EXPLAINING THE JAPANESE
FINANCIAL SYSTEM: A REVIEW OF
THE BANK OF JAPAN'S RECENT VOLUME

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This is the definitive description of the Japanese banking system and more generally the Japanese financial system, prepared by the Director and staff of the Institute for Monetary and Economic Studies of the Bank of Japan, the central bank. It is essential both as an introduction and reference work to understand Japan's complex range of financial institutions, and now burgeoning variety of financial instruments and financial markets.

But this book is more that. It provides in the two rather brief chapters of Part I a succinct, analytical overview of the nature and causes of Japan's process of financial deregulation and liberalization from the early 1970's to the mid-1980's. And, following the three detailed chapters on the nuts and bolts of the financial system, the book concludes with an interesting, analytical though cautious introduction to the objectives, instruments, and avowed success of the monetary policy of the
Bank of Japan. The analytical touch of the editor, Dr. Yoshio Suzuki, a distinguished scholar of Japanese finance, is clearly in evidence.

The past always shapes the present, and that is especially true for Japan's financial system today. The analytical and the institutional starting point of this book is the postwar period prior to the early 1970's, when Japan's financial system was highly regulated and insulated from foreign financial markets and institutions. Interest rates on deposits, loans and bond issues were fixed; only a narrow range of financial instruments were allowed; the types and numbers of financial institutions were fixed and new entry of institutions, though not of branch offices, virtually prohibited; and financial markets were highly segmented, with each type of financial institution expected to stay in its own area of expertise. The city banks and the long-term credit banks were at the top of the heap. Government debt was negligible, the bond market virtually non-existent, and the stock market only a minor source of corporate funds.

To finance their very rapid growth, businesses borrowed from banks in huge amounts (termed "indirect finance"). Excess funds in local financial institutions were transferred to city banks through interbank call loans; the Bank of Japan provided the necessary expansion of credit to support non-inflationary growth by loans to city banks (there were no government securities to
use for open market operations). Markets were important, but segmented, and credit rationing was used in combination with interest rates (prices) to allocate the funds corporations eagerly sought. It was a cozy, tightly controlled, highly effective system that benefited borrowers over savers, business over consumers, big business over small. There were, of course, various ways to ameliorate the obvious rigidities and non-market clearing features of the system, such as required compensating deposit balances on loans to increase effective interest rates and tax exemption of interest of small deposits (the maruyu system abolished April 1, 1988). Nonetheless, by and large, the system worked quite well in the era of extremely rapid economic growth between 1955 and 1973; given the well established financial structure, the burgeoning demand for investment funds, and the equally rapid growth in savings channelled through the financial system such success is not surprising.

The central theme of this book is how, to what degree, and why this previously highly regulated system has broken down, where it is now, and where it is likely to go. The basic story is one of gradual but accumulatively massive liberalization, deregulation, and integration among domestic financial markets, from an inflexible to a free market-determined system for pricing and allocating funds. While the process has been incremental, for many, frustratingly slow, and still not completed -- there was no "big bang" as in London recently nor a massive surge of
deregulation as in the United States at the beginning of the 1980's -- it has resulted in a major transformation of the rules, modes of operation, activities of financial institutions, expansion of types of financial assets and liabilities, and a virtual explosion of financial activities as measured by daily transactions and total amounts outstanding.

The dominant position of big banks has been eroded by the sharp increases in new corporate bond and stock issues (direct finance), and by securities companies underwriting and trading them. They have been afflicted by disintermediation -- the shift of bank deposits, especially the large ones, to other, better-yielding financial assets. They have responded by expanding into new activities -- loans to medium and small business, foreign lending, the underwriting of securities in Europe (still not allowed in Japan under Japan's Article 65 of the Securities Act based on the U.S. Glass - Steagall Act which separates commercial banking and underwriting activities).

Financial institutions are invading each other's markets while fighting hard to maintain their own turf; market segmentation is breaking down. However, this transformation is not yet complete. Important restrictive regulations remain, such as interest ceilings financial institutions can pay on the smaller time deposits of ordinary persons or the new issue of government bonds through syndicate allocation rather than by
market auction. And the Ministry of Finance persists in refusing to issue sufficient amounts of short-term government bills (Treasury Bills or TB's) on competitive terms so that, unlike the United States and the United Kingdom, Japan lacks this financial market which provides the key short-term risk-free interest rate upon which all other money market rates are usually based.

This book chronicles these fundamental, innovative changes from the early 1970's to 1985, the terminal date for most data in the volume. That is not a serious problem though; the basic trends continue, and data can readily be updated from current Bank of Japan publications.

The chronicle takes two forms. From the viewpoint of a macroeconomist or a specialist on Japanese economy and finance, the two chapters of Part I (comprising only 61 pages) are a dream. They provide a clear, concise description and analysis, backed by excellent data in tables and text, which lay out the major financial trends of 1970-1985 in historical perspective, and carefully discuss the major forces making for deregulation since 1975. The non-specialist may find it somewhat heavy going, especially Chapter 1, since a great deal of substance is presented in fairly concentrated doses. But the material is well worth the effort - and is well presented in literary and tabular, not mathematical, form.
The macroeconomic changes in savings, investment, and hence flows of funds are traced for the personal, corporate business, government and foreign sectors. One key point is that while the share of private saving in GNP has decreased since 1975 that of private investment has declined even more. The financial system has been awash in surplus savings for more than a decade. Almost all financial institutions have had more funds than their traditional lending activities required. Between 1975-80 these surplus savings were absorbed by large and expanding government deficit spending financed by government bond issues, and from 1981 to the present by large lending to the rest of the world (especially the United States) based on merchandise export and current account surpluses.

As chapter 2 discusses, the now substantial government debt outstanding together with ongoing new issues, the rise of corporate and individual holders of large surplus funds, the opportunities for lending and borrowing abroad, and technological innovations in communications and payments systems, all created market pressures and powerful domestic (and foreign) interests which virtually forced deregulation upon the Ministry of Finance and the Bank of Japan. Probably the single most important factor was the government's need to sell huge amounts of bonds to finance its deficit spending, and the development of active trading of already-issued bonds in freely competitive markets.
While this liberalization process is generally beneficial it does increase risk for financial institutions individually and for the financial system as a whole, as is nicely if tersely treated (pp. 50-57).

Part II is the nuts and bolts primer, comprising some five-sixths of the book. Its four chapters - on financial assets, financial markets and interest rates, financial institutions and the Bank of Japan and monetary policy - are descriptive, factual, rich in institutional detail, and accordingly very informative. They make this an essential reference work. However, Part II is not issue or problem oriented. While the very real change and growth that has occurred is documented it is done so rather dryly, without emphasizing the very real turbulence of the process. In general, the chapters focus on the banking system, particularly the city and regional banks ("ordinary banks"), with relatively little attention to the securities companies and capital markets. This is not surprising, given traditional central bank responsibilities for maintenance of the banking system and the operation of monetary policy through it.

Chapter Three ("Financial Assets"), as its title indicates, provides a useful description of the characteristics of the various types of financial assets from the perspective of individual or corporate asset holders as of early 1986: the various kinds of deposits, trust accounts, government and
corporate bonds, corporate shares, mortgage securities, and insurance contracts. Where appropriate special tax treatment provisions are noted, such as the maruyu interest exemption, the securities transactions tax, withholding of income taxes on interest or capital gains and the special tax benefits for corporations of special purpose trust accounts (popularly called tokkin) and pension trusts. This chapter tells you as much as you ordinarily need to know about the characteristics of different types of financial assets. For example, this is the place to go if you want to know what a gensaki short-term instrument and transaction is, the three types of gensaki, who participates in the gensaki market, and so on.

Of course, this discussion is not designed to provide the reader specific guidance as to what financial assets to hold. That depends on the particular mix of yield, safety, maturity, liquidity and other specific attributes desired by an asset holder. It also depends on the amount of funds available since, for example, all but quite large deposits (from the perspective of the average individual) continue to be subject to regulated interest rate ceilings.

The chapter begins with a useful classification of financial assets according to function (for transactions or investment purposes), certainty of return (safe versus risky), whether the interest rates on particular assets are regulated by the monetary
authorities or market determined, whether the financial asset can be sold (such as deposits versus bonds), and whether the asset is a liability of a financial institution (indirect finance) or shares or bonds issued by a non-financial business corporation (direct finance). The classification of specific financial assets and their characteristics is by no means static, especially since financial innovation has developed so many new financial instruments and new ones are being created all the time. The deregulation process has been gradually moving down from large denomination financial instruments ("wholesale markets") to smaller units ("retail markets" for ordinary individuals). The presentation includes a clear explanation of the narrow and broad definitions of money and measures of money supply. One nice touch: in what is a rather dry, straight-forward presentation, the authors refer to and explain a number of popular phrases such "wide" coupon bank debentures, "jumbo" government bond investment trusts, "big" loan trusts, and "hit" money trusts (marketed as a big hit among potential customers).

Chapter 4 ("Financial Markets and Interest Rates") is key to understanding Japan's financial system. The short-term money market, the foreign exchange market, and the securities market are described: their size, evolution, who the players are, how trading is carried out, collateral requirements, tax treatment. Not surprisingly, most attention is given to the money market, since the Bank of Japan participates actively in the interbank
call and bills markets to influence those short-term interest rates, which normally quickly spread to the free, competitive open market for *gensaki*, negotiable certificates of deposit (CD's) bankers acceptances (BA's), Euro-yen deposits, large unit time deposits and, since November 1987, commercial paper (CP).

The explanation of the various mechanisms of interest rate determination is central to the story of Japan's liberalization (and non-liberalization) process. Interest rates are the price for holding or issuing financial assets. When interest rates are determined by the interaction of demand and supply in competitive markets they provide information as to how participants in the economy evaluate riskiness of different kinds of assets, the trade-off between the present and the future, expectations about future rates of inflation, and, in now internationally linked financial markets, expectations about exchange rate movements.

Japan has three categories of interest rates: the official discount rate set by the Bank of Japan as the basic policy rate; rates regulated by law or agreement, notably those on bank and postal saving deposits, the short-term and long-term prime rate of banks, and the rate for government and other new bond issues; and the market-determined "free" rates for many short-term financial instruments (*gensaki*, BA's, CD's, Euro-yen deposits, large denomination time deposits, CP), and the yields on bonds (and stocks) already issued and being traded. The rate
setting arrangements for bank deposits and loans and separately for postal savings are clearly described.

The co-existence of regulated and market-determined interest rates and yields on financial assets which are reasonable close substitutes for each other is inconsistent and ultimately untenable. Indeed, this is the most important force driving deregulation in Japan and elsewhere. Once holders of large amounts of short-term surplus cash could freely invest in gensaki instruments, then it was inevitable that banks would insist on the right to issue competitive, large denomination certificates of deposit and time deposits. The development of other types of financial assets and movement into less large denominations has been an ongoing process.

There are, not surprisingly, other regulatory constraints which create artificial gaps between highly substitutable financial assets. These create opportunities for profitable arbitrage as loopholes are found. I gather, as a recent example, regional banks have been subject to guidance by the monetary authorities limiting their holdings of large-denomination city bank time deposits. Several top ranking trading and other companies can now freely issue commercial paper. One would expect their interest rates not to be lower than those on bank competitive time deposits since risk and maturity are comparable. That, in fact, such rates have been lower, suggests they are
engaging in arbitrage, selling their commercial paper to regional banks, buying city bank time deposits, and earning the spread. This sort of anomaly forces further deregulation and liberalization.

But one should not infer that such pressures make complete liberalization inevitable in the foreseeable future. As the authors dryly point out, the lack of an effective Treasury Bill (TB) market impedes the ready use of open market operations as an instrument of monetary policy; but there seems to be little inclination by the Ministry of Finance to create a highly liquid, large-sized TB market. And the Ministry of Posts and Telecommunications, which controls postal savings and postal life insurance rates, is likely to remain unresponsive to the desires of both the Ministry of Finance and the Bank of Japan.

The detailed, straightforward description of Japan's types of financial institutions (Chapter 5) comprises almost one-third of the book. Figure 5.1 (pp. 166-67) provides an excellent overview, including the system of classification which serves as the basis for organizing the subsequent discussion of each category of financial institution. The first division is between private and governmental financial institutions; the former predominate in numbers and in funds involved. Private institutions are classified into three categories: banks, (depository institutions) broadly defined; other financial
intermediaries, for insurance, housing finance, consumer finance, securities finance, and venture capital; and other financial institutions, namely securities companies and the six interbank money market dealers. For each type of financial institution the discussion proceeds, in more or less detail, from overview to operations to their assets, liabilities, and income and expenditure. It is all necessary, if almost inevitably mundane and dry, material.

Japan has many types of financial institutions that can accept current deposits and accordingly are technically classified as banks. These include: city banks, regional banks, foreign banks, long-term credit banks, trust banks, sogo banks, and a large number of small credit institutions for small business, agriculture, forestry, fishing and labor organizations and their regional and national peak institutions. In practice, and certainly in the thinking of the Bank of Japan, the core of the banking system, and indeed perhaps the entire financial system, has long been the city and regional banks (termed "ordinary banks"). The treatment of their activities is the most detailed, including their now huge amounts of foreign currency loans and borrowings, their role in underwriting, selling and trading government bonds, and their underwriting of corporate securities in the Euro-currency markets. There is, however, no discussion of bank hidden reserves in the form of undervalued securities holdings, or of loan portfolio problems of poorly
performing loans to certain developing countries and certain domestic industries.

This chapter briefly treats the various government financial institutions, and provides a nice if terse delineation of the Government's Fiscal Investment and Loan Program (FILP). In essence, the government pools postal savings and life insurance funds and national welfare and pension funds, and provides them (as loans, bond purchase, or capital subscription) to local governments, public corporate bodies, and government financial institutions. Almost two-thirds of the FILP funds are eventually relented to the private sector, mainly for housing and small business. Overall the share of total private business industrial funding is modest but non-trivial (5.8 percent overall but 19.2 percent of plant and equipment financing in 1984).

Postal savings in Japan are huge, having grown substantially more rapidly over the past twenty years than bank time deposits so that they now are about equal to the total deposit balances held by individuals in all banks (p. 290). They are an immense source of relatively cheap funds for the government, to finance both the FILP program and its own bond issues. Much to the dismay of the Ministry of Finance, the Bank of Japan, and the private financial institutions, the Ministry of Posts and Telecommunications (MPT) has considerable control over setting postal saving interest rates and even over how the postal life
insurance funds are invested. The authors stress that the effectiveness of monetary policy is undermined when two separate authorities can set ceiling rates on time deposits, and quietly press for a unified system under the monetary authorities. The role of postal savings and the power of the MPT is fascinating, but that is another book. The recent elimination of tax exemption on interest earnings (maruyu) makes postal savings somewhat less attractive; and in the longer run postal savings, like small-scale bank time deposits, will have to compete with the attractive new financial products the Ministry of Finance reluctantly allows the securities companies, life insurance companies, trust banks and others to create.

Several general themes emerge from the welter of institutional description in Chapter 5. First, the formal structure of Japan's financial system has been very stable, by category and even by number of financial institutions in major categories. While there have been some mergers, essentially there have been no new domestic entrants. The only new entrants have been foreign -- banks, securities companies, and trust banks. Their market shares remain small. Second, over time major shifts in funding and power have taken place among institutions in different categories, muchless within each category. These include: the rise in postal savings; the increasing fund surplus of specialized agriculture and small business institutions; and especially the surge of securities
companies, notably the Big Four, to the forefront of financial transactions and profits. Third, with increasing freedom of activities, financial institutions are expanding beyond their traditional markets, invading each other's turf previously protected by the regulatory authorities. Market segmentation and traditional niches continually erode.

The final chapter - on the nature and functions of the Bank of Japan as central bank - contains a nice, clear, general explanation of the objectives and implementation of monetary policy. As in other countries the fundamental objectives of monetary policy are domestic price stability, economic growth, equilibrium in the balance of payments and prevention of financial crisis ("maintenance of orderly credit conditions"). On occasion, the first three objectives are in conflict in Japan as elsewhere, and the terms of the trade-offs and the choices made indicate relative priorities of nations, as their historical episodes of monetary policy inform us.

The Bank of Japan has the standard array of central bank policy tools: the official discount rate, loans to financial institutions, reserve requirements against bank deposits, and some limited capacity for open market operations though seriously constrained by the lack of a true Treasury Bill market. It also uses "window guidance" -- quantitative limits on quarterly increases in loans for each financial institutions of any size to
reinforce periods of monetary tightness — though now mainly as a supplementary tool.

A major issue for all central banks is whether to make their prime policy target interest rates or money supply. Since the mid-1970's the Bank of Japan has made broadly defined money (M₂ +CD's) its intermediate policy objective. It publishes quarterly "forecasts" which turn out, in practice, to be remarkable close to realized results. The Bank of Japan controls the money supply by influencing the short-term call and bill market interest rates (interbank market) through its own buying and selling operations and, allegedly, by moral suasion on the six intermediary dealers. Some foreigners have complained that, unlike the U.S. Federal Funds market which clears instantaneously by interest rate (price) movements, from time to time the interbank market dries up when the interest rate is not competitive. The view of the Bank of Japan as reflected in this text and other writings is that money supply targeting has been rather successful in implementing monetary policy (the right hand scale on Figure 6.1, page 317 is incorrect, I believe, in showing faster monetary growth than in fact occurred), though, ongoing financial innovation in Japan and in Euro-yen poses measurement and control difficulties.

Japan's policy process of financial liberalization, still underway, has been very Japanese: quite controlled, slow
(especially in the perceptions of foreigners), but consistent in its liberalizing trend, and almost inexorable in the widespread acceptance of the inevitability of change - at some time in the near or less near future. It is a process primarily under the jurisdiction of the Ministry of Finance, not the Bank of Japan. The Ministry of Finance has had to pursue a delicate political balancing act. Any specific piece of liberalization benefits some financial institutions, often by taking away previous privileges (rents in the economic jargon) from others; they in turn have to be compensated by some other beneficial liberalization. Because there are many conflicting vested interests at stake, the negotiations are complex and the process piecemeal. The political economy of the process of Japanese financial liberalization is a study yet to be published (but see Frances Rosenbluth, *The Politics of Japan's Financial Deregulation*, Cornell University Press, forthcoming).

This book excellently achieves its objectives. It provides an authoritative, detailed, quite up-to-date description of Japan's financial system. As such, it is the definitive study, an essential reference work. It also provides a good, clear exposition and analysis of Japan's process of financial deregulation, liberalization, innovation, and internationalization over the past fifteen years.
At the same time, one has to be clear what the book does not do, and should not be expected to do. As essentially an official central bank document, it takes the high road in tone and content. Its style is straightforward and rather dry (in both Japanese and Western meanings). There is no place here for the rich dissection of specific cases of tumultuous conflict, of gossipy, insightful anecdotes, of the jockeying for power and benefit by different institutions and personalities. All that is properly the domain of private writers.

The authors do not back away from several important controversial issues, notable the lack of a Treasury Bills market, the incompatibility of independence of postal savings for monetary policy, the need to complete the process of deregulation of interest rates so that, in part at least, the benefits accrue to small depositors as well as large. On the whole, nonetheless, they do not tackle in any substantial way a number of important issues for Japan's banking system. Given the nature of the book that is appropriate; but it does not mean such issues do not exist. With deregulation and greater competition, how can banks be prevented from excessive risk-taking? (How about problems of moral hazard since the Bank of Japan's safety net apparently is so strong?) What will be an appropriate system of prudential regulation to protect depositors and the system itself? Should commercial banks be allowed to engage in domestic underwriting and other activities heretofore reserved for securities
companies, and vice versa (should Article 65 be repealed)?

Many of today's financial issues involve Japan's stock and bond markets, both new issues and trading: favored access to new issues, high fixed commissions, insider information. However, the capital markets and the securities companies receive only cursory treatment in this book. That is not surprising; after all they lie under the jurisdiction of the Ministry of Finance not the Bank of Japan.

Nor is this book intended to be a detailed history and analysis of Japan's recent monetary policy, and the strains to which it has been put in the efforts simultaneously to stimulate domestic demand-based real growth, prevent inflation, stabilize the exchange rate, and contain the exuberant rise in asset prices, notably Tokyo land and corporate shares listed on the stock exchanges.

Nonetheless, as the definitive description in English on the Japanese financial system, the book does provide the structural skeleton and much substantive meat of institutional description. The data are readily updated from standard Bank of Japan sources. It certainly is the place to start, and for many purposes, provides as much information as may be needed, more detailed, technical analyses appear regularly in the Bank of Japan Institute's journal, *Monetary and Economic Studies*. Other useful
studies in English emanate from time to time from the research departments of several Japanese and foreign banks and securities companies (investment banks), as well as specialist financial newsletters. Useful descriptions of specific markets and institutions are available in the series of forty pamphlets being prepared under the aegis of the Foundation for Advanced Information and Research (FAIR, Japan) titled "FAIR Fact Series, Japan's Financial Markets." Aron Viner's *Inside Japanese Financial Markets* (Homewood, Illinois: Dow Jones - Irwin, 1988) is a readable and informative book, particularly on Japan's stock markets and securities companies. And the Japanese vernacular literature, especially newspapers and magazines, provide tremendous amounts of current information, insight, gossip, rumors.

One final small point. For those used to the American numerical system, it should be noted that the British system is used throughout the test. That is, Y milliard equals Y 1,000 million (U.S. billion), and Ybn. equals Y million million (U.S. trillion). In only a few instances is the American system used (e.g. Figure 5.2). In practice in almost all tables yen measurements are in units of 100 million.