A Monologue on Japan's Financial Markets

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I have been invited to present to you a kind of "verbal essay" on some of the many issues Japan faces in its financial and securities markets today. I am delighted to have this opportunity.

Before I begin my talk, I first would like to tell you of a personal connection I have with Columbia University.

I graduated from college in Japan in 1946, the year after the Second World War ended. I joined Daiwa Securities in that same year. In 1951, I passed the examination for a Fulbright Scholarship for overseas studies. The site for my studies was to be Columbia University.

To my great disappointment, however, shortly before I was to depart for the United States, I became quite ill. As a result, I never got the chance to study at Columbia after all.

Who would have thought that I would be standing here forty years later, at this university from which I might have graduated, speaking to all of you about Japan's financial markets?! I am truly pleased and honored, and would like to express my
sincere gratitude to Professor Hamao for kindly arranging this opportunity for me.

My presentation today is entitled "A Monologue..." which necessarily means that I will be the only one speaking. But rather than approaching this as though I were speaking in front of a large group of people, (which I am!), I would prefer to talk to you as though I were talking to myself about these issues alone in my study. Because of this, my remarks may not always strictly follow the rules of order of poetic composition!

First of all, I would like to talk a bit about Daiwa Securities. I know some of you are probably not that familiar with it. Daiwa Securities was founded 90 years ago. It is the second largest securities company in Japan. It is capitalized at $1.138 billion, of which $528 million is paid-in capital, based on the number of shares outstanding. Our company has $1.22 billion in statutory reserves, and $5.12 billion in voluntary reserves. In other words, Daiwa has a total of between $6.34 and $6.35 billion in retained earnings.

Daiwa Securities employees roughly 10,000 people in some 130 offices in Japan and 30 offices overseas. We have offices in New York, Chicago, London, and Paris, among many other places. Daiwa has traditionally been very strong in international business. There are currently more than 130 foreign companies listed
on the Tokyo Stock Exchange, of which about half are American. Daiwa has assisted 30 of those American companies gain listing on the Exchange, acting as the lead manager or sponsoring securities company for them. We have helped such well-known as IBM, Citicorp, and ITT, companies which are at the forefront of American business.

We at Daiwa are also very proud to have introduced several innovative products to the international capital markets. One such product was the Asian dollar bond which Daiwa Securities first introduced in Singapore some 20 years ago. 15 years ago, Daiwa created the first Euroyen bond issue in the Euro currency markets. Most recently, Daiwa designed the first yen bond in Asia, the Asian yen bond. As you can see, our company has a long tradition of many "pioneer" type activities in the international capital markets.

I think it is particularly timely to be talking about corporate business performance at Columbia Business School. There is currently much restructuring going on in Japan. First, I would like to remind you of Daiwa's hearty retained earnings which I mentioned earlier, which are characteristic of Japanese securities companies. In that connection, I would also like to describe the nature of some of the restructuring measures we are taking during these recessionary times.

Even though we must streamline to some degree due to the current climate, four
or five out of any ten rationalization, or streamlining, measures we take are in the form of forward looking investment aimed at positioning for the future. This custom is not Daiwa's alone. Most companies in Japan operate in this way. Great emphasis is placed on determining how much advance investment should be made in recessionary times in order to be strongly positioned when circumstances improve. It is also very important to invest with an eye toward the more distant future. For this reason, we at Daiwa are extremely busy even during periods of slow, or no economic growth. Perhaps we would make a good subject for a case study!

Daiwa is not a manufacturer, or "maker." Therefore, our company's biggest investment for the future is made by educating our human resources. We have virtually no budgetary controls in this area, which I think demonstrates its importance to us. Earlier, I mentioned that Daiwa has some $6.34 billion in retained earnings. Our strong position today is a result of lessons we learned back in 1965, during the so-called "securities recession" in Japan. What we learned from that experience was this: it is impossible to avoid a recession altogether. But it is also extremely important to strengthen one's powers to withstand it. That lesson helped us greatly enhance our financial situation. As individuals, we save money for times of illness or other unplanned events. In the same way, we learned very well during the 1965 securities recession that, as a company, we need to put savings away for emergencies. In other words, we learned about the need for
reserves. Thanks to that experience, our reserves are where they are today.

Another important element is rigorous inventory control. Looking back, I am convinced that poor inventory management was a primary cause of the securities recession in 1965. Because we understood this point, we began and ended the recent "boom" era under a policy of strict inventory management. As a result, we suffered almost no losses from holding large positions in securities.

But what have we learned from the recent collapse of the so-called "bubble" in Japan? First of all, over the next 10, 15, or 20 years, we must realize that if there are peaks, there will also be valleys. This is simply part of the business cycle. We must look carefully and humbly at the lessons to be learned from this bubble phenomenon. Then we must incorporate our findings into our current and future business methods.

Here, I would like to tell you a little story by way of illustration. Back in 1968, I was in New York on a business trip and happened to be involved in an auto accident. I broke my left leg. I was taken to Roosevelt Hospital on West 59th Street, where I underwent emergency surgery. The doctors told me that I had a compound fracture.

Shortly after I entered the hospital, an elderly man moved into the room next to
mine. He was very kind to me in many ways. It seems he had been the manager of a circus which traveled around the United States. Soon after arriving, he appeared in my room, asking all kinds of questions like, "Do you have enough money?" "Can you pay the hospital bills? This Roosevelt hospital is a very expensive hospital, you know." He helped me find a nurse. He arranged for a chamber pot. He even said that, if I didn't have enough money, he would negotiate with the government for me so that I would be able to pay! He was very kind indeed.

I stayed in the hospital for 2 weeks, receiving medication. When it was time for me to leave, the elderly man escorted me to the entrance way. There, he told me he was having a lung operation the following week. I will never forget how kind that man was to me. At that time, we were insured with a life insurance policy during overseas business trips, but we didn't have insurance against illness or injury. I somehow managed to pay the hospital bill myself. After that, our company did get insurance which would cover accidents on business trips overseas. But at the time, I was so fortunate to have that nice old man worry about even the matter of money for me.

I was staying at the Waldorf Astoria Hotel on that business trip to New York. But ever since the auto accident, I decided not to stay in that hotel. I'm not particularly superstitious, but I'm afraid I will be reminded of the pain of my
broken leg if I stay there. So I don't!

Getting back to our subject, Japan's economy does not have a broken leg and does not need to be hospitalized, as I was. But we can at least say that Japan's economy is "under the weather" and needs some good medicine. Many things have contributed to its current condition. Just as my fracture was a compound fracture, the current "post-bubble" recession in Japan is a compound, complex recession. The name "compound recession" was coined by a famous economist, and I think it is an excellent name. There are certainly many geniuses among university professors; their forecasts are often inaccurate, but they are extremely skillful at analysis!

One of the most important lessons we have learned from this "bubble" and its collapse relates to Japanese banks. Japanese banks have been generally regarded as "strong." They used to line up on the list of the top ten banks in the world. Notice that I put this in the past tense. They were extremely strong. But after the "bubble" burst, I took an X-ray of their business and realized that Japanese banks have weak points along with their strong points! The Chinese have a saying which goes something like this, "A good safe has hidden compartments." A good businessman never piles all of his wares up in the front of the store. Instead, he keeps many goods in the warehouse. This saying means that it is better for a businessman to keep some goods in the back store room than to put all of his
goods out in the store window. I think this saying applies to Japanese banks.

Many huge numbers are batted around with regard to the amount of "hidden assets" that Japanese banks have. The point is, they don't only have holdings of stocks. They also have large amounts of land and other assets. They also own affiliated companies. As a result, it would be very difficult, if not impossible for them to write down or amortize all of their non-performing assets all at once, even if someone told them to do so. But I believe that, over a period of several years, they will be able to pare down all of them, and do so without having to borrow funds from the public.

That is one of the points of strength of Japanese banks. But they have weak points, too. Let me give you one or two examples. Unlike banks in the United States, Japanese banks are permitted to invest in common stock in their portfolios. The reason for this goes back to 1945 and the end of World War II. When the War ended, Japan's "Zaibatsu," or financial cliques, were ordered to disband. When the shares that the former Zaibatsu had held were released onto the open market, the stock market and the general investor public still had limited money to spare for investment. As a result, a large portion of the shares which had been held by the Zaibatsu were bought up by financial institutions, such as banks and life insurance companies, and by business corporations. That event began the tradition of common stock holding by Japanese banks.
In any event, nowadays, banks must comply with BIS standards and maintain a ratio of owned capital at a level above 8%. Japanese banks are able to count 45% of the market value of their stock holdings toward this requirement. Until recently, Japan's stock market had continued to rise over a period of 10 or 20 years, and this system was a plus. No one predicted the kind of decline we have just witnessed, and therefore owned capital was valuated up to the 45% level.

Until recently, this was no problem, as long as we were riding on the wave of the stock market's rise. After the "bubble" burst, however, people realized just how dangerous it was for banks to rely on their stock holdings and on this 45% valuation level of them. The mere fact that banks were dependent on 45% of the market value of the stocks they held meant that their owned capital was extremely vulnerable to fluctuations in the level of the stock market. That realization has added to the uneasiness of the situation. Previously, while the stock market was rising, nobody realized this drawback. But since the "bubble" burst four years ago, stock prices have lost more than half their value, and with them, the owned capital of Japanese banks has fallen dramatically. In some cases, it has even dipped below the 8% requirement of the BIS.

This has been one area of weakness of Japanese banks. The lesson to be learned from this is that banks must decrease their degree of reliance on their stock holdings from the current 45% level .... gradually, by degrees. The ideal level of
reliance would be zero, but in any event, there needs to be a system in which a vicious circle between stock price fluctuations and owned capital and BIS standards does not arise.

Another related point concerns the 8% BIS standard itself. Even though Japanese banks have a very strong foundation, I believe that the next step should be to raise the requirement from 8% to 10%, or even higher. We have no way of knowing when the next period of financial instability might occur, but certainly, a ratio of owned capital of 8% is not adequate. Japanese banks will need to aim for 10%, like U.S. banks, or even 12%, as in England.

Now, I would like to talk a bit about lessons we have learned, and lessons we need to learn, in the securities markets. What kinds of things should we be reflecting on?

During my career at Daiwa, I have probably spent more time in the Equity Department than in any other area, since 1961. I was the head of the Equity Department, and more recently, I was a director in charge of that area. If you look at the Who's Who directory put out by a famous Japanese newspaper, you will find that I am credited with promoting internationalization of Japan's capital markets. The directory also says that I am the one who introduced the concept of Price
Earnings Ratios, or the theory of growth stocks, to the Japanese stock market.

Back in the 1960s, the mainstream thinking in the Japanese stock market was to buy stocks based on their dividend yields rather than on analysis of their price earnings ratios. Also at that time, stocks were offered not at market value but at par value. In contrast, I argued that, although it was only natural to purchase stocks which were profitable on the basis of dividend yield, it was also time to start considering stock purchases based on potential for growth. At the time, the PER theory I advocated was somewhat contrary to the traditional emphasis on dividend yield. But I believe that the essential make up of a stock market calls for looking at various kinds of stocks; there are those which should be purchased for dividend yield, those which have growth potential, and those which are in between.

As it turns out, since the 1970s, the Japanese stock market has been placing less and less emphasis on dividend yield. Increasingly, mainstream attention is being placed on the selection of growth stocks. Japanese economic growth has been extremely high, and as a result, so has the growth of corporations. Corporations are the supporters of the growth economy in Japan. Thus, it should have been only natural that stocks with price growth potential should be preferred over stocks offering only dividend yield. But then, in the latter half of the 1970s, dividend yields on Japanese stocks plunged below international levels.
It may seem simple, but a stock market should offer a mixture of growth stocks and those with good dividend yields. From an investor's perspective, this mixture is necessary in order to build a sound portfolio. Today, the average dividend yield on shares of major Japanese corporations is less than one percent. Let's look for a moment at the stock market in the United States. Since January of this year, the Dow Jones Industrial Average has risen about 30%, while the yield is roughly 2.9%. By contrast, the rise in the Dow Jones Public Utilities Average has paled. It rose only about 1.3% over the same period. But the dividend yield offered on those utility stocks continues to be around 6.5%. In short, we can see that in the United States stock market, there is a clear distinction between yield stocks and growth stocks. But they co-exist.

In Japan, from the mid-1950s to the mid-1960s, stocks with good yields and stocks promising capital gains also co-existed in the market. With that in mind, let's think about the reason for the large number of growth stocks in the Japanese securities markets today. For one thing, I believe it indicates that there are many growth companies in Japan, reflecting both Japanese economic strength and corporate growth potential. But I also get the feeling that more stocks with good dividend yields could appear.

During the recent stock market decline, the first stocks to bottom out were those of the electric power companies. As soon as the dividend yield of electric power
shares dropped to the 2.5% level, that dividend yield acted as a safeguard mechanism and stopped the shares from falling further. This shows us that the dividend yield mentality stills lives among investors. Some of you might think that a yield of 2.5% is pretty low. But if you consider that Japan's official discount rate is now 3.25%, and also that the interest rate on time deposits is just over 3%, the 2.5% yield on electric utility shares doesn't seem so bad after all!

I cannot judge whether or not the current level of Japanese stock prices is appropriate. But I do think that patterns of business management behavior at Japanese corporations during previous recessions can be used as a good reference. Of course, companies have been trimming excess fat that they gained during recent boom times. But as I said earlier, most Japanese corporations have not cut their research and development budgets during the current economic slump.

Daiwa is no different. We are now streamlining various unprofitable areas which unfortunately emerged during the recent economic boom. But even so, we have created a medium and long-term vision. We are making a variety of advance investments with this vision in mind, particularly in terms of employee education and training. There are also areas of research and development which are appropriate for a securities company. We have not cut any forward looking investment along those lines either. These types of actions and policies are not peculiar to Daiwa Securities. Most Japanese corporations engage in this type of
behavior during recessionary times.

When Japan's economy rebounded after the Second World War, people said it was a "miracle." But after the first oil shock, Japan's economy was again thrown into chaos, which prompted some foreign critics to say that the "miracle" had ended. Nevertheless, we were able to overcome that crisis pretty impressively. People say that a miracle can only occur once. It was thus recognized that the reason that Japan's economy was able to rebound a second time was due to hard work and ability. I do not believe that Japan or Japanese companies have lost that ability to recover from recession even now. They are tremendously resilient.

As a result, I think that we will soon see that strong adaptability begin to blossom in the case of the Japanese stock market. One lesson that seems to have been learned from the decline in share prices after the bubble burst is that issuers have come to consider the value of returning profits to shareholders. A new concept is gaining wide acceptance; that is, that corporate shares are actually products constructed by a company's board of directors. Quality control of that product is the responsibility of the issuer. Also, more and more shares are being issued at market value, but there is still no system in Japan under which issuing companies can own their own shares. Such a system is currently under rush preparation in the legal system. Management thinking regarding stockholders and share prices is undergoing many dramatic changes.
After entering the current recession, we have realized just how important shareholder capital is. Or rather, we have been reminded of its importance. I believe that this realization will be a major supporting factor in the stock market. Unless stocks are of high quality, meaning unless stocks are made sufficiently attractive to investors, whether with good dividend yields or with growth potential, the stock market will not be viable. A mood is growing among issuing companies that says that stocks must be attractive to investors so that they will hold them for the long term. I believe this growing mood will support Japanese stocks and their prices. I also believe that we will soon begin to see long-term oriented buying of growth stocks, whose prices dropped along with the recent plunge in the stock market.

Here, I would like to mention one other interesting element in the Japanese financial markets. During the postwar reconstruction period, Japan relied primarily on banks for its reconstruction funds. Thus, unlike American companies, Japanese companies have long depended on indirect financing from banks. As a result, they have large amounts of money on deposit with banks, compared with American companies. For example, according to some statistics, American companies have, at any given time on average, a deposit amount equivalent to 9 days of sales proceeds. In contrast, just before the bubble burst, Japanese companies had about 50 days - worth on deposit. Some companies even had 60 days - worth. Under ordinary circumstances, Japanese companies usually have the equivalent of about
30 days - worth of sales proceeds on deposit. But with the protracted period of low interest rates in Japan, at the peak of the bubble, in which a glut of money prevailed, the liquidity of Japanese companies increased sharply, to anywhere between 50 and 70 days - worth of sales proceeds. Compared with the 9 - day equivalent of American companies, this was an enormous amount.

Recently, growth in the money supply in Japan is said to be slowing. Even so, excluding some small and medium-sized companies and marginal producers and cottage industries, most companies in Japan continue to have deposits of the equivalent of up to 30 days - worth of sales proceeds. While it might not be possible to decrease these amounts to the equivalent of U.S. levels over night, it is not enough to decrease them to 20 or 30 days-worth. In any event, as the amount of excess liquid deposits is decreased, and corporations are not in need of funds from banks, money supply in Japan will decrease somewhat, as a matter of course.

The next subject I would like to discuss is the barrier between the securities and banking industries. How will the Japanese securities markets change when the wall between these two is lowered and banks and securities companies can engage more in each other's lines of business?

After the Great Depression of 1929, the boundary between the securities and the
banking businesses in the U.S. was clearly drawn with the introduction of the Securities and Exchange Act. As I recall, the main reason that this Act was introduced was to deal with such things as insider trading abuses and conflicts of interest. I can't remember whether there was debate at the time about the danger of monopolization of financial functions by banks, or distinctions between direct and indirect financing.

In Japan, in the period before the war, the Zaibatsu were present, and at the center of the Zaibatsu were the banks. As a result, both direct and indirect financing centered around the banks. Just what were the securities companies doing at that time? I believe that they were acting as sort of sub-contracted underwriters of stocks and bonds which banks had primarily underwritten. They were also involved with the secondary distribution of these securities. The long and short of it was, both direct and indirect financing was effectively controlled by banks.

The Securities and Exchange Law, which was adopted in Japan after the War, changed that. Article 65 of that Act separated the banking and securities businesses. Japan has operated under this law until today, but now change is in the wind. Revisions of the Law are proceeding, and moves are being made to lower the barrier between banks and securities companies, thereby allowing the two to handle each other's lines of business. Nevertheless, you are probably aware of the term in Japan, "main bank." The concept of a having "main bank" is still alive and
well among Japanese corporations. This system certainly has its merits. One of the most obvious is that, if a corporate client lapses into recession, it is common practice for its "main bank" to assume responsibility and extend financial assistance.

If such "main banks" are to handle even the securities business, and thus have both direct and indirect financing in their grasp, there is a very real danger of monopoly, or oligopoly, in terms of financial functions. The consciousness of having long been a Zaibatsu bank, or having long been a member of a group and its resultant personal network, is not that easily erased.

In conclusion, from the perspective of a business corporation which issues securities in the markets, I think that it is better to have the freedom to choose between procuring funds directly from the securities markets or procuring them indirectly from bank loans. If the power that banks have over business companies becomes too strong, however, companies will lose the feeling of freedom of choice. Financial decision-making will become tilted in the direction of banks. If the past is any indicator, there was a long period during the last 30 years in which issuing companies were tightly in the grip of their "main banks" and were subject to their will and intentions.

What we are worried about is this; even though current trends would have us
lower the barrier between banks and securities companies, it is still a troublesome situation to have issuers lose their freedom of choice, as they might if both financial functions were held in one hand.

On this point, I will end my "monologue," for fear of being termed an Alzheimer's case if I go on any longer!

One final note; two years ago, I had occasion to act as a lecturer for six months at Yokohama National University. The topic was, "The Securities Business as an Industry." Recalling how painful it was to prepare the texts for each session, I would like to pay tribute to the hard work professors Hugh Patrick and Yasushi Hamao must put in everyday. I admire you both.

Thank you very much.