Japan's "Super" Big Bang: Hashimoto's Make-or-Break Gamble

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I realize there is great skepticism whenever Japanese declare they are about to implement reform. But I am convinced this time reform is for real. In order for Japanese to get serious about reform, we must see it as being in our own interest, and we now do.

Why Reform is Needed

Reform is needed because we have failed to stimulate the Japanese economy through traditional remedies which rely on fiscal and monetary policies. Meanwhile, Britain and the United States, which have pushed deregulation since the early 1980s, have regained economic vitality. The slump in Japan and the boom in Britain and the United States have prompted Japanese to think seriously about deregulation and, more generally, structural reform.

Let me cite some of the problems that we see in our economy today and believe need fixing. First, deterioration of the national budget has reached crisis proportions. People still think Japan manages a healthy budget, but in fact our accumulated national debt, including that of local public bodies, will have grown almost as large at the country's GDP (500 trillion yen) by the end of fiscal year 1996.

Second, demographic factors, particularly the aging of the Japanese population, are putting additional pressure on the national budget. Higher growth would make it easier for the Japanese economy to absorb large budget deficits. But high growth is a thing of the past, and the Japanese population is rapidly aging as families become smaller and the rate of population growth declines. According to the Economic Planning Agency, 4.2 people of working age (between 20 and 64 years) support one elderly person today, but by the year 2020, there will be only 2.1 working people supporting each elderly person.

Third, excessive regulation written and administered by bureaucrats is hampering economic activity across the board. An additional problem with bureaucratic rules and decisions is that they are made by rigidly compartmentalized government agencies. Even decisions made within the same ministry are sometimes contradictory, as well as cumbersome and stifling. This compartmentalization is one major reason why fiscal measures to reflate the economy do not work.

Fourth, Japan has been slow to adapt to the globalization of economy and business. With globalization, cross-border movement of goods and services has increased vastly. The explosion of cross-border transactions in information — and, along with it, capital — has been particularly astounding. Given the development of communications technology, Japan can never again close off its borders as it did during the Tokugawa era. Instead, we will have to adopt global business standards and practices, notably in accounting and taxation. The Japanese government, too, must change, making its regulations more transparent and comprehensible to non-Japanese.

Fifth, the Japanese government's economic policy has put the interests of manufacturers and suppliers first, neglecting the interests of consumers. This, too, must change. After the Meiji Restoration and in the post-World War II period, we strived to catch up with the West economically. In doing so, we have tended to give precedence to producer-supplier interests at the expense of consumers.

<u>Reform Timetable</u>

Last summer, Prime Minister Hashimoto announced his intention to implement reforms in five broad areas: the bureaucracy, the national budget, economic structure, financial industry, and social welfare. Hashimoto added another area of reform in December — the educational system.

So we now have six major reforms planned. Many committees are making recommendations to the government, and a great number of bills are in the Diet's legislative pipeline. In the area of financial industry reform alone, there are three bills awaiting enactment over the next month or so. These bills concern reform of the Bank of Japan, Ministry of Finance, and foreign exchange controls.

A proposal for another crucial reform —the reorganization of government bureaucracy— will be submitted by the advisory committee on administrative reform to the cabinet by the end of November. The nature of this proposal is not yet known but will probably reflect the views of the committee deputy chairman, a former LDP Diet member, Mr. Mizuno.

Mizuno's idea is to define five key roles of government and then decide which government agency will play these roles, rather than starting out with the agencies. The five government roles are: ensuring the continued existence of the nation; increasing national wealth; providing for the livelihood of the citizens; promoting education and culture; and overseeing those who govern. In this scheme, for example, roles now played by the Ministry of Finance will be divided into two agencies. The budgetary function will go to the new Treasury Ministry, while supervision of financial and capital markets will be taken up by the new Ministry of Economy and Industry, which will absorb what is now MITI, part of the Ministry of Post, and others.

"Big Bang" Reform of the Financial Industry

Prime Minister Hashimoto has stated that without a much-improved financial system, Japan's economic growth cannot be sustained. He stressed that since we face an aging society, we need efficient markets which provide better returns for the 1,200 trillion yen worth of financial assets held by private Japanese individuals. Hashimoto has said further that he aims to revitalize the Japanese financial market and make it as advanced as the New York and London markets by the year 2001.

Reform of the financial industry has two objectives. One is system reform and the other is disposition of bad loans. Regarding the bad loan problem, the Japanese government claims that the worst is over, and I basically agree. According to the Ministry of Finance, problem loans held by the entire Japanese banking sector amounted to 29 trillion yen at the end of last September, down from 34 trillion yen at the end of March, 1996. This drop resulted mainly from the write-off of banks' bad loans to *jusen* (or housing loan companies), the Japanese version of the Resolution Trust Corporation.

The total amount of special write-off reserves held by the banking sector was 9.9 trillion yen in September, 1996. If these special reserves are indeed applied and if, in addition, banks can capitalize collateral of about 12 trillion yen against bad loans, 7 trillion yen in bad loans will remain. On the other side, the sum of operating profits (averaging 6 trillion yen over the last five years), unrealized capital gains (23.5 trillion yen), and reserves excluding those for special write-off (2.6 trillion yen), the total of 32 trillion yen can be considered a comfortable buffer. Recent movement in the Japanese property market is another positive factor because most bad loans are connected with the property market.

As to the other objective of system reform, Prime Minister Hashimoto announced three principles: the Tokyo market should be free, fair and global. "Free" means that the Tokyo market will be open to new players, with an expanded line of business for various types of financial institutions, deregulated brokerage commissions, liberalized cross-boarder transactions, and an improved system of managing assets, such as pension and mutual funds. "Fair" means improving the transparency of rules, promoting greater disclosure, and strengthening policing and enforcement against wrong-doing. "Global" means changing laws, regulations and practices to match accepted international norms, and coordinating further with supervising agencies of other countries, such as members of the G-7.

How will this system reform proceed? We will not have a clear picture until summer, when various committees are expected to come up with specific proposals for revising the current relevant laws, including the banking law and securities exchange law. But revision of one law relating to the financial system is imminent. The bill amending the Foreign Exchange Control Act is to be presented to the Diet within the month. I focus on this piece of legislation because it comes before the others and will have truly far-reaching consequences.

Revision of the Foreign Exchange Law

A while ago, Mr. Sakakibara, Director General of the Ministry of Finance's International Finance Bureau, told me of his determination to revise the foreign exchange law. After the law is revised, the Ministry of Finance will no longer have the power to say "yes" or "no" to private institutions seeking to engage in various offshore transactions. This is because, under the new law, no Ministry of Finance permission will be required for such transactions except in cases involving countries subject to economic sanctions, and in cases in which international agreements are violated. He further explained that at least two sections within his bureau will cease operation. What surprised me was that Sakakibara, head of the most powerful government agency in Japan, intended to surrender that agency's privileges and reduce its size.

Under the current foreign exchange law, only designated banks have the right to deal in foreign currency exchange. The revision will change this. Further, private Japanese are now not permitted to hold a bank account or a brokerage account outside Japan. Under the new law, any Japanese person can open such an account. Mr. Sakakibara added that if the foreign exchange law is revised, other laws — including the one which governs foreign securities companies — will also have to be revised. This last law restricts Japanese entities, other than financial institutions, from opening accounts with securities companies outside Japan. When this law is relaxed, private Japanese investors will be able to invest even in U.S. mutual funds.

Implications of the New Foreign Exchange Law

Amendment of the foreign exchange law will have far-reaching consequences worthy of the name "Big Bang." I will mention five of these. First, it will remove some of the firewalls dividing the various types of financial business, and will give more discretion to the managers of financial institutions. Division of labor among financial institutions has been clear-cut in Japan, perhaps even more than in the case of the United States. The banking sector is divided into ordinary commercial banks, long-term credit banks, and trust banks, for example. Institutions in each sector are licensed and controlled under separate laws. The privilege of dealing in foreign exchange is in the hands of banks licensed under the Foreign Exchange Control Act. The revised foreign exchange law will revoke various special rights given to institutions.

Second, intensified competition from foreign financial institutions following relaxation of foreign exchange controls will put extra pressure on inefficient domestic institutions. Until now, the "convoy system," under which fast and efficient ships traveled at the speed of the slowest and most inefficient ship, has protected the weaker institutions. The "convoy" is also a splendid system for efficient institutions because they can keep excess profits accruing to them without appearing to be anti-social. But just as Japanese resort hotels face serious competition from hotels in Hawaii and Guam as a result of freer foreign travel, relaxation of exchange controls will bring more foreign competition to the Japanese financial industry. Unless domestic institutions produce better products, individual investors will take their money to foreign institutions. Under these circumstances, the more efficient domestic financial institutions will no longer want to travel with the slower ships in the "convoy" for fear that they will lose business to foreign competitors. New competition should bring an end to the "convoy system."

Third, the system of fixed brokerage commissions will be deregulated so that Japanese markets can compete with markets overseas. Japanese securities houses still depend heavily on fixed commission revenue which accounts for as much as 50 percent of total revenue even among the Big Four firms. Therefore, in exchange for the liberalization of commissions, securities companies will ask the Ministry of Finance to give them freedom to trade in a greater variety of financial products. Under the current Securities Exchange Law, Japanese securities companies are only allowed to deal in "negotiable securities" as defined and listed in that law and are prohibited from dealing in other financial instruments. This has been extremely constricting and stifling, given that modern financial markets are creating an unending stream of new financial products. Incredibly, Japanese securities companies spent more than three years before they were able to obtain permission from the Ministry of Finance to handle asset-backed securities. This was not only because of the long-standing rivalry between securities companies and banks, but also because of issues concerning non-banks which fall under the jurisdiction of a different ministry. The power struggle between the Ministry of Finance and the Ministry of International Trade and Industry caused this long delay.

Fourth, revision of the foreign exchange law will put pressure on Japanese to harmonize their tax rules with prevailing international practice. For example, the Japanese transaction tax, charged at 0.21 percent for stocks and 0.03 percent for bonds, will raise a total of 380 billion yen for the Ministry of Finance in the fiscal year 1997 budget. This burden is certainly a handicap for the Tokyo market and is very likely to be abolished, albeit only after the frugal Ministry of Finance finds a way to make up for the revenue loss of 380 billion yen, either by reforming the overall assets-related tax system or by raising the withholding tax rate. So changes in the tax system will become necessary. The point here is that liberalization of foreign exchange controls will have to be followed by changes even in the tax system.

Fifth, deregulation in foreign exchange dealing as well as other areas will give the private sector greater responsibility. In the past, regulations introduced by the authorities provided an excuse for the private sector not to make difficult decisions by itself. But as deregulation advances, companies and individuals have greater freedom, and responsibility, to act. They will have to make up their own minds, weighing the rewards against the risks.

Why This Is A “Super” Big Bang

Why believe the Hashimoto government will succeed in the “Big Bang”? Is Hashimoto strong enough to deliver on his promises? I, for one, believe that Hashimoto is indeed strong and that he will deliver. The January 11th London *Economist* carried an article titled “Changing Japan.” Commenting on the proposed “Big Bang,” the writer pointed out that “Japanese politicians have been saying this sort of thing for years,” and asked, “what is different now?” The writer went on to answer his own question: “The short answer is that this time there is more than waffle.” I agree with the *Economist*. Under the new electoral system in which single constituencies are more prevalent, the interests of business groups and bureaucrats are less likely to be put ahead of the public interest, and parties’ campaign promises have taken on new meaning. Moreover, financial reform is what the public is looking for today.

Why is reform of the financial industry spearheading Hashimoto’s grand scheme? I can think of several reasons, none very flattering to the industry. First, the financial industry is regarded as, and indeed is, one of the most heavily protected and regulated in Japan. Second, due partly to various recent scandals, the financial industry is among the least popular and least likely to receive public sympathy. Third, the industry has fallen far behind foreign competitors, and the public is demanding better service from their bankers and brokers. Fourth, to revitalize the Japanese economy, restoring confidence in the financial industry is absolutely crucial.

So the Hashimoto government is serious. But change of law and bureaucratic system will not be sufficient to make a success of financial industry reform. Reform must be executed within each financial institution. Before closing my presentation, I would like to share with you my conversation with Dr. Michael von Krem, who was Chairman of Credit Suisse First Boston (CSFB) in London back in the mid-1980s.

Von Krem told me then that CSFB had won the competition against British merchant banks and was now targeting Japanese houses in Tokyo. He said that as an American house, CSFB had four major assets: capital, human resources, computer technology, and open-space offices. On capital, he pointed out that Japanese firms also were well-capitalized. "CSFB and the Japanese are even on this point," he said. On human resources, von Krem said that while British merchant banks had well-educated Oxford or Cambridge University graduates, an American firm like his utilized broader-based talent than the British. His number-one sales person was a Filipino woman and the number-two was a Chinese. A European came in only in third place. So von Krem felt that Japanese are similar to the British in mobilizing their human resources and that CFSB would therefore "get a point" in this area.

Von Krem boasted that Americans were the pioneers in applying computer technology to finance and that he would thus gain another point at our expense. Finally, he pointed out that CSFB took full advantage of open-space offices in the most modern building in the city. Offices of the old British merchant banks had more pillars and walls that separated one office from another. In von Krem's open-space offices, his currency traders, for example, could easily follow movements of bond traders, equity traders, and commodities traders. This was unthinkable at British merchant banks.

Interestingly, he pointed out that although Japanese have open-space offices like some Americans, legal restrictions prevent them from taking advantage of such offices. Japanese securities companies are not permitted to deal in foreign exchange or commodities, for example. "We will win three points and have one even. You will lose," he said. Unfortunately von Krem was right. We lost.

This is the reason why I support Hashimoto's drastic reform agenda. Fortunately we still have huge financial assets held by Japanese individuals which are not being properly managed on their behalf. Almost 60 percent of these funds are still in savings accounts with banks and post offices. If we introduce better products, we will be able to enrich the Japanese public. We have not only world-standard manufacturing enterprises such as Sony and Toyota, but also a great number of small- and medium-sized enterprises which need capital, and perhaps we can service them better. If those of us who work in the financial industry succeed in our reforms, we will be able to revitalize Japanese industry and enrich Japanese workers. But time is limited, and we must finish our reform before the Japanese people get old.