1996.10.7
(No.2, 1996)

IIMA
Institute for International Monetary Affairs
Newsletter
財団法人国際通貨研究所

The Changing Financial Markets and the Future Prospects of Japanese Banks

Toyoo Gyohten
President, IIMA

To consider the issues of today's Japanese financial sector, we must first have a full grasp of what is going on in the financial industry and markets around the world. The changes that have been taking place globally can be summed up in four major points: First, over the past decade and a half, the world's economy, including its financial markets, has become much more integrated; one may truly say it has become "borderless". No longer does each country have its own distinct financial markets and sets of relationships. Second, deregulation of finance has progressed dramatically around the world. Within Japan too, financial regulations have been relaxed or eliminated since the 1980s. The driving force behind this has been market globalization. Third, the volume of funds flowing around the world has grown to immense proportions. Fourth, information technology has made tremendous strides. Computers have gained hugely in capacity, and telecommunications have also advanced with the use of satellites, optical fiber, and other new tools and techniques.

The progress in information technology has produced a succession of new financial services and products, "derivatives" being a prime example. Furthermore, thanks to the strides in communications, the new products, technologies, and services that have emerged have been able to spread with lightning speed around the world.

For a while the Japanese financial industry and its regulators made assiduous efforts of their own to keep up with the changes going on elsewhere. In 1980 the government totally revised the Foreign Exchange and Foreign Trade Control Law, and the following year it amended the Banking Law. And in 1984 the "real demand" rule for forward transactions was removed, part of a set of moves to relax and simplify the regulations applying to foreign exchange. But efforts like these

slackened in the latter part of the decade as the country entered what we now call the "bubble" years.

During the bubble years in Japan, the volume of funds expanded at an extremely rapid pace. Lending by banks grew almost 12% a year. Assets like real estate and stocks ballooned in value, and they served as collateral for the provision of additional liquidity. Interest rates were low, and it became extremely cheap to raise funds. Meanwhile, in the wake of the 1985 Plaza Accord among the major industrial nations, the value of the yen was soaring. The combination of a strong currency and low domestic interest rates made it possible for Japanese financial institutions to wield tremendous clout overseas. At one point Japanese banks accounted for a full quarter of the total assets of banks in London, and Japanese institutions were responsible for 20% of the corporate lending in New York.

As an unfortunate result of the bubble economy, however, the Japanese became lax in their efforts to cope with the developments in global finance.

Then, starting in 1990, the inevitable happened: the bubbles burst. No longer could borrowers raise funds at virtually no cost by putting up real estate as collateral. With stock prices plunging, equity funding was also out. Banks, saddled with a growing volume of loans gone sour, were not in a position to lend. Under these conditions, the international presence of the Japanese financial institutions rapidly contracted.

Since the image of a financial superpower that emerged in the bubble years was just a facade, its collapse was a perfectly natural development. After the bubbles burst, Japan's financial sector found itself back where it had been in the early 1980s. There is no point lamenting the loss of transient glory; what is unfortunate, though, is that at least 10 years-including the period of shock after the fall-were wasted. The Japanese economy, including the financial sector, took a long, extremely costly detour.

While Japan was marking time, others-the United States and some European countries in particular-were making huge strides in reforming their financial industries and markets. In America's case, events starting with the Latin American debt crises of the early 1980s ended the go-go years for lenders well before the Japanese bubbles burst. And from the late 1980s through the beginning of the 1990s, the U.S. economy stagnated, causing financial institutions great pains. These developments served as the impetus for them to make serious efforts at change. They worked to improve their balance sheets, upgrading the quality of their assets by getting rid of nonperforming items, and to strengthen their capital bases. They also ventured beyond their traditional areas of business, actively developing new products and new markets, notably in such fields as derivatives. In addition they cut jobs, sold off unprofitable operations, and carried out mergers. In these and other ways they strove valiantly to streamline their businesses and lower their break-even points.

When Japan's financial institutions snapped out of their post-bubble daze, they found themselves stuck with huge volumes of loans gone bad. They were in a greatly weakened state, and meanwhile their international competitors had been making considerable progress. It is useless to cry over spilt milk, but one can certainly say that the lost years of the bubble period and its

aftermath have cost Japan's financial sector dearly.

What, then, is to be done now? The answer is relatively clear. The first item on the agenda is to correct the deterioration of balance sheets. This means sweeping away bad loans without a day's unnecessary delay. Capital positions must be strengthened also. In other words, Japan's institutions must go through the same process that their leading Western counterparts completed several years ago. Unfortunately, the Japanese banks carry a heavy burden of luggage from the past.

The prime example is the convoy system of regulation. For one thing, it has kept Japanese financial institutions from experiencing true competition.

While it was in effect, interest rate controls guaranteed banks a profitable spread between deposit costs and loan income. The only rivalry among them was in terms of size, and so all they needed to do was work at expansion.

Their profits were a function of the volume of their business, not of efforts to improve efficiency. Furthermore, in practical terms they had no competition with non-Japanese institutions either.

Second, convoy regulation meant a lack of transparency. The system was designed so that no bank would fail. Under these circumstances there was no need for institutions to reveal the contents of their affairs to external rating agencies, nor was there any need for individual depositors to have such information.

The implicit guarantee provided by the Ministry of Finance and Bank of Japan was in a sense a tremendous plus for Japanese banks, and even now some favor this traditional arrangement. But it is clear that it greatly limits transparency. Transparency has not been present either in institutional operations or in financial administration-nor, in fact, has it seemed to be necessary.

A third byproduct of the convoy system is the damper it placed on the development of new products and services. Closely regulated institutions had no incentive to compete in this area, and even if they felt like doing so, the regulatory environment did not permit them to. All the ships in the financial convoy were supposed to move together; none was allowed to slip out of formation. In practice, if one bank tried to do something new, all the others would gang up on it, and MOF would join them in bringing the renegade back into line. Under these conditions, innovation was impossible.

These are the three biggest minuses produced by the convoy system. And their effects continue to be strongly felt, making it quite hard for Japanese institutions to catch up with their international rivals.

Now that the framework for financial business has become so nearly borderless, the industries and institutions in this business face fundamentally the same set of issues throughout the world. One common development is deregulation, which has resulted in a blurring of the lines between traditionally distinct sectors, such as commercial banking, investment banking, the securities business, trust banking, insurance, and the investment advisory business.

The barriers between these types of business are being lowered to respond better to clients'

needs. They do not care whether the medium for fund raising is loans, bonds, or stocks as long as they can get the best possible terms. This creates a demand for institutions that can offer all types of services. Hence the "universal bank"-one of the models for today's financial institutions.

Another important perspective is that of globalization. A single major corporation may operate in Japan, Europe, North America, Southeast Asia, and elsewhere. Since it produces and sells goods wherever it is most profitable to do so, it may be said to have no national allegiance.

That is not to say that every bank should aim to be universal in scope and global in reach; this is clearly not a practical objective for all of them in view of such constraints as fund volume, human resources, expertise, and know-how. Over the next decade or two, institutions around the world will have to appraise their survival strategies accurately-and implement them successfully. Some will of course manage to go both universal and global.

But many others will not and, indeed, cannot go this way.

One alternative course is to become a "boutique" bank, specializing in a particular field and winning a high reputation in it. Possible areas of specialization include investment banking, private banking for wealthy individuals, and retail banking. Institutions may be able to survive by concentrating their resources in a particular field like this rather than spreading them around too thinly. Another alternative is to focus on the home country or region, building up a solid base of clients as a regional bank.

It would be dangerous, in my view, for Japan's financial institutions to continue to pursue the same dreams they had when the country was being called a financial superpower. Japanese banks may be able to recover to the point where they can pursue the course of universalization and globalization. But the fact is that it will be significantly harder for them to achieve this than for their Western competitors.

During the past 10 years, when Japan was wasting time on its bubble-induced detour, the top American and European banks have captured almost all the key positions. The United States holds overwhelming superiority now in the information industry, including its financial product development aspects. Others have no choice but to adopt the U.S. standards.

This is a disadvantage that the Japanese face as latecomers. Another disadvantage is Japan's corporate culture, which acts as a barrier to globalization. To be truly global, a bank must reach around the world not just in the provision of services, crucial as that is, but also in its hiring and fund-raising operations. Raising funds globally means listing shares in New York and London, as well as in Tokyo. But doing so creates requirements for further disclosure and presupposes healthy figures for return on equity and return on assets, not to mention a good credit rating.

Hiring globally also presents considerable challenges for the Japanese institution. Japanese banks do of course hire local staff for their overseas branches and subsidiaries, but they are way behind their Western counterparts when it comes to placing locals in charge. Japanese corporations in general are highly centralized, and even foreign operations are kept under control from headquarters. Probably the world's most globalized bank today is Citibank. It operates in nearly 100

countries, and in almost all of them a local person is in the top position. Japanese banks would be hard pressed to imitate this performance. The traditional practices of lifetime employment and seniority-based pay and promotion stand in the way.

Despite carrying much of the same load of baggage as Japanese banks, Japanese manufacturers have in some cases made significant progress toward true globalization. But they have the advantage that their products speak for themselves, at least to a certain extent, lessening the need for verbal communication. This obviously is not true of financial services, which, like most other services, boil down in the end to person-to-person relationships, where words hold the key to success or failure.

Japan's financial institutions must accept the fact that, unless they change themselves significantly, they cannot hope to compete on an equal footing with the world's top banks.

(C)1996 Institute for International Monetary Affairs （財団法人国際通貨研究所）

All rights reserved. Except for brief quotations embodied in articles and reviews, no part of this publication may be reproduced in any form or by no means, including photocopy, without permission from the Institute for International Monetary Affairs.

本文の一部または全部を著作権法の定める範囲を超えて、無断で複写、複製、転載することを禁じます。