securities
[3] Excludes U.S. government and depository institution deposits and cash items
[4] ATS, NOW, Super NOW and savings accounts with telephone transfers
[5] Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
[6] Includes items not shown separately
[7] Annualized percent change