Economic Recovery and Reform of Japan's Financial System

Yasuyuki Fuchita

An Economic Revival Produced by the Best of Old and New

The results of the Bank of Japan's Tankan Survey released on 1 April have combined with a buoyant stock market to raise hopes that Japan's "lost decade" may now be drawing to a close and that the Japanese economy may now have begun a new process of recovery. The reason for this optimism is that not only did the diffusion index of business confidence among major manufacturers improve for the fourth month in succession, but the figures for nonmanufacturers, while still slightly negative, were at their highest level in 12 years. Similarly, business confidence among small companies, while still negative, continues to improve after bottoming in the first quarter of 2002. In the view of some, the current economic recovery is being driven by big business while smaller companies have yet to recover from recession, but that is not supported by the actual data.

A host of explanations have been suggested for the improvement in business confidence, including the digital revolution and the strength of demand from China, but the following two points are also important.

First, the seeds of reform sown since the late 1990s have begun to bear fruit. Some of the biggest improvements in profitability have been achieved by companies that have bitten the bullet and restructured during the past few years. Driving this restructuring have been recent reforms such as the following:

1) Financial reforms aimed at encouraging (1) banks to dispose of their nonperforming loans and reduce their cross-shareholdings, and (2) both banks and their corporate clients to become more self-reliant and face up to their problems.

2) Accounting reforms aimed at encouraging companies to rely more on cash flow (i.e., income) and less on unrealized gains on their securities and property portfolios (i.e., assets).

3) Amendments to company law aimed at improving corporate governance and encouraging companies to increase their asset efficiency by making it easier for them to restructure.

Furthermore, the government has made it quite clear that it is determined to tackle the budget deficit and expects companies to become more self-reliant and less dependent on subsidies and fiscal stimuli. Moreover, the return of retail investors that has helped to drive the recent stock market rally might have been a much more faint-hearted affair had the various reforms to the country's securities markets that began with the Financial System Reform Law ("Big Bang") not been carried out.

Second, the effects of these recent reforms have been enhanced by the best of traditional Japanese management. In the United States, where managers have always been much more highly paid than in Japan and it has been common practice for greedy executives to cook the books and demand stock options, greed has had serious repercussions for the capital markets. In Japan, on the other hand, it is probably fair to say that there have been far fewer cases of this kind in major companies. Instead of seeking personal gain, managers have tended to focus their efforts to dispose of surplus plant and labor on what seemed best for the company.

Furthermore, by coordinating the work of their production, planning, development and sales departments, Japanese companies have been able to transfer some of their production back to Japan. This contrasts favorably with the situation in the United States, where outsourcing (or offshoring) has become a political issue even though the country is also enjoying an economic recovery.

However, even though the best of old and new Japan has produced a nascent economic revival, unbridled optimism would be out of place.

Violent Swings in Business Confidence Indicate Problems in the Financial System

Although the recent improvement in business confidence is based partly on fundamental improvements (e.g., in profitability), the kind of reversal that we have seen—from a situation only 12 months ago where the Nikkei 225 Average was threatening to break below 7,600 and everyone was talking about a crisis to one where the index has risen more than 50% in a short space of time and people have become increasingly optimistic—cannot be explained simply by fundamentals.

In fact, these violent swings in business confidence and share prices indicate just how serious the problems facing Japan's financial system still are.

One of the factors contributing to this reversal during the past 12 months was the decision to inject public funds into Resona Bank in May 2003. Opinion about the decision was sharply divided, with some welcoming it as a means of alleviating concern about a financial crisis and others criticizing it as an example of moral hazard. Judged purely by results, there is no doubt that, by bolstering the stock market and producing unrealized gains for banks on their equity portfolios, the decision produced a virtuous cycle where helping to ease concern about the stability of the financial system helped to bolster the stock market and boost business confidence.

An analysis of the percentage gains by different sectors since the stock market rallied from its low of 7,607.88 recorded on 28 April of last year shows that by far and away the biggest gains have been achieved by the big (seven) banks (see Figure 1). In addition, unlike other sectors, where big gains by some stocks contrast with a dismal performance by others, reflecting careful stock selection, even the worst performing bank stock achieved a gain of 112%.

Figure 1 Top Sector Gainers

Rank	Sector	Average % change (%)	Biggest gain (%)	Company	Smallest gain (%)	Company
1	Major banks	368.0	722.8	Mizuho Financial Group	112.1	Sumitomo Trust & Banking
2	Marine transportation	221.0	627.9	Inui Steamship	23.8	Nippon Yusen
3	Securities & commodities	185.6	369.6	Matsui Securities	11.9	Kobayashi Yoko
4	Real estate	170.6	540.0	Towa Real Estate Development	11.0	Toho Real Estate
5	Miscellaneous finance	137.8	858.5	Softbank Investment	1.8	Central Finance
6	Iron & steel	129.0	605.9	Nippon Yakin Kogyo	-2.8	Aichi Steel
7	Nonferrous metals	86.9	131.3	Furukawa	-14.5	S-Science
8	Construction	78.0	475.0	Haseko	-46.7	Nittoc Construction
9	Metal products	75.7	324.8	Chugokukogyo	-4.7	Sanyo Industries
10	Glass & ceramics	74.2	128.8	A&A Material	22.6	Danto

Notes:

1) We calculated the percentage change in the price of all the shares on the First Section of the Tokyo Stock Exchange from the day the Nikkei 225 Average recorded its low for last year (28 April) to 16 April of this year, then calculated the (simple) average for each sector, adjusting for stock splits.

2) Companies that have been reported as being unable to continue in business have been excluded. Similarly, where a company has transferred its shares to a holding company, only the surviving company has been included.

3) The sector "major banks" consists of the following companies: MTFG, UFJ Holdings, Resona Holdings, Mitsui Trust Holdings, SMFG, Sumitomo Trust & Banking and Mizuho Financial Group (in stock code order). The other sectors follow the TSE 33-sector classification system.

The reason for the relatively modest gain by this stock during this period is probably that the banking group concerned was highly rated by the market in the first place. What is fairly certain is that the performance of bank stocks during the past 12 months is the result neither of a spectacular improvement in their core profitability nor of the unleashing of capitalist economic forces.

Another point of interest is that some of the nonfinancial stocks that have performed well during this period are companies bedeviled by nonperforming loans. It would appear that, as the threat of drastic government action against the major banks has receded, the share prices of their debtors have rallied, boosting the share prices of the major banks, which hold these stocks in their portfolios.

What the events of the past 12 months show is just how dependent Japanese banks still are on what happens to the stock market and just how dependent the Japanese economy is on what happens to the banks' share prices.

However, the fact that the stock market and business confidence can improve so much in such a short space of time as a result of what happens to the banks' share prices also means that, should those share prices stop rising, the stock market and business confidence would immediately head in the opposite direction. By its very nature the stock market tends to fluctuate. Therefore a mechanism whereby the financial system and business confidence are no longer at the mercy of such fluctuations is badly needed.

Commercial Banks' Deposits and Bond Portfolios Continue to Grow

One of the main reasons why Japan's financial system is at the mercy of what happens to the economy and the stock market, and why the economy and the stock market are themselves at the mercy of what happens to the financial system is quite simply the fact that the banks continue to dictate the flow of money in Japan. Also, unless a start is made soon on reforming the way money flows in Japan, the economic recovery could be threatened.

Two of the main issues raised in the debate about how this should be done are reform of the country's securities markets and reform of Japan Post (i.e., the postal service, the postal savings system and the postal life insurance system). Solid progress has been achieved in reforming the country's securities markets, beginning with the publication of the report "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management" in 2001. This was followed at the end of 2002 by the inclusion in the government's tax reform program of measures to reform the taxation of securities and at the end of 2003 by proposals to allow banks and other financial institutions to act as stockbroker agents.

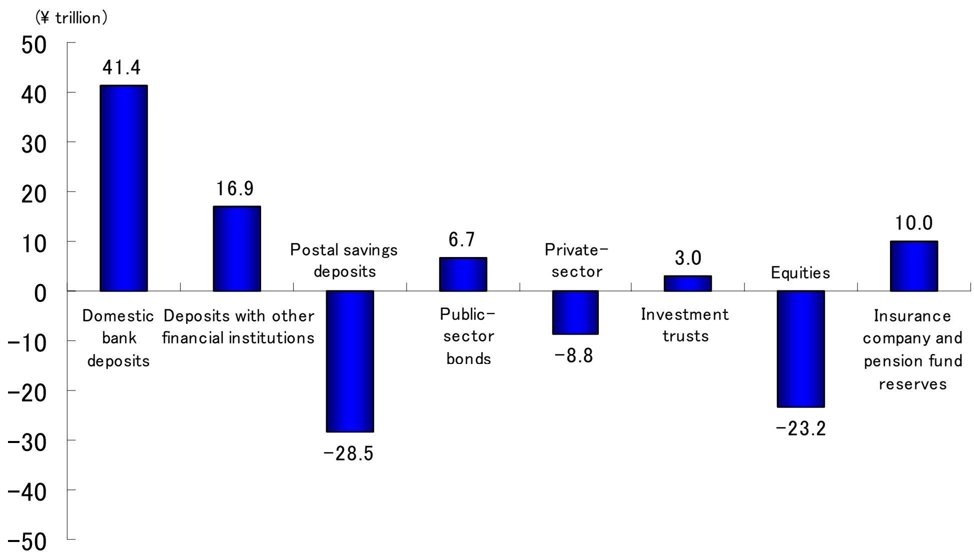
Meanwhile, the debate on reforming Japan Post is in full swing as the Council on Economic and Fiscal Policy considers whether the organization should be privatized by 2007. In April of this year a start was made on drawing up a privatization bill. Just as the postal savings and postal insurance systems will have to be rightsized if money is to flow more effectively through the Japanese economy, what happens to their massive bond portfolios is also important.

In spite of this progress in reforming the country's securities markets and Japan Post, it is important to realize that neither of these in itself can solve the problem of how to radically improve the flow of money.

As was indicated above, what is fundamentally wrong with Japan's money flow is the fact that its overdependence on bank assets tends to produce a concentration of risk in the banking system that, in turn, threatens the financial system. Indeed, this problem is now, if anything, worse than even a few years ago.

As can be seen from Figure 2, which shows the changing composition of personal financial assets in Japan during the past four years, even more of these assets are now held in the form of bank deposits while there has been a significant decline in the proportion held in the form of postal savings and equities.

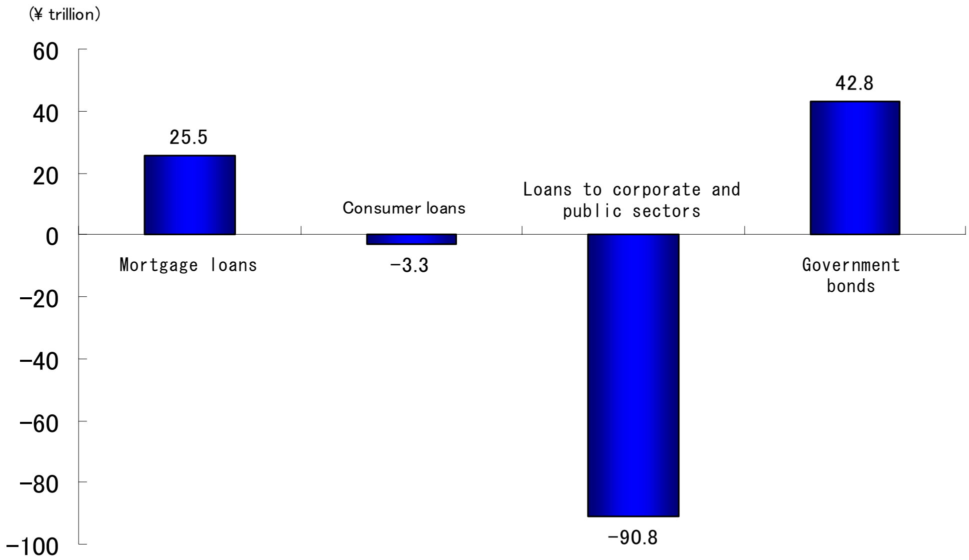
Figure 2 Composition of Personal Financial Assets (end-1999 to end-2003)



Source: Bank of Japan, "Flow of Funds Accounts."

If the banks were using this concentration of personal financial assets to support and stimulate industry, they would deserve to be commended for their positive contribution to the economy. However, as can be seen from Figure 3, bank lending to both the corporate and public sectors has declined while investment in government bonds has surged.

Figure 3 Composition of Bank Assets (end-1999 to end-2003)



Source: Bank of Japan, "Flow of Funds Accounts."

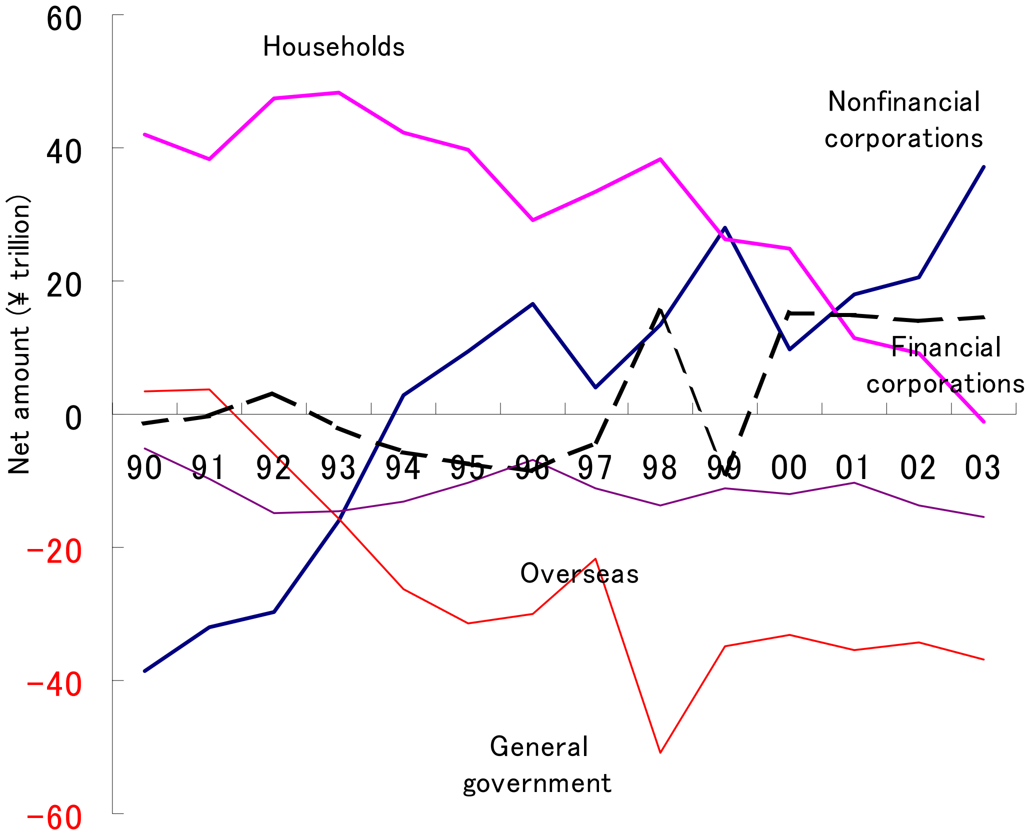
Although the unhealthy expansion of the postal savings and postal insurance systems and the surge in their bond investment have attracted the most attention, it is the surge in bank deposit taking and the investment of those deposits in government bonds that should really be a cause of concern.

Given the way in which the banks dictate the flow of money in Japan, this increase in bank deposits indicates that, far from showing any signs of fundamental improvement, the extent to which the banks are at the mercy of what happens to the economy and the extent to which the economy is at the mercy of what happens to the banks have actually increased. Moreover, the banks' growing bond portfolios threaten both to further reduce their profitability and to make them more vulnerable to interest rate risk. Similarly, the question whether the banks can continue to increase their exposure to government bonds needs to be debated in terms of its implications for government debt management.

The Changing Savings and Investment Balance, and the Role of Financial Intermediaries

As we have seen, whatever can be achieved by reforming Japan's securities markets and Japan Post, any attempt to improve the flow of money needs to focus on the nub of the problem—the banks. However, instead of simply trying to reduce the importance of bank balance sheets for the flow of money, the role of financial intermediaries needs to be considered in the light of recent changes in the savings and investment balance of each sector of the economy (see Figure 4). Two significant recent developments are the fact that the corporate sector's surplus is still growing and the fact that the household sector's surplus finally disappeared in 2003 after steadily declining.

Figure 4 Net Savings and Investment of Different Sectors



Source: Bank of Japan, "Flow of Funds Accounts."

Although capital investment has been reasonably buoyant as corporate profits have recovered, most companies have financed their capital investment from their excess cash. As a result, instead of displaying a net demand for capital, the corporate sector as a whole is still paying off its debt.

On the other hand, the disappearance of the household sector's surplus and the sector's decline into debt have been attributed to factors such as sluggish income growth and a falling savings ratio caused by an aging of population.

Although opinion is divided over whether the present savings and investment pattern will continue, a tendency can be observed in all industrialized economies for companies to use equity rather than debt financing much more than during the period of rapid economic growth. Similarly, the tendency for the savings ratio to decline as a result of an aging population appears to be a universal one.

This savings and investment pattern means that financial intermediaries are no longer expected to fulfill their traditional macroeconomic role of pooling household savings and deciding how to finance corporate investment.

This is not to say that banks will lose their *raison d'être*. However, their role as financial intermediaries will be less one of maximizing the amount of funds sourced and applied and more one of optimizing how they are sourced and applied.

In order to achieve this, they will need to allocate their funds efficiently on the basis of risk and return. This process will involve questioning whether the concentration of personal financial assets in bank deposits and the banks' increasing investment in government bonds are really the most efficient allocation of funds for the Japanese economy.

One of the reasons the banks have felt compelled to increase their investment in government bonds is the fact that they have not increased their lending. The result has been that the banks have been unable to improve the performance of their portfolios. This means that households have been investing an increasing share of their financial assets in bank deposits not because the banks have been offering them higher returns but because years of talk of "March crises" and "September crises" have made them increasingly risk-averse and appreciative of the safety and convenience of bank deposits.

Reform of the Banking System Must Form the Basis of Any Reform of the Flow of Money

The problem, however, is whether households have borne a fair share of the cost of this safety and convenience when allocating their assets. What has actually happened is that the government has postponed its deadline for removing its blanket guarantee on bank deposits while extending banks' eligibility for injections of taxpayers' money. It has given depositors a wider safety net without presenting them a bill for the cost.

The main near-term objective in reforming the flow of money in Japan should be to make the most of the current rebound in business confidence and remove the blanket guarantee on bank deposits by the April 2005 deadline. And, in order to ensure that transaction accounts do not serve as a loophole, banks should be obliged to charge customers for managing them.

In addition, banks will be failing in their duty as credit creators if they simply take deposits and invest them in government bonds: as well as continuing to strive to lend on terms that match risk and reward, they need to put more of an effort into loan securitization, investment banking, fund management and the marketing of financial products such as investment trusts.

For their part, the financial authorities should make it easier for banks that are unable to change their business models in this way or to recapitalize unaided to exit the industry rather than offer them a helping hand on the grounds that they represent a systemic risk.

The biggest challenge facing Japan's financial system this year and next is whether the authorities can deal with the nub of the money flow problem before the stock market changes direction yet again and business confidence heads in the opposite direction.