The Need for Japanese Savers to Become Investors

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2006 Starts on a Note of Both Optimism and Pessimism

At the beginning of each year there is usually considerable speculation about what the new year (and, indeed, the future) has in store. This year has been no exception. Last year saw a big improvement in both business and consumer confidence in Japan as the country's leading banks achieved their objective of halving their nonperforming loans, corporate earnings recovered and the stockmarket rally continued. Non-Japanese investors were also heartened by strong public support for the Koizumi government's reform program in September's general election. This optimism has been carried over into the new year, and the focus of attention is now on when deflation will end, when the Bank of Japan will abandon its current monetary policy and whether the economic recovery will beat the previous postwar record of 57 months (November 1965 - July 1970). Indeed, some observers are even worried about overoptimism and that the recovery in the property and stock markets could lead to another bubble.

Although the out-and-out pessimists are in a small minority, many people share deep-rooted concern over the future. Underlying this concern are not only external imponderables such as the price of oil and the economic outlook for the United States and China but also domestic certainties such as a declining population (since last year) and an enormous national debt that shows no signs of declining. There is also concern about growing inequality in Japanese society.

This seemingly strange mixture of growing concern about the formation of an asset bubble and continuing caution about abandoning "quantitative easing" and consigning deflation to the history books reflects, on the one hand, the signs of prosperity that come from the reality of economic recovery and stockmarket gains and, on the other, the signs of decay that come from the growing reality of a shrinking economic base, the burden of rising welfare costs, and increasing inequality.

Nor is this mixed picture peculiar to 2006: it may well dominate discussion of Japan's economic outlook following 15 lost years for some time to come. Clearly, there will continue to be plenty of negative developments. The decline in population is not going to be reversed overnight even if the government takes effective action to boost the birth rate or generates a wave of immigration. Similarly, the government will have to stick to its goal of balancing the country's primary balance by fiscal 2011 and then set about reducing government debt. Fiscal policy will therefore have to remain restrictive in the medium to long term, and this will tend to damp expectations of higher rates of growth.

However, there is unlikely to be a shortage of positive developments, either. This is because the current economic expansion cannot be explained solely by cyclical factors, suggesting that the Japanese economy must also have undergone some structural changes.

Neither the public nor the private sector can count any longer on the public purse each time they find themselves in difficulty. Instead, it is now widely accepted that the private sector should be the provider of choice, and the move from public to private sector provision is likely to continue as an increasing number of services are put up for tender. As well as placing a strain on its public finances, the sheer scale of its public debt is forcing Japan to wean itself off its dependence on its inefficient public sector.

Having overcome the three "overs" they faced when the boom of the 1980s turned to bust in the 1990s (namely, overcapacity, overmanning and overindebtedness), Japanese companies are at long last set to increase their capital investment. This indicates that the changes that have taken place are not simply cyclical but structural in nature and that Japanese companies are unlikely to suffer from these problems again. This is because a drastic reduction in cross-shareholdings and greater awareness and regulation of corporate governance now ensure that market forces play a much greater role than they used to.

If management fail to boost shareholder value, they now face the threat of a takeover. Shareholders are also no longer willing to allow companies to employ irresponsible tactics when mounting a defense. Similarly, business partners that might once have been willing to enter into cross-shareholding agreements now have to consider how their own shareholders would react. 23.7% of the shares of listed companies (in terms of market value) are now owned by non-Japanese investors, and this figure is more than 40% in the case of some leading companies. Gone are the days when companies could rely on the Japanese-ness of their shareholders.

These positive and negative factors are pretty clear. The question, however, is which will eventually prevail and whether, as some commentators have argued, the sun will once again rise in Japan as a new golden age begins.

The future depends on whether the benefits produced by the structural reforms will simply be consumed or whether they will help to offset some of the negative developments that are clearly on the horizon. Those who are in a position to act need to steer a middle course between optimism and pessimism and do what is right for the future. In other words, they need to invest.

Two Types of Investment

There are two types of investment: real investment (e.g., in plant and equipment) and financial investment (e.g., in stocks and shares). They are similar in that both involve forfeiting the short-term gratification that comes from spending cash in hand for a long-term return. Those who are in a position to do so and have the necessary ability invest in a business to increase its future cash flow ("real investment"), while those who are not provide the former with the necessary capital ("financial investment"). Both activities are investment, and the economy would cease to function if the financial system linking them broke down.

For an activity to be investment, it must involve weighing up the likely risks and return, carefully choosing what to invest in and actively seeking to generate a positive cash flow in the future. In this regard, Japanese investors are on unfamiliar territory.

When Japan was still catching up with Western economies after the Second World War, there were relatively few risks attached to real investment as companies could borrow as much as they wanted to invest from their banks. However, once Japanese companies caught up with their Western rivals, the returns from real investment became much riskier. Japanese companies also had to deal with the transition from fixed to floating exchange rates as well as from fixed to variable interest rates, and much greater ability was now required to weigh up the likely risks and returns of real investment.

Encouraged by deregulation and internationalization, Japanese banks stepped up their lending in search of greater returns. However, their ability to manage the attendant risks failed to keep pace. As a result, by the mid-1980s, Japan found itself in the midst of an asset bubble and a wave of overinvestment, which was exacerbated by the banks' traditional reliance on collateral and guarantees rather than cash flow projections. Instead of adopting an even more cautious approach to assessing risk and return in response to changing investment conditions as they should have done, the banks and their clients did the very opposite and became carried away by credit growth and rising asset prices.

Now that the need to overcome the three "overs" that this created is no longer top of the agenda, Japanese companies can at long last concentrate on real investment.

Just as used to be the case with corporate real investment in Japan, financial investment by individuals has tended to neglect risk and return. Instead, individual investors have tended to prefer the security offered by savings accounts. At the same time, there has been no shortage of investors who have let themselves be talked by unscrupulous salesmen into taking unreasonable risks by investing in get-rich-quick schemes. This shows that, apart from the issue of misselling, many investors still behave irresponsibly.

With such an attitude to financial investment so widespread among individual investors, Japanese companies facing increasingly unpredictable business conditions and the need to compete globally cannot count on Japanese individual investors to continue to finance their activities. Similarly, these very investors are expected to shoulder a larger share of the tax burden and the cost of social security at the same time as the government is forced to reduce expenditure in order to manage Japan's huge national debt at a time when the average age of the population is rising. However, unless these investors understand the need for them to strike the right balance between risk and return, they may eventually find themselves unable to provide for their own future.

As we shall see in the next section, both real investment by companies and financial investment by individuals still leave much to be desired in spite of apparent changes in investor attitudes. More fundamental changes are required if both types of investment are to flourish.

Reform of Financial Investment Has Lagged Reform of Real Investment

Generally speaking, more progress has been made in reforming real investment by companies than financial investment by individuals. In other words, major changes in corporate behavior and the relations between companies and their banks as well as between companies and capital markets have not been matched by changes in the relations between individuals and their banks or between individuals and capital markets.

Changes in the former have been induced by wide-ranging reforms, including: a move away from overreliance on loan collateral and guarantees; efforts to revive business activity by passing the Industrial Revitalization Law and the Reorganization Law as well as setting up the Industrial Revitalization Corporation; reform of the banks by means of the Program for Financial Revival; thorough risk assessment of corporate loans; efforts to make it easier to securitize and sell loans by passing and then amending the Special-Purpose Company Law; deregulation of share buybacks and the creation of companies with a committee system by amending the Commercial Code; tighter disclosure regulation; tighter auditing controls; and the adoption of market value and impairment accounting for financial products. Moreover, this year the new Company Law will come into effect.

These reforms have made it easier for big companies and banks to radically restructure and merge their operations as well as making it easier to turn companies round, reduce cross-shareholdings, carry out share buybacks, increase dividends, and make hostile takeover bids. It is also largely as a result of these reforms that Japanese companies have succeeded in overcoming the three "overs," becoming more profitable and improving their return on equity.

However, with the return on their equity still low by international standards and, as we have seen, still having to face a number of negative factors, Japanese companies cannot afford to take things easy. The corporate sector as a whole is still a net saver sitting on its biggest cash pile ever. Real investment has therefore only begun.

There have also been reforms that have changed the attitude of individuals to financial investment. These include, since 2001, the Koizumi government's policy of encouraging people to save less and invest more,[1] reform of the way in which securities are taxed, the launch of exchange-traded funds, the creation of "securities intermediaries" (i.e., stockbroker agents), a relaxation of the rules governing wrap accounts, and a reduction in the minimum amount required to invest in equities. Progress has also been made in improving disclosure and combating irregular trading activity.

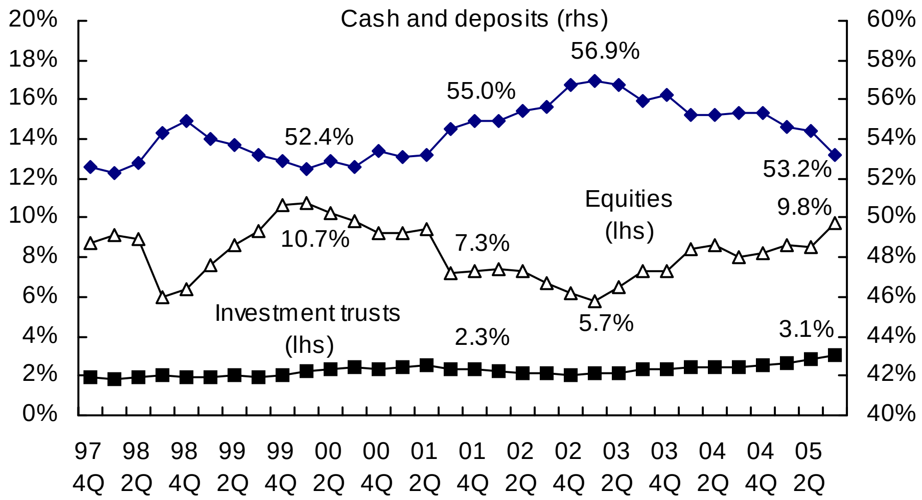
Similarly, the lifting of the blanket guarantee on bank deposits and the introduction of 401(k) plans, although not primarily intended to encourage people to save less and invest more, had the effect of encouraging individuals to adopt a more responsible attitude to financial investment. Also worth mentioning is the role played by the Financial Services Agency, the stock exchanges, the Japan Securities Dealers

[1] In this context, "save" is not used in the sense of refraining from consumption. The admonition that people in Japan should save less and invest more is intended to bring about a shift in the distribution of personal financial assets from a portfolio dominated by low-risk, low-return assets (such as savings accounts) to a more diversified portfolio that includes assets with greater risk and greater return (such as equities).

Association and a number of securities companies in organizing courses and seminars on investment for the benefit of the general public.

In spite of all these efforts, however, the figure for cash and deposits as a percentage of personal financial assets was exactly the same (53.2%) at the end of September 2005 as at the end of June 2001, when the government launched its campaign to encourage people to save less and invest more. It is therefore very difficult to claim that the attitude of individuals to financial investment has changed (Figure 1).

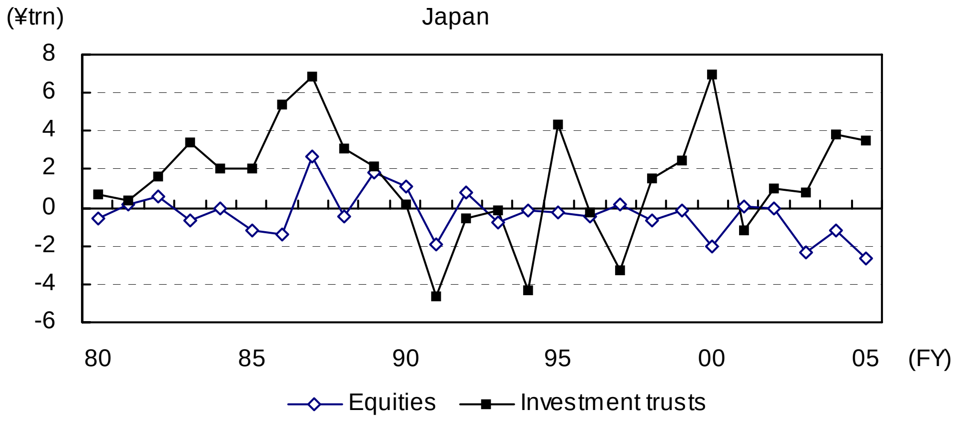
Figure 1 Breakdown of Japanese Personal Financial Assets



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

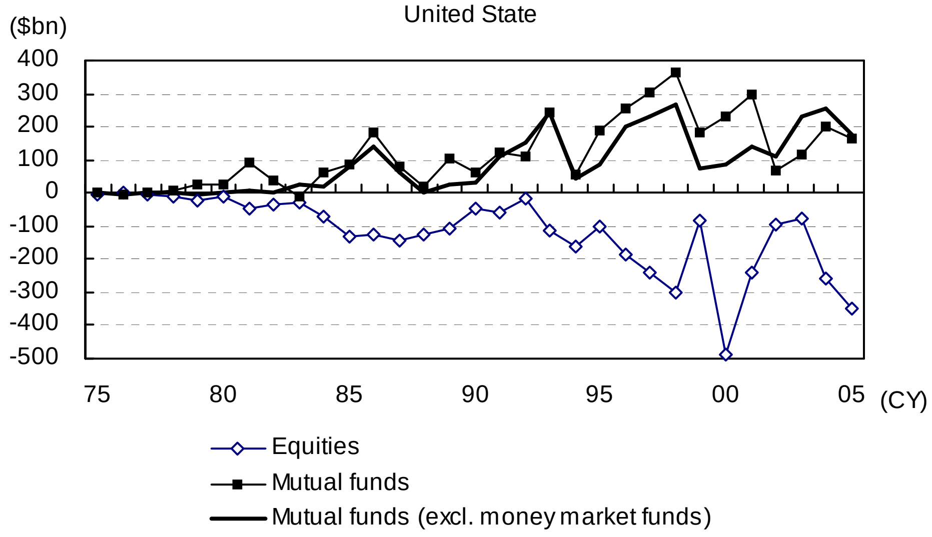
Although, as Figure 1 shows, the proportion of equities and investment trusts has risen slightly, the increase in the proportion of equities is simply the result of higher share prices: individual investors remain net sellers (Figure 2). It may be, of course, that individual investors are simply taking advantage of rising share prices to take profits and that there is no reason to view this as a negative development. In the United States, for example, individual investors have continued to reduce their shareholdings while increasing their holdings in mutual funds. Nevertheless, equities and equity stakes accounted for only 7% of personal financial assets in Japan at the end of 2001—the lowest figure for any G7 country. Just how low the Japanese figure is can be seen from the fact that the figure for the United Kingdom, the second-lowest for any G7 country, was 13%. This suggests that, if the situation as regards financial investment in Japan is to change, individual investors will at some stage probably have to turn net buyers of equities.

Figure 2 Household Investment in Equities and Investment Trusts/Mutual Funds



Note: The figure for fiscal 2005 is the total for the second and third quarters. The figures for equities do not include equity stakes.

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



Notes: (1) The figures include nonprofit organizations. The figures for equities include non-US equities.

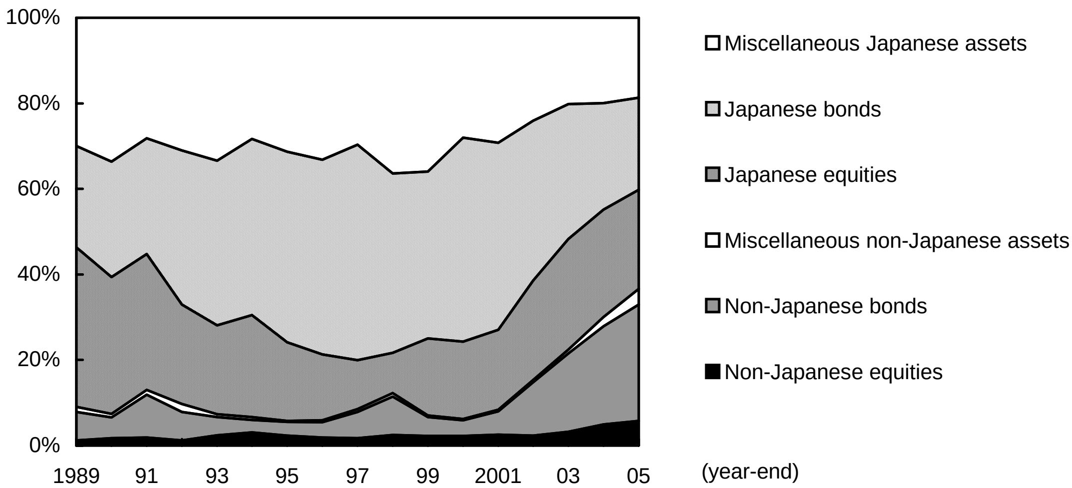
(2) The figure for 2005 is the total for the first, second and third quarters.

Source: NICMR, from US Federal Reserve "Flow of Funds Accounts."

Although the proportion of personal financial assets accounted for by investment trusts has also risen slightly since 2001, much of the increase is the result of an increase in demand for monthly distribution funds investing in non-Japanese sovereign debt. This can also be clearly seen in Figure 3, which shows that in recent years Japanese investment trusts have sharply increased their exposure to non-Japanese bonds. Although there is a certain logic behind these products, it is difficult not to wonder whether such a big increase in individual investors' exposure to non-

Japanese bonds is really the result of a dispassionate assessment of the trade-off between risk and return. It is only very recently (namely, since 2005) that individual investors have shown signs of investing in high-yielding and emerging market equities and of diversifying into investment trusts that invest in a wide range of asset classes, including property.

Figure 3 Breakdown of Investment Trusts by Assets



Note: The figures for 2005 are those for end-November. Miscellaneous assets include bank deposits and commercial paper.
Source: NICMR, from Japan Investment Trust Association data.

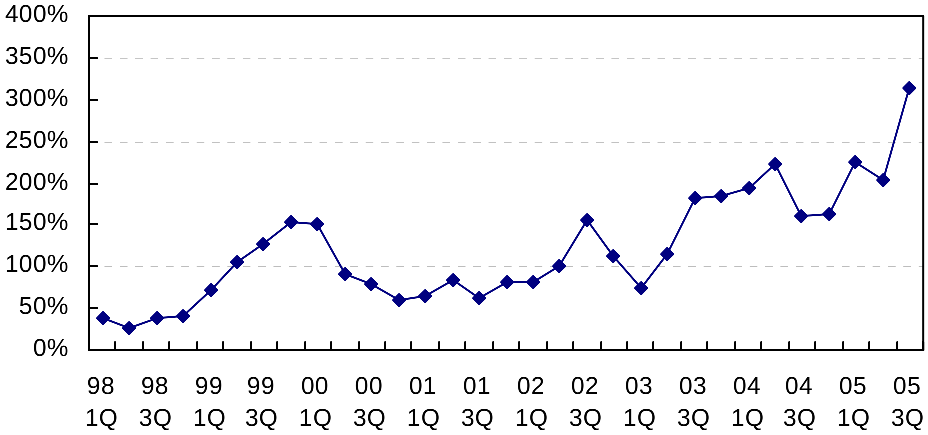
Therefore, although individual financial investment has undergone a number of reforms in recent years, there is still no sign that these reforms have been successful.

From Mass Consumption to Mass Investment

Individual investors in Japan remain net sellers of equities even though individual share ownership is still low by international standards. Similarly, it is widely believed that individual investors have been caught up in an investment bubble, reflected in sales of investment trusts, even though most of this investment has been in monthly distribution funds specializing in non-Japanese bonds.

Although, as we have seen, individual investment in equities has declined on a net basis, the value of the shares traded by individual investors last year rose sharply. In other words, their turnover ratio (defined as "trading value ÷ market value") has increased sharply, as can be seen in Figure 4.

Figure 4 Individual Investors' (Annualized) Turnover Ratio

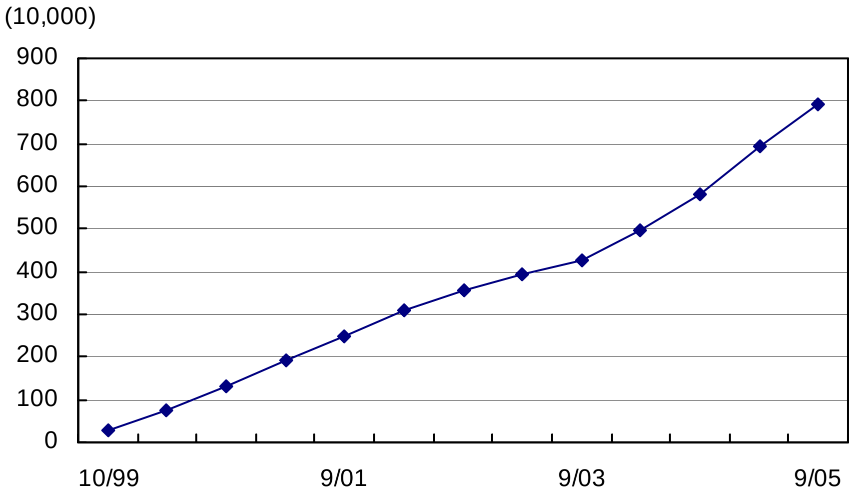


Notes: (1) Turnover ratio = trading value/((market value as of end of previous quarter + market value as of end of current quarter)/2).
(2) The trading value of individual investors has been calculated using the data for the Tokyo, Osaka and Nagoya stock exchanges and JASDAQ.
Source: NICMR, from Tokyo Stock Exchange and JASDAQ data, and Bank of Japan "Flow of Funds Accounts."

As a result, the annual trading value of the stocks listed on the First Section of the Tokyo Stock Exchange reached a new record (¥572 trillion), with orders placed by individual investors accounting for 33.1% of agency business, its highest level since 1988. Similarly, on 8 November 2005 Sumitomo Metal Industries made headlines when more than 500 million of its shares were traded in a total of 3,500 transactions (or one transaction every 4.6 seconds).

This surge in activity by individual investors is apparently the result of day traders using the Internet to execute sales and purchases in rapid succession. As can be seen in Figure 5, there are now nearly 8 million online trading accounts in Japan. It is not simply that the Internet has made it easier for individual investors to place orders: competition has forced securities companies to cut their brokerage commission rates to the point where customers can trade in and out at far lower cost than ever before.

Figure 5 Online Trading Accounts in Japan



Source: NICMR, from Japan Securities Dealers Association data.

Although there has been no significant increase in the percentage of shares owned by individual investors, there have been signs of progress. For example, the number of households that have invested in equities continues to increase. Similarly, the special features on shares and investment that have appeared not only in economic and financial publications but also in magazines for women and magazines for primary school children since the current stockmarket rally began last autumn have probably also served to increase public interest in investment, although it is difficult to say to what extent this has been translated into actual investment. Similarly, the headline-grabbing activities of shareholder activists such as Yoshiaki Murakami, president of M&A Consulting Inc., and Takafumi Horie, former president of Livedoor, which include making hostile takeover bids for companies, have done much to increase public interest in the stock market.

One frequently hears comments that these developments—particularly, the activities of day traders and the spread of interest to the younger generation—are abnormal. The author, however, cannot agree with this view.

First, as we have seen, a dispassionate analysis of the data shows that, on a net basis, individual investment in equities has not increased. For all the marginal increase in the number of individual stockmarket investors, the simple combined total of Japanese households that have invested in either equities or investment trusts is less than 10 million. This compares with more than 50 million in the United States. The day when there are 100 million investors in Japan is still a long way off.

It also seems strange to question the activities of day traders. As well as providing valuable liquidity to the securities markets, repeatedly creating and then liquidating positions is less risky than staying either short or long for an extended period.

Above all, the revolution in information technology (especially, the spread of the Internet) and the sharp decline in brokerage commission rates that this has produced mean that we have to look at individual investment in a new light. Before the Second World War equity investment was the preserve of rich men in bowler hats. Now, however, individual investors have more technical resources at their fingertips than professional investors only a few years ago, even without expansive trading floors and sophisticated workstations.

The analogy may not be appropriate, but the process is similar to that undergone by gambling and sport. Once the preserve of high society, they are now a popular pastime and a way for many people to improve their intellectual and physical powers. The days when people expected the state to look after them from the cradle to the grave—far less the days when it was considered a virtue to spend your money as soon as you earned it—are long gone. For most people investment will be as normal and essential as eating, working and sleeping.

The age of mass consumption will soon be history as we begin an age of mass investment. Traditional views of the regulatory frameworks and computer systems needed for investment will no longer hold. Rather than somewhere where investment professionals can systematically practice their skills, the market will be a place with a much greater variety and volume of transactions. Computer systems and regulatory frameworks will have to accommodate these demands. Moreover, just as many different industries sprang up when demand for catering, leisure and education spread from a privileged minority to the rest of society, we can expect the investment services industry in an age of mass investment to undergo a transformation and for some of the players that emerge to be very different from the mainstream investment professionals that preceded them.

Reform Needs to Be a Daily Process, Not Just a Political Slogan

However, the main players in this age of mass investment will, hopefully, not be day traders but sensible medium- and long-term investors with their own life plan, their own views about risk and return, and their own notions of what constitutes fundamental value.

Whatever the pros and cons of short-term economic agents, they are present in all fields of economic activity. What matters is not so much the abundance of such short-term activity but whether there is a solid base of medium- and long-term economic activity.

What has happened in Japan is that a traditional shortage of individual investors has led to the activities of a relatively small number of day traders who have made full use of the opportunities provided by online trading creating the impression that all activity by individual investors has got of hand. The important thing is not to criticize these day traders but to encourage more, sensible medium- to long-term investors so that the general public saves less and invests more.

As we have seen, much has already been done to encourage this. However, without schemes designed to encourage individuals to invest, such as the 401(k) plans, individual retirement accounts (IRAs) and employee stock options plans (ESOPs) that have been the driving force behind individual equity investment in the United States, it is hardly surprising that the gap between (direct and indirect) share ownership in Japan and the United States continues to widen. Such schemes have also increasingly been adopted in Europe as a means of trying to mitigate the costs of an aging society.

The decision to introduce transaction deposits on a permanent basis at the same time as the blanket guarantee on bank deposits was phased out served only to reinforce individual investors' predilection for bank accounts and can only be described as an aberration in an industrialized economy.

What the investment industry needs to do is not to coerce customers into saving less and investing more but to provide computer systems, regulatory systems, investment products and services that will be reliable and convenient enough to encourage them to invest.

In view of the fact that so little progress has been made in encouraging people to save less and invest more (one of the cornerstones of the government's reform program), more action needs to be taken to make up for the 15 years that have been lost. As we have seen, the major progress that has been achieved in changing corporate attitudes and the relations between companies and their banks as well as between companies and the capital markets has not been matched by progress in changing the relations between individuals and their banks or between individuals and the capital markets.

What we need to beware of is the risk that the relations between companies and their banks, which would appear to have undergone a fundamental change, may revert to their former state if individuals continue to save (e.g., through bank deposits) rather than invest. So long as banks remain the main destination for individuals' savings, the corporate sector will have no alternative but to continue to depend on the banking sector. The banks, in turn, will continue to face considerable risks, including that of a resurgence of bad debts.

With regard to the continuity of the government's reform program, there is some concern that this may lose some of its momentum when Prime Minister Koizumi's term in office comes to an end this September. Since the government's capital market reforms (including the tax breaks for securities investment and the launch of exchange-traded funds) all go back to the package of measures adopted on 6 April 2001 and the committee behind the package (chaired by Hideyuki Aizawa) was set up in response to the stockmarket decline that followed the bursting of the dotcom bubble, there is a risk that the need for reform may be felt less keenly now that the bad debt problem has been resolved and the stock market has recovered.

However, reform needs to be a daily process that operates at all levels of society. There is something far wrong if it becomes a slogan that is identified only with a particular political program or a plan that is implemented only in response to a crisis.

It will be interesting to see—not least as an indication of whether the country can save less and invest more—whether Japan can engage in a reasoned discussion of reform and implement those reforms that are necessary in a businesslike manner without either a charismatic leader or the pressure of a crisis.