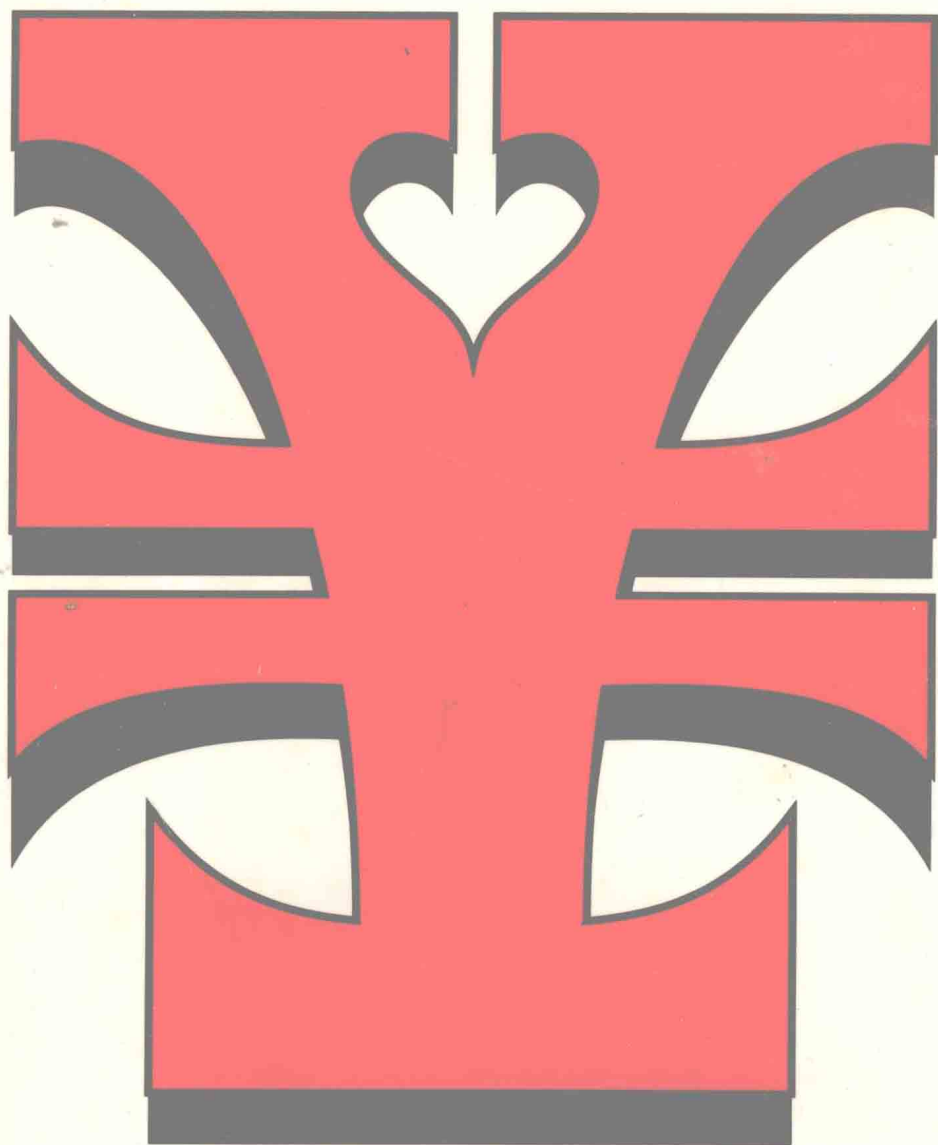


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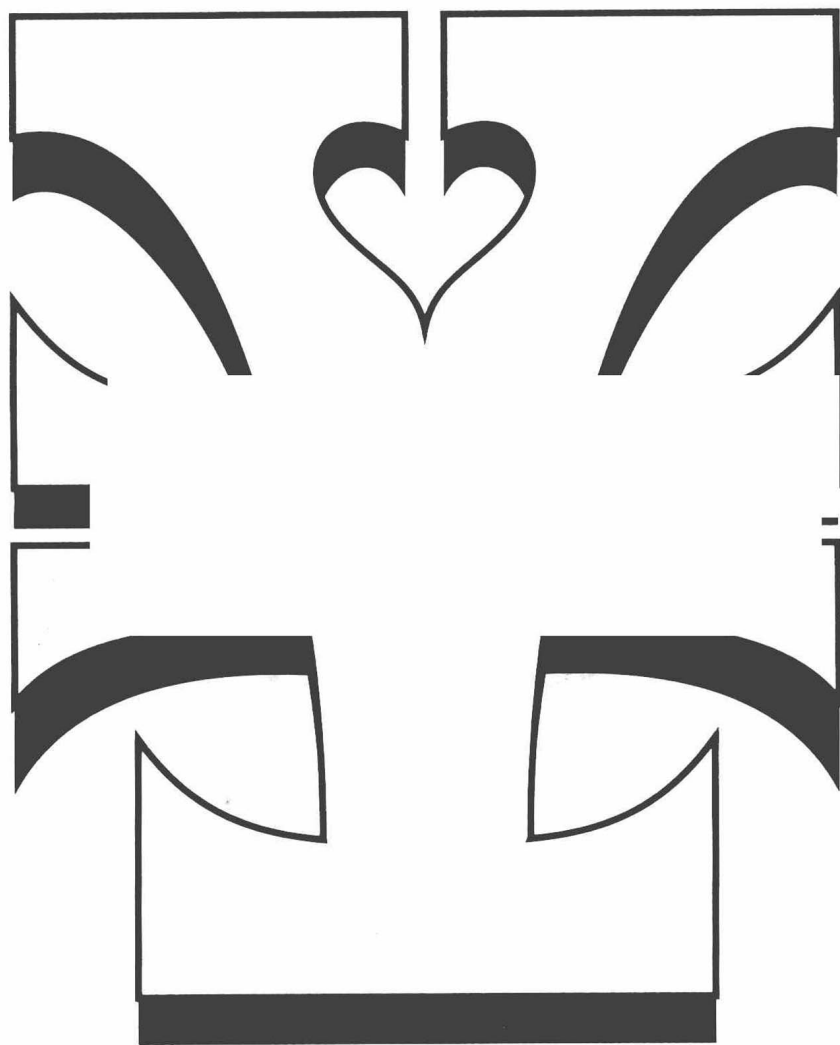
Aron Viner



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This book is dedicated to

Hiroshi Katsuta

who during a career spanning 40 years

has tried to bridge the gap between East and West.

*Although he may disapprove of my lack of tact and disagree with my opinions,
he encouraged my interest in Japanese financial markets*

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Aron Viner

Preface

On a cool spring day in 1986, a wrecking crew completed the job of destroying the century old Tokyo Stock Exchange building. Meanwhile, on an adjacent site, a larger more modern stock exchange building had been open for trading since June 1985. The construction of a new Stock Exchange building and the dismantling of the old one a year later, provide an apt symbol of the destruction and creation taking place in all of Japan's financial markets.

Of course, in Japan, as elsewhere in the world, the new relentlessly replaces the old. However, institutions and the regulations which protect them are usually slower to change in Tokyo than in New York or London.

In November 1983, under direct pressure from the US Treasury Department, the 'Working group of the Japan-US Yen-Dollar Committee' was created. At the Bank of Japan, the joint committee was termed, without humour, the 'arrival of the American "black ships"', a reference to Commodore Perry's use of force as a means of pressuring Japan to open its markets to international trade.

Commodore Perry arrived in Japan in the mid-nineteenth century and used a style of gunboat diplomacy characteristic of his era. The threat implicit in a demonstration of superior fire power precipitated a period of modernisation and industrialisation of dazzling speed. During the Meiji Restoration (1868–1912) feudal bureaucrats of the warrior (samurai) class became bankers and industrialists. A government which in 1865 still collected its taxes in the form of rice, had no navy, and a standing army with few guns won a war against Russia in 1905.

The 'black ships' of 1853, like their namesake, are triggering a transformation. These changes, which in their own way are as remarkable and as sweeping as those which occurred under the Emperor Meiji, are altering the character of Japan's financial sector. The ramifications extend far beyond the narrow purview of bankers and brokers.

In 1985, while the USA became a debtor nation, Japan became the world's largest creditor. According to a leading country credit rating survey,¹ in 1986 Japan replaced the USA as the number one sovereign risk in the world. Yet at the time of writing the yen is not an international currency and derivative securities have no place in Japan's financial sector.

¹ *Institutional Investor*, 1986.

Japan is catching up during the late 1980s – a period in which global financial markets adjust to new patterns in the flow of funds. Twenty-four hour securities trading, made possible by international financial marketplaces in North America (New York), Europe (London) and eventually Asia (Tokyo), will lead to a standardisation of products and procedures. It is only a matter of time before Japan's adeptness at creating and marketing leading edge international financial instruments will replicate its manufacturing prowess. Japanese financial products will some day rival in competitiveness those of Europe and North America.

Japanese financial institutions, despite their emerging international role, are still the product of a uniquely Japanese social structure and culture. An understanding of Japan's financial markets requires some sensitivity to attitudes and perspectives which may diverge from prevalent views in the West. The historical imperatives which shaped Japanese banking and securities markets are present today in a web of regulations. Japan is, and will continue to be for quite some time, the most tightly regulated and compartmentalised economy in the free world.

Despite the vast size of the Japanese financial sector, little information has been available in any language other than Japanese. The limited materials which are written in English are often inaccessible. There has been a growing number of securities analysts, based permanently in Tokyo, writing about Japanese investment opportunities in English. The institutional investor has been the direct recipient of their unpublished reports. Individual investors have sometimes benefited indirectly by consulting a broker with access to such reports or by purchasing a mutual fund heavily oriented towards Japanese security investment. These reports cannot usually be purchased because they are available to large institutional clients on a 'soft dollar' basis. Similarly, comprehensive information about Japanese banking and money markets has been available to professionals. A small number of densely written monographs and privately circulated memoranda have provided detailed information regarding the structure of Japanese institutions and money market instruments. Such sources are difficult to locate and difficult to read.

This book is designed to give the non-Japanese investor an easy to read overview of all Japanese financial markets. The character of the Japanese economy and the social and political imperatives which made it the most regulated in the free world are explained. In this way, the various Japanese markets are not divorced from their wider context.

Reading the book will give the investor enough information about Japanese financial markets to begin a programme of investment diversification in Japan. Although no prior knowledge of Japanese financial markets is assumed, the book is sufficiently detailed to serve as a reference for both individual and institutional investors who have invested in Japan in the past.

The book assesses the role government plays in shaping the structure and function of securities companies, banks and regulations governing the stock exchange, and shows how the interplay of these financial forces shapes the investment climate in Japan. The Japanese socio-economic

structure and value systems are examined in order to reveal how they influence Japanese investors. The psychology and behaviour of Japanese investors affects opportunities available to foreign investors, just as Japanese investment patterns increasingly are affected by foreign markets.

Aware that most North Americans and Europeans with an interest in international investment are most likely to be concerned with capital markets, particularly equities, I have given detailed attention to the securities markets and only brief coverage of the money markets and the market in foreign exchange. Foreign bankers working in Japan have their own sources of information about money markets and foreign exchange, while most non-bankers have little need – or opportunity – to participate in them.

Just as a guidebook written for the tourist points out interesting sights and puzzling rarities, I have made every effort to draw attention to the unique and sometimes enigmatic characteristics of Japan's financial markets. Greatest emphasis is, of course, given to the major attractions: the stock market, bond market and banking. Whenever possible, I have attempted to draw attention to special attitudes or approaches which distinguish the financial markets in Japan from their US or European counterparts.

Each of the chapters is written as an autonomous unit and can be read separately, without reference to the book as a whole. However, if the chapters are read in sequence they can give the reader who may have little familiarity with Japan a comprehensive survey of the Japanese financial system. Certain terms peculiar to Japanese finance are briefly explained when they first appear. A glossary of commonly used terms is provided as a reference tool.

For the reader with little exposure to Japanese financial markets who is seeking a deeper understanding and appreciation of Japanese business, there is no better way to approach the subject than through the financial market structure. Although financial markets are fundamentally similar throughout the world, each of the nation's markets wears the national costume. A comprehension and appreciation of Japan's markets can lead to an enhanced understanding of Japanese approaches to business and international finance.

Author's Note

While this book has been in the process of being published, Japan's stock markets have been growing like bamboo. The Tokyo Stock Market is now the largest in the world (in terms of capitalisation), while the Osaka Stock Market ranks third after Tokyo and New York. In just six months, the average P/E ratio for all issues listed on the first section of the Tokyo Stock Exchange has risen by nearly 50 per cent. The sharp rise in the market has been accompanied by volatility: the Nikkei stock average has been a swinging pendulum. The index broke the 25,000 barrier on June 4. Just eight days later, it flew dizzily above 26,000 before drifting into the doldrums at 23,500 one month later. Japanese real estate has paralleled the stocks with the choicest pieces of land in Tokyo costing as much as \$200,000 per square foot.

Less impressive changes have occurred in Japan's financial markets. None of these developments is surprising. Most of them are the direct result of deregulatory actions taken by the Ministry of Finance. While Japanese government bond futures contracts are being traded in London, Japan's domestic financial institutions have been allowed to deal in foreign financial futures and options markets. A fully-fledged credit rating system for Japanese companies is being applied to their issues of bonds and debentures.

The changes will continue. Before the end of this year, stock brokerage commissions will be cut yet again. In 1988, more foreign securities firms will join the stock exchanges. Stock index futures and futures contracts for US Treasury bonds will be traded on the Tokyo Stock Exchange. Shelf registration, floating rate notes and domestic commercial paper, as well as other new instruments and procedures, will be introduced. More government bonds will be sold at auction and a growing number of foreign institutions will be bidding for them.

Today, the total market value of Japan's land exceeds the value of the entire United States. Nomura Securities Company is capitalised at more than all the securities firms on Wall Street. In terms of stock market capitalisation, nine of the world's ten biggest banks are Japanese.

The rapidity with which Japanese finance has pushed its way into the headlines and the hearts and minds of the world's financial leaders is dazzling. Last year, it was reasonable to assume that the soaring stock market and astronomical Japanese real estate prices were a fragile South Sea bubble. Indeed, most investors are waiting for the bubble to pop. They may not be disappointed. However, I think that they will wait for an aeon.

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Chapter 1

Introduction

Prewar History

Before the Second World War Japanese financial markets led a marginal existence. Although a stock market had been created in 1878 (see Chapter 3), for the trading of government bonds, capital markets constituted a minuscule part of Japanese financial activities. Similarly, the short-term money markets, created in 1902 (see Chapter 8), consisted entirely of call-money transactions and did not achieve a major role in the implementation of monetary policy for quite some time. The emergence of *zaibatsu* holding companies was far more important to Japan's economic and financial development than financial market activity.

The *zaibatsu*, the world's first multinational conglomerates, were family owned bank centred holding companies. Between 1900 and 1940 they expanded through vertical integration of manufacturing and acquisition of raw materials while simultaneously diversifying horizontally into nearly all industrial and financial sectors. Most Japanese corporate equity and debt was held by *zaibatsu* members. Thus, the financial market history of prewar modern Japan (which begins with the Meiji Restoration in 1868 and concludes with the beginning of the Occupation in 1945) is largely the story of the flow of funds and goods among Japanese government institutions on the one hand and *zaibatsu* controlled entities on the other.

Postwar Evolution

In August 1946 a Securities Holding Company Liquidation Commission, created by the Occupation authorities, began the task of overseeing the dissolution of the *zaibatsu* combines, which were thought to have been closely involved with Japan's militarist and expansionist policies. Eighty-three holding companies, containing roughly 4,500 subsidiaries, were reorganised. More than 50 members of *zaibatsu* families were required to relinquish their securities holdings. By the time it was disbanded in 1951, the Holding Company Liquidation Commission had redistributed more than 200mn shares of stock with a value of ¥9.1bn. In its attempt fully to democratise Japanese industrial structure, hundreds of corporate officers

were purged and all corporate officials were prohibited from serving more than one corporation at a time.¹

After the end of the Occupation in 1952, a gradual regrouping of *zaibatsu* interests occurred. The new groupings were termed *keiretsu*, derived from the word *kei*, meaning 'faction or group', and *retsu*, meaning 'arranged in order'.² In common parlance, the term refers to the successors of the prewar *zaibatsu*. There are also, however, many types of *keiretsu* based on a variety of types of relationship. The *keiretsu* utilised interlocked cross-shareholding as a means to seal the control of group companies within the collective organisation. Thus, each company owned no more than 1–3 per cent³ of the equity in each *keiretsu* member, but the result is that the majority of corporate shares are held by member companies.

During the period of post-Occupation reconstruction (roughly 1952–60), the Japanese government deployed the nation's financial institutions as levers carefully designed to lift domestic industrial capability from rubble to full production levels. With this motivation, Japan's financial institutions were given special rights, obligations and limitations by law. Thus, for example, the Long-term Credit Bank Law (1952) established that the three credit banks would provide long-term capital to corporations. Certain industrial areas specified by the government (such as power companies and chemicals) were given privileged treatment in the allocation of funds.

During this period Japan's financial institutions were oriented exclusively towards domestic recovery. Favoured industries were nurtured and protected. Japanese international finance at the time consisted primarily of the foreign exchange dealings conducted by the Bank of Tokyo on behalf of the government and those corporations involved in the export of manufactured products. Nearly all imports (97 per cent) and the majority of exports (more than 60 per cent) were denominated in foreign currencies and the yen was not used as a reserve currency by the world's major central banks. Japan under reconstruction was a provincial nation.

The period from the 1970s

During the 1970s the market value of Japan's stock exchanges grew at a rate which paralleled the nation's remarkable economic expansion, growing from ¥25 trillion in 1971 to ¥100 trillion in 1982. At the same time, the government was forced to abandon its balanced budget policies (see Chapter 5) and issue debt to finance its deficits. For the first time in history, Japan's capital markets began to rival those of Europe in size. Meanwhile, the protected enclaves of specialised financial institutions became anachronistic. As Japan joined the leading industrial nations as a

¹ E. M. Hadley's *Antitrust in Japan* discussed the dissolution of the *zaibatsu* conglomerates and the deconcentration of monopolies in considerable detail. The interlocking of particular industries in the prewar period and their transformation during the postwar period are described thoroughly in this study.

² Hadley, 1970, p. 257.

³ In 1972 this percentage was increased further (see Chapter 3).

major world economy, the compartmentalised structure and function of the banking and securities industries was rendered unnecessary. At the same time, foreign banks and securities companies were demanding opportunities to set up operations in Tokyo with equal access to domestic sources of funds.

Thus, under combined domestic and international pressures, Japan's Ministry of Finance was forced to undertake a process of amending the financial regulatory structure. While the Japanese government wanted to limit the speed of change to the minimum, foreign governments insisted upon rapid modifications which would guarantee equal foreign access.

Elements of the financial system

The basic constituents of Japan's financial system are much the same as those of other industrialised nations. They are as follows.

1. A *commercial banking system* accepts deposits, extends loans to businesses and deals in foreign exchange.
2. *Specialised government owned financial institutions* help to fund various sectors of the domestic economy.
3. *Securities companies* provide brokerage services, underwrite corporate and government securities, and deal in the securities markets.
4. *Capital markets* offer the means for financing public and private sector debt and for selling residual corporate ownership.
5. *Money markets* offer banks a source of liquidity and provide the central bank with a tool for the implementation of monetary policy.

In 1977 the Economic Research Department of the Bank of Japan, Japan's central bank, prepared an English language brochure entitled 'The Japanese Financial System'.⁴ The book explains in four parts the structure and function of Japan's financial institutions and the financial markets in which they participate. Table 1.1 is reproduced in full from the book and today still serves as an accurate summary of Japan's financial institutional structure.⁵

In the postwar Japanese financial system upon which Table 1.1 is based, **city banks** (large commercial banks based in cities) provided short-term lending to major domestic corporations. **Regional banks** (smaller commercial banks scattered throughout Japan) took deposits and extended loans to medium- and small-size businesses. The **commercial banks** could not issue, sell or underwrite bonds. All of the commercial banks were strictly domestic institutions and engaged in little international business other than a small volume of foreign exchange trading. A special foreign exchange bank, the **Bank of Tokyo**, took care of most of the government's

⁴ Economic Research Department, Bank of Japan, Tokyo, 1978.

⁵ The numbers of institutions have changed little since 1977. For example, there are now 64 regional banks (not 63); foreign banks now number 79 (not 55); trust banks now include foreign institutions and so number 16.