The Thorny Path to Direct Financing

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Confused Debate about Reforming Japan's Financial Markets

The debate so far

In an article in the previous number of this journal ("Some Reflections on Proposals for Reinvigorating Japan's Securities Markets," Spring 2001) I suggested that there was an urgent need for specific policies to promote the use of direct financing (market-type indirect financing) in Japan and for the government to give a clear signal of its commitment to reforming the flow of money in the economy.

The ruling coalition's interim report ("Measures to Revitalize Japan's Capital Markets") published on 9 February went a long way to address some of the issues raised in that article. For example, in its introduction the report states: "… By linking the corporate sector with its need to raise capital to the retail investor with his need to invest his savings, the nation's capital markets are a vital element of its economic infrastructure and should be considered a public asset. There is an urgent need to revitalize the country's capital markets in order to redress the balance between indirect and direct financing so that industry can raise more capital more easily from capital markets." This is surely the first time that Japanese politicians have admitted the importance of direct financing so clearly.

The body of the report also deals with a number of the issues that we have focused on, including the need for legislation on 401(k) pension plans to be passed as soon as possible and the need to consider introducing employee share ownership plans (ESOPs), exchange-traded funds (ETFs) and more favorable tax treatment for individuals investing in equities.

When the ruling coalition published its emergency package of measures four weeks later on 9 March, however, the emphasis was on revitalizing the financial system and the economy.

This probably reflects the fact that the communiqué issued on 17 February following the G7 meeting in Palermo called on Japan to strengthen its financial sector and deal with its bad loan problem as soon as possible.

In the March emergency economic package the proposal to set up a mechanism to support the stock market, which until then had frequently been proposed as a means of stimulating the economy, was also put forward as a means of revitalizing the financial system. At this stage, however, the proposal was simply for a private-sector fund.

The package contained eight specific tax proposals for revitalizing the country's capital markets: (1) a reduction in the rate of tax on investment earnings declared separately from other income; (2) a system for allowing losses to be carried forward and offset against earnings; (3) a reduction in capital gains tax on long-term equity holdings; (4) a system for exempting small transactions from capital gains tax; (5) a reduction in the tax on dividends paid to individuals; (6) an increase in the amount of income from dividends that need not be declared; (7) a reduction in inheritance tax and gift tax on equities; and (8) an end to dual taxation on corporations.

However, there was no specific mention of employee share ownership plans or some of the other items that had been proposed in February.

The government's official emergency economic package was published on 6 April. The main item was a plan to set up a government-backed body to purchase banks' equity holdings.

The package contained plans for four structural reforms to the country's capital markets: (1) the lifting of restrictions on treasury stock and the abolition of net asset value as a criterion for determining trading lots (i.e., the minimum number of shares in a company that can be bought or sold on the stock market); (2) the introduction of defined-contribution pension plans and defined-benefit company pension plans; (3) a better securities settlement system; and (4) exchange-traded funds.

On 20 April a government tax committee presented more detailed proposals for reforming securities taxation, including introducing a capital gains tax allowance for individual investors of ¥1 million on long-term equity holdings in October, abolishing restrictions on including equity mutual funds in tax-exempt savings schemes; reforming the tax system to deal with the lifting of restrictions on treasury stock; and deciding how exchange-traded funds should be taxed.

During the past three months the debate on how to reform Japan's financial and capital markets has thus shifted from calls to reform capital markets in order to redress the balance between indirect and direct financing to calls to revitalize the country's financial sector and deal with its bad loans in response to the G7 meeting in Palermo.

As a result, there have been some serious proposals to revitalize Japan's capital markets. This is particularly true of the tax proposals, which were drawn up much more quickly than would once have been possible. At the same time, however, some important proposals (such as that on employee share ownership plans) have been left out while the progress that has been made has been marred by some misguided proposals (such as that on setting up a body to purchase banks' equity holdings) for violating some of the fundamental principles of capital markets in the name of revitalizing Japan's financial system.

Misconceptions

In this report I should like to explain why I consider some of these proposals (namely those on setting up a body to purchase banks' equity holdings and on restricting banks' freedom to own equities) to be misguided—something that is probably obvious to many sensible market professionals.

These proposals indicate three misconceptions: (1) that the state is justified in intervening in the stock market in order to rescue the banking sector; (2) that adjusting volume can avoid the need to adjust prices; and (3) that the view that banks should be restricted in holding equities is supported by both theory and practice (when, in fact, it is supported by neither and runs contrary to the current trend in international banking regulation).

After dealing with these misconceptions, I shall reexamine the need for measures (such as the introduction of employee share ownership plans) to revitalize Japan's capital markets (rather than for ingenious schemes that may cause more harm than good) and point out the need for more direct financing—and not only by individual investors.

Problems Surrounding the Proposal to Set Up a Body to Purchase Shares from Banks

Reasons for proposal

This year was the deadline Ryutaro Hashimoto set for achieving the goals he set out in his proposal for a Japanese Big Bang in November 1996. Now that the deadline has been reached, we can only say that Japan's financial markets still fail to reflect his ideal (of being "free, fair and global").

The recent proposal for a body to purchase shares from banks entails the intervention by the state in a free economic transaction and special treatment for banks at the cost of being unfair to other market participants. Nor does it reflect international standards.

In its emergency economic package the government sets out two reasons for the need for such a body.

First, in its view, restricting banks' freedom to hold equities would ensure that they remained financially sound. Furthermore, reducing banks' cross-shareholdings would help to revitalize the stock market and make it easier to implement structural reforms. This would have positive effects (e.g., on corporate governance) that, in turn, would help to revitalize the economy.

Second, as such action might produce a short-term glut of stock on the market and hit share prices, thereby threatening the financial system and the economy as a whole, there is a need for a temporary government-backed scheme to purchase the shares.

Unsound reasoning

Both of these arguments are problematic. While the first might appear sound, it is actually an oversimplification, which has, unfortunately, provided the basis for government policy. I shall have more to say about this later.

Moreover, even if this argument were sound, it is difficult to see any need for such action right now on a scale that might threaten market stability in the short term.

First, some facts. In terms of value, the amount of shares held by Japanese banks on their domestic accounts declined by about ¥4.5 trillion in the three years from October 1997 (¥47.9 trillion) to December 2000 (¥43.4 trillion) (Figure 1). An analysis of net sales and purchases of equities (on the Tokyo, Osaka and Nagoya stock exchanges) by city, long-term credit and regional banks shows that they have been net sellers of some ¥300-500 billion in Japanese equities on a number of occasions (Figure 2). During this time, the stock market has both risen and fallen for a variety of reasons. During the second half of last year, for example, when it was falling, banks even became net purchasers.

Given that the stock market has shown itself capable of absorbing several hundred billion yen of selling by Japanese banks in some months, anyone arguing for a body to purchase these shares directly from the banks because he was afraid that the market might otherwise crash is presumably expecting the banks to have to sell on a much larger scale. In fact, however, what has been proposed is that banks' equity holdings "might" be limited to an amount equivalent to their equity capital. In order to comply with such a requirement, the banks would have to sell about ¥10 trillion in equities. However, no one has suggested that they should be forced to do this in a short space of time (of only 12-24 months, for example). Rather the suggestion is that they should be allowed to do this gradually. In that case, one wonders why the market should not be able to cope as it has done so far.

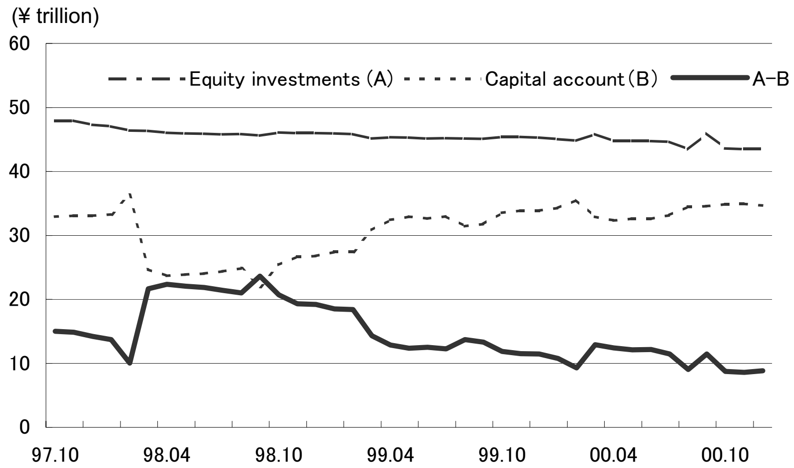
It is therefore very difficult to make sense of this line of argument. An alternative might be to offer the following two arguments.

First, although the banks as a whole can reduce their equity holdings by selling them on the stock market, thereby reducing share price volatility, there is a risk that particular banks might not be able to do this successfully and therefore a need for a government-backed body (such as the one proposed) in order to deal with such an eventuality.

Second, such a body might be able to support the stock market. Given the risk not only from the unwinding of long-term cross-shareholdings but also of a sell-off triggered by what may happen on Wall Street, any safety net would help to soften the blow to the economy and the banking system.

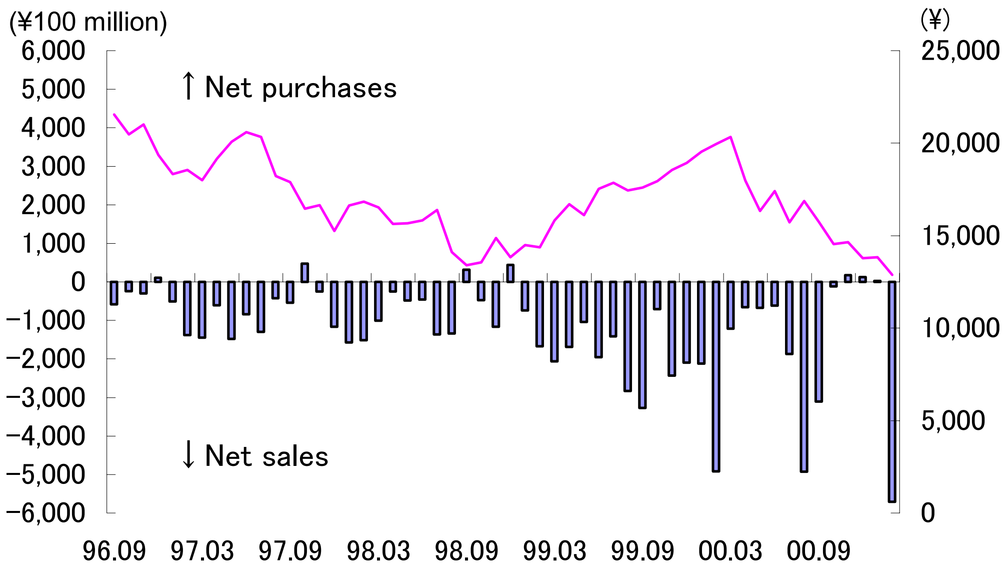
If these are the real arguments for a body to purchase banks' shares, both of them are misconceptions.

Figure 1 Equity Investments and Capital Account of Japanese Banks



Source: NRI, from Kin'yu Keizai Tokei Geppo [Monthly Bulletin of Financial and Economic Statistics], Bank of Japan.

Figure 2 Nikkei 225 Average and Net Sales and Purchases of Equities by City, Long-Term Credit and Regional Banks (monthly total for Tokyo, Osaka and Nagoya stock exchanges)



Source: NRI, from Tosho Tokei Geppo [TSE Monthly Bulletin of Statistics], Tokyo Stock Exchange.

Any attempts to stabilize the financial system should use conventional measures

First, let us suppose that the coming market decline is going to seriously affect some banks over the next 6-12 months and that this, in turn, could seriously affect the financial system as a whole. If we assume such a scenario for the near future, it would be wrong to rule out government intervention to support the markets and the economy.

However, such government backing should not lead to a situation where taxpayers' money in the broad sense is used for other than a specific purpose. In order to ensure that this does not happen, the proper course of action would be to identify the problem banks and follow the normal procedure for trying to stabilize the financial system, including capital injections for the banks concerned.

Any government guarantee for such a body or any preferential tax treatment—regardless of the scale of the risk to the banks concerned or whether there was a risk to the financial system—would mean that the state was extending preferential treatment to the banking sector as a whole. That would be grossly unfair to other equity investors, whether companies or individuals.

Similarly, if there was a genuine risk that a problem at a particular bank could destabilize the financial system, the only way to deal with the problem would be at its root—the bank itself—and not to use a special body to gradually purchase every share owned by every bank over a number of years. The argument that banks in general should own fewer shares concerns the future shape of the financial system and is quite a separate issue from any action that needs to be taken to deal with any systemic risk. The two have different objectives that naturally require different solutions.

As for the technicalities, the banks would be the equity holders and creditors of the new body, and all that would happen would be that their shareholdings would become shares in the new body or loans with an equivalent risk. That would be no way to shield banks from share price volatility. Nor is share price volatility the only risk to which banks are exposed. They are also exposed to risks from non-performing assets and property held as collateral—not to mention all the securities they hold, including ¥60 trillion in Japanese government bonds. Any special measures by the government to deal only with the risk from equities could therefore hardly be said to be a serious attempt to stabilize the financial system as a whole. If, as a result of injecting taxpayers' money into the banks in order to cover any losses they incurred on their equity holdings, the government found itself having to issue more bonds, the banks might then face the risk of losses on their bond holdings.

Penchant for trying to control supply reveals a failure to learn from the mistakes of 35 years ago

As far as the second line of argument—and, in particular, the argument that purchasing the banks' shareholdings would reduce share price volatility—is concerned, spending ¥10 trillion spread over a number of years would not achieve this.

Equities are assets (rather than normal goods), and their prices are formed in a different way. Whereas the price of a normal good depends on its utility and current availability, the price of an asset depends on a variety of factors, including the cash flow it is expected to generate over its life, the market rate of interest, and the risk premium. Unless expectations about economic growth and earnings growth change, it is very difficult to move share prices.

In Japan—and not just on this occasion—people rely too much on the authorities to try to curb selling or to provide a safety net. Because they cannot face the prospect of an adjustment in share prices—or, at least, a downward adjustment—they are only too eager to resort to trying to adjust volume. This is hardly in keeping with a market economy.

People should have learnt from the stockmarket panic in the early 1960s that efforts to control volume by setting up stock purchasing agencies are ineffective. Between them, the two agencies that were set up at the time purchased ¥428.5 billion worth of shares. In spite of that, however, the market failed to recover. What did trigger a recovery was an announcement by the government that it would issue deficit-financing bonds for the first time since the Second World War—in other words, a major change in the fundamental outlook.

Not only did these measures not succeed in supporting the market: they actually impaired the market's ability to function properly, leading to a steep decline in volume and to a widening gap between the price of those shares that were being purchased by the two agencies and those that were not. In other words, far from achieving its goals, official intervention made matters worse.

Unfortunately, some people are reluctant to learn from such mistakes. There is no reason to believe that policies that did more harm than good 35 years ago should prove less than problematic this time or produce the results that some people expect.

In the early 1960s the total capitalization of the First and Second Sections of the Tokyo Stock Exchange was about ¥8 trillion. The government spent the equivalent of 5.4% of that on trying to support the market through its two purchasing agencies. Given that the market's capitalization today is ¥375 trillion, a support operation on the same scale would cost some ¥20 trillion. The lesson to be learnt is that even that would not be enough to turn the market round.

The Japanese stock market 35 years ago was dominated by Japanese investors. Foreign investment—whether short-term or long-term—was limited. Nowadays, stock markets react to what happens on markets in other countries—especially in the United States and Europe—and investors move their money from one market to the next. Therefore it would hardly seem possible that what failed to work when the Japanese stock market was isolated from the rest of the world should work in the 21st century, when it forms part of a global market.

Weakness of Arguments for Restricting Banks' Equity Holdings

Dangerously oversimplified arguments

Unlike the numerous proposals that have been made before for setting up a body to purchase shares, the aim this time was to reduce the risk to the banking sector rather than explicitly to support the stock market.

Indeed, the government's official emergency economic package published on 6 April and the debate that was going on at about the same time suggest that there is a kind of consensus about the justification for such a body. The argument runs as follows: "Because Japanese banks have large equity holdings, the resulting price volatility poses a serious threat to the banks' financial stability. In the United States banks are prohibited from owning shares, while in Germany such holdings are limited to 60% of their equity capital. Therefore, in order to maintain a stable financial system, Japanese banks should be subject to a similar restriction, and a stock purchasing body is essential if this is to be achieved. Reducing these equity holdings will help banks to unwind their cross-shareholdings and thereby improve corporate governance. In turn, this should increase enterprise value, boost share prices and contribute to the development of Japan's capital markets."

The risks posed by the banks' equity holdings have been pointed out over the years, and there has clearly been a need to try to rectify this situation. Indeed, action should have been taken sooner. However, some of the arguments that have been put forward to justify this are oversimplified. If thinking on such a superficial level should lead to important policy decisions being made "as quickly as possible" and the government's emergency economic package being used as the vehicle for implementing such decisions, the results could be counterproductive: the financial system could be destabilized, and any hopes of boosting share prices by improving corporate governance could be dashed.

Contrary to popular perception, Japanese banks' equity holdings are not proportionately larger than those of banks in other countries. As can be seen in Table 1 (a survey of banks in the G10 economies and the European Union), the country whose banks have the largest proportion of equity holdings in relation to their assets is

Finland (6%), followed not only by Japan but also Germany, Greece and Switzerland (5%). Next come Denmark and Spain (4%), followed by France and Sweden (3%).

The data show that Japanese banks' equity holdings are by no means disproportionately large compared with those of banks in other developed economies.

Table 1 International Comparison of Share Ownership by Banks(1966)

Country	Number of commercial banks	Shares/assets (%)
Finland	8	6
Germany	258	5
Japan	136	5
Switzerland	85	5
Greece	20	5
Austria	1,019	4
Spain	165	4
Denmark	117	4
France	400	3
Sweden	15	3
Italy	264	2
Belgium	100	2
Netherlands	172	1
United States	9,575	0
Luxembourg	221	0
United Kingdom	44	0
Portugal	39	0
Canada	11	0

Source: Bank Profitability: Financial Statements of Banks 1998, OECD

Easing of restrictions on bank equity holdings in the United States

Nor is the popular perception that US banks are prohibited from holding shares correct. Although Section 16 of the Banking Act of 1933 prohibits Federal Reserve member banks from holding shares of any company for their own account, the Bank Holding Company Act of 1956 allows bank holding companies to hold up to 5% of the voting shares of any one company (subject to a maximum limit of 25% of their total equity holdings) as "passive investments" (i.e., shares held purely for their investment return rather than for any control rights) only.

Furthermore, since 1958, the Small Business Investment Act has allowed banks to set up small business investment companies (SBICs) directly (i.e., not just via a subsidiary), provided they obtain the approval of the Small Business Administration, and to own up to 49.9% of the shares in any one small business. In addition, they can take a substantial equity position in any distressed company they lend money to.

This framework underwent a major change in November 1999 when the Gramm-Leach-Bliley (GLB) Act was passed. Although Section 16 of the Banking Act of 1933 was not affected, the Bank Holding Company Act was revised and banks were allowed to set up financial holding companies for the first time.

This enabled banks to engage in investment banking (i.e., to hold shares in a company either to sell to investors or to manage on their own account) via another company belonging to the same financial holding company. Furthermore, GLB held out the possibility that banks might be allowed to own shares via a subsidiary (rather than solely within the framework of a financial holding company) five years later, after the Federal Reserve and the Treasury had considered the matter.

Federal Reserve's desire to ensure that financial holding companies are adequately capitalized

However, the Federal Reserve was keen to ensure that any financial holding companies created under the act would be adequately capitalized. Therefore, in March 2000, it published a set of draft rules on merchant banking and capital adequacy for equity holdings, and invited public comment.

As well as proposing that the regulator should review the situation if a bank's equity holdings (held as part of its merchant banking business) breached a certain limit, the draft rules proposed various restrictions on equity holdings, including a 50% capital charge. However, critics of the draft rules countered that restrictions of this kind violated the spirit of congressional legislation to deregulate banking and that the Federal Reserve had misunderstood some of the technical aspects of calculating risk.

In response to these criticisms, in January of this year, the Federal Reserve and the Treasury published a set of regulations ("final rules") on merchant banking. At the same time, the Federal Reserve and the Office of the Comptroller of the Currency published a set of draft regulations on capital adequacy for equity holdings, and invited public comment.

In the final rules the section with a maximum investment limit has gone, leaving only a limit of 30% of Tier-1 capital, while in the draft regulations on capital adequacy for equity holdings the capital charge has been reduced to 25%. Once the regulations are adopted, the existing maximum limit will be abolished.

Notwithstanding these concessions by the Federal Reserve, there were calls from the Congress and the financial lobby for more far-reaching deregulation, and on 4 April a hearing of the House Financial Services Committee was held.

As we have seen, the situation in the United States has shifted from one where banks were generally prohibited from holding equities to one where restrictions are being eased. However, where the debate about capital adequacy restrictions on equity holdings involves easing these restrictions, the changes are discussed carefully. As the debate proceeds, these restrictions may well be eased further.

European regulations on bank ownership of shares

In this section we shall consider the argument that in Germany bank ownership of shares is also restricted—to 60% of equity capital. Strictly speaking, this is not a German regulation but a European Union one based on the Second Banking Directive. According to this rule, a bank's qualifying investments in any one company (an equity stake of more than 10%) must not account for more than 15% of the bank's equity capital. Nor must its total qualifying investments account for more than 60% of its equity capital.

In other words, the regulation is an attempt to use capital adequacy restrictions to discourage banks from becoming major shareholders (with an equity stake of more than 10%) in other companies. Insofar as the regulation not only limits the risks to a bank from other companies but also a bank's ability to control other companies, it is similar to Japan's Banking Law and the Antimonopoly Law, which limit share ownership by Japanese banks in any one company to less than 5% of their equity capital. To that extent, it could be said that Japan's regulations on share ownership by banks are already tougher than the EU regulations.

International trends in trying to ensure banks' financial soundness

As we have seen, the regulatory approach to share ownership by banks is different in the United States, Europe and Japan, so it would be simplistic to argue that Japan should adopt an approach just because Europe and the United States have done so.

However, it is worth trying to discern whether any common international approach is likely to emerge. In this respect, the approach adopted by the Basel Committee on Banking Supervision is instructive. The New Basel Capital Accord (Consultative Document), which was published in January of this year, proposes the following ("Significant Investments In Commercial Entities"):

"Significant minority and majority investments in commercial entities which exceed certain materiality levels will be deducted from banks' capital. Materiality levels will be determined by national accounting and/or regulatory practices. Materiality levels of 15% of the bank's capital for individual significant investments in commercial entities and 60% of the bank's capital for the aggregate of such investments, or stricter levels, will be applied.

"Investments in significant minority- and majority-owned and controlled commercial entities below the materiality levels noted above will be risk weighted at no lower than 100% for banks using the standardized approach. An equivalent treatment will apply for banks using an IRB ["internal rating-based"] approach based on methodology the Committee is developing for equities."

Although it is unclear from this section exactly how big an investment would have to be in order to be considered a "significant minority investment," the fact that this proposal is similar to the Second Banking Directive regulation referred to above would suggest that the 5% limit on shareholdings by Japanese banks would not be regarded as "significant."

In the section on the standardized approach to credit risk, there is a sub-section entitled "Higher-risk categories," which contains the following regulation: "National supervisors may decide to apply a 150% or higher risk weight reflecting the higher risks associated with some other assets, such as venture capital and private equity investments."

It is also clear from the above that the Committee is proposing that national supervisors should be allowed to exercise their discretion, reflecting the fact that the situation in each country is different.

A more important point is the notion of "three pillars" that is central to the New Accord. Under the first of these pillars ("Minimum Capital Requirements") the Committee recommends that, in calculating their capital ratios, banks should be allowed to use their own risk valuation models where these are suitable rather than be obliged to use a standard risk weight. Under the second ("Supervisory Review

Process") it recommends that more attention be paid to monitoring risk management than to capital ratios calculated using a standard risk weight. And under the third ("Market Discipline") it recommends that, given the limited ability of national supervisors to monitor complicated risks, market forces should be allowed full play on condition that banks improve their disclosure.

Banks face a whole range of risks—not just from their equity investments—so it would be wrong for regulators to single out equities and focus on capital adequacy. The international trend is for regulators to monitor how banks are managing and dealing with all these risks (including the one they face from their equity investments), and, at the same time, to allow market forces to play their part. Any suggestion that equity investments should be singled out and subjected to standard restrictions at the expense of market forces would run counter to this trend.

In the United States, the above proposal on banks' merchant banking activities is regarded as a bridge to be used until banks develop their own models. It is to be hoped that any regulations adopted in Japan will assume that an increasing number of Japanese banks will also wish to develop their own models and not make it more difficult for them to do this.

Banks' ability to control other companies and the theory of corporate governance

As well as posing a risk to banks, equity investments are a means by which they can exercise control over other companies.

Under the Banking Law and the Antimonopoly Law, Japanese banks are already subject to a 5% limit on their equity holdings, and in the debate on the subject there appears to be a growing reluctance to impose even tougher limits and a growing willingness to allow banks more flexibility.

In fact, some of the leading academics and others in this field have emphasized the need to establish whether or not companies are actually being disadvantaged as a result of the control that banks exercise over them—rather than simply to restrict that control by imposing a standard percentage limit on their equity holdings.

The line of argument is no longer the simplistic one that, by owning shares, banks control (i.e., "exploit") companies.

It is an established principle of corporate finance that it is actually better for banks to be shareholders (rather than just creditors) in a company because this enables them to exercise their rights in both capacities. From that point of view, some of the arguments that have been made are based on rather superficial premises. Rather than quote any such arguments here, may I remind the reader that it is not so long since "mochiai" (the holding of shares in business partners for strategic purposes rather than short-term returns) was held up—by Japanese and non-Japanese admirers alike—as a good example of the Japanese approach to management.

Therefore the argument that reducing banks' equity holdings will improve corporate governance and increase enterprise value would seem to be rather simplistic.

Ill-considered decisions can prove costly

All this would suggest that the debate on the ownership of shares by Japanese banks should be conducted dispassionately, taking into account factors such as the fact that, by international standards, the ownership of shares by Japanese banks is not excessive and the fact that, even if new regulations on this are adopted, there are major differences between the regulatory regimes in the United States and Europe, and reflecting the spirit of the Basel Committee on Banking Supervision as well as current developments in competition policy.

Even if the ownership of shares by Japanese banks has produced some of the side effects attributed to it, these are the result of a long historical process. It would be one thing if Japanese banks decided of their own accord to reduce these shareholdings, but quite another if they were forced to dispose of them as quickly as possible by means of a body created in defiance of market forces. Any such side effects have not just appeared overnight, so there would seem no reason why the situation should suddenly deteriorate so rapidly that a solution has to be found in the next few years.

In the United States, even now that the decision to allow a subsidiary of a financial holding company to own shares has been made, great care is being taken over how it should be implemented, and the debate on this aspect is still going on after more than a year—presumably because people are only too aware of what the consequences of ill-considered deregulation could be.

Equal caution is required when rules are being tightened rather than eased. No one can be sure what the effects of imposing artificial rules on the long-established share ownership practices of Japanese banks would be or that they would all be positive and, for example, affect only the ills they were supposed to cure.

At any rate, this issue should be discussed properly as part of a debate about the future of Japan's corporate and financial systems that takes into account current international trends, the facts, and both theoretical and empirical studies and not as a crisis or as part of an emergency economic package.

Need to Take Serious Action to Increase Direct Financing

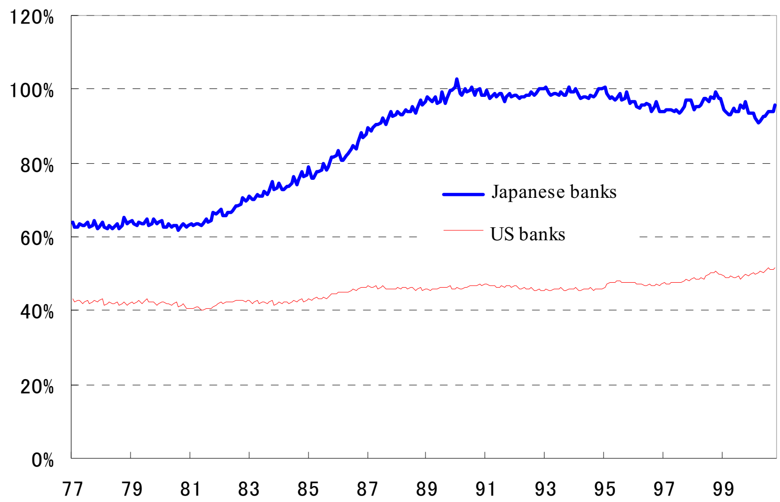
Lack of direct financing at the heart of the problem

The corollary of the fact that banks have always been major shareholders is the fact that at one time there were not enough "normal" investors such as individuals and mutual funds. In other words, a lack of direct financing and a bias towards indirect financing over many years has led to a situation where personal financial assets have gravitated towards the banks and, as a result, corporate borrowers have had no alternative but to accept them as major shareholders. There is little sense in trying to solve a problem without looking at its causes. No solution will be found so long as most equity risk is borne by institutions specializing in indirect financing—be it the banks, the Bank of Japan or a stock purchasing agency. The only way to tackle the problem head on is to adopt policies to encourage a broad range of investors to assume this equity risk according to their risk tolerance—in other words, policies to increase direct financing. Although the report on revitalizing Japan's capital markets (see above) highlighted this point, the debate that has followed has become confused, and those involved need to be reminded what the debate is actually about.

One of the reasons the debate (which, until then, had been clearly focused on the need to increase direct financing, as highlighted in the report) became confused when the emergency economic package was announced was that after G7 the focus switched to dealing with the bad loan problem facing the banks. While there is no denying that this issue is important, solving the problem will not prevent investment capital gravitating towards the banks again if they simply resume their old role as providers of risk capital. Therefore the two issues (of devising a mechanism whereby direct financing can supply the risk capital that industry needs and of solving the bad loan problem) need to be dealt with simultaneously.

In addition to the bad loan problem, there is a need to appreciate the scale of bank lending in Japan. As can be seen in Figure 3, which shows bank lending as a percentage of GDP, bank lending in Japan rose sharply during the boom of the late 1980s and has remained at that level since. Although it is often said that the Japanese economy became dependent on indirect financing during the period of rapid economic growth in the 1950s and 1960s, Figure 3 shows that this dependency increased during the 1980s' boom. As a result, what happens to the banks has a bigger impact on the economy than it used to, while what happens to the economy has a bigger impact on the banks. Direct financing needs to be increased not only in order to revitalize the country's capital markets but also in order to restore normality to both the banking system and the economy.

Figure 3 Total Bank Loans/GDP (1977-2000)



Note: Data are as of end-March.
Source: NRI, from Kin'yu Keizai Tokei Geppo [Monthly Bulletin of Financial and Economic Statistics], Bank of Japan, and US Department of Commerce data.

Significance of employee share ownership plans

Many different ways of trying to increase direct financing have already been debated, and I should like to take this opportunity to stress yet again the significance of introducing employee share ownership plans (ESOPs)—a point I made in the above article and a policy which was included in the above interim report. Employee share ownership plans would be a new investment vehicle in Japan; but, if leveraged plans were used, the change could occur relatively quickly. Also, if the shares purchased by the plans were offered to individuals over a period of time on relatively favorable terms, they could form the basis of more diversified individual long-term savings and investment schemes as well as employee remuneration and retirement benefit schemes.

As I calculated in the above article, if we assume that under a Japanese version of such a scheme companies contributed ¥500,000 per employee per year and that all the companies listed on the First and Second Sections of the Tokyo Stock Exchange purchased shares for their own employee share ownership plans (borrowing the money for 10 years), more than 80% of these companies would have purchased more than 5% of their own shares by the end of the 10-year period and more than 400 companies would have purchased more than 20%-40% of their own shares. Moreover, the total value of the shares purchased (assuming the extreme case that all the companies took part in the scheme) would be about ¥23 trillion.

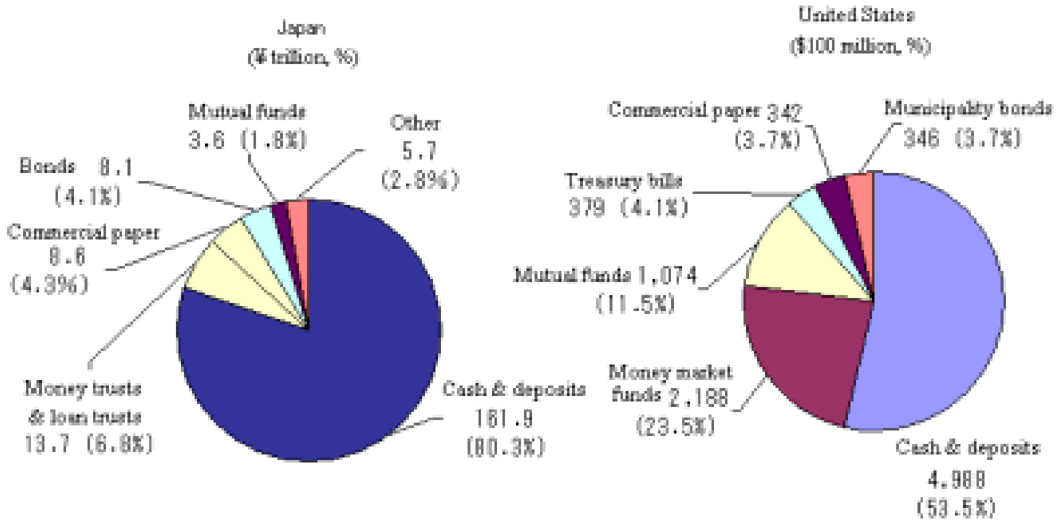
Obviously, employee share ownership plans would not necessarily be suitable for all companies, and it is unlikely that a scheme could be implemented on such a scale. However, I should like to take this opportunity to point out yet again that it is better to carry out the vital process of reforming the structure of share ownership in Japan by easing regulations and providing incentives for economic agents than by setting up a stock purchasing agency in defiance of market forces.

Bias towards indirect finance not confined to individuals

If there is to be a shift in emphasis from indirect to direct financing, retail investors in Japan need to invest more in securities. However, retails investors are not the only Japanese investors that prefer to invest their money by means of indirect rather than direct financing. As can be seen in Figure 4, which compares financial investment by US and Japanese non-financial companies, cash and deposits account for just over 80% of Japanese companies' investments but only just over 50% of those of US companies, just over 20% of whose investments are in money market funds.

Similarly, a comparison of the composition of the financial assets (excluding loans and equity stakes) of US and Japanese local authorities (see Figure 5) shows that, whereas 94% of Japanese local authorities' financial assets are in cash and deposits, only 12% of those of US local authorities are. In the United States, local authorities invest in a wide range of financial assets (ranging from Treasury bills to agency bonds, repos and commercial paper) chosen according to their risk, liquidity and return. For example, if the California Department of Finance has surplus cash for a period of 1-60 days, it tends to invest it in commercial paper, while for longer periods it prefers Treasury bills (6-12 months) or corporate bonds (1 year or more).

Figure 4 Comparison of Financial Assets of US and Japanese Non-Financial Companies (as of end-2000)

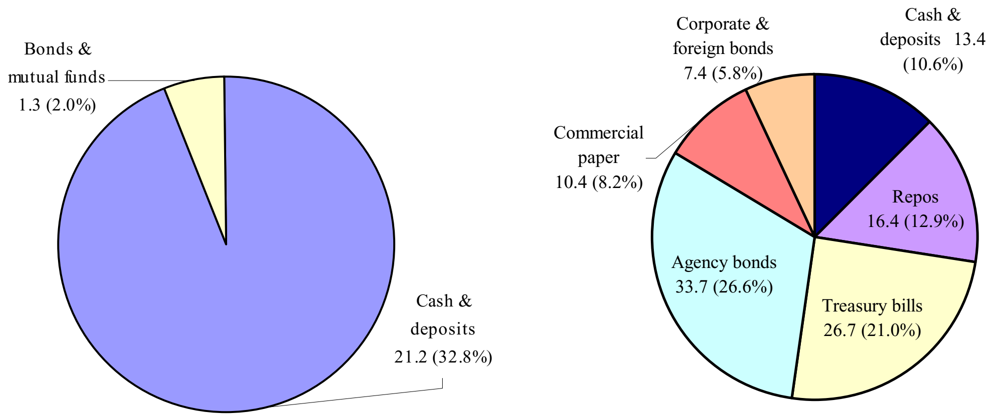


Note: Japanese figures are preliminary. Only financial assets held for investment purposes are included.

Source: NRI, from Shikin Junkan Kanjo [Flow of Funds Accounts], Bank of Japan, and Flow of Funds Accounts, Federal Reserve Board.

Figure 5 Comparison of Financial Assets of US and Japanese Local Authorities

Japan | United States



(End-March 2000, ¥ trillion, %) Total: ¥22.5 trillion

(End-1999, ¥ trillion, %) Total: ¥108.0 trillion

Note: Only financial assets held for investment purposes are included.
Source: NRI, from Shikin Junkan Kanjo [Flow of Funds Accounts], Bank of Japan, and Flow of Funds Accounts, Federal Reserve Board.

There is now less than a year to go before a payoff system (originally due to be introduced this April but postponed for a year) is introduced next April. No longer can an investor making a one-year fixed-term deposit take it for granted that the bank concerned is financially sound and that his money is completely safe. Moreover, deposit rates are extremely low. At the same time, there is no shortage in Japan of non-financial companies with a higher rating than banks and which issue commercial paper or bonds.

In the above article I suggested that one way of encouraging more use of direct financing would be for companies to invest more in short-term instruments such as commercial paper and money market funds—as well as employee share ownership plans—and this could happen as the investment policies of companies and local authorities change.

If retail investors prefer to keep their financial assets in the form of bank deposits, that is up to them. However, organizations (such as companies and local authorities) that manage the money of shareholders, local residents and other such stakeholders have an obligation to invest it in a responsible way. With less than 12 months to go before a payoff system is introduced, it is not good enough for them simply to follow past practice and put the money on deposit: they will increasingly be expected to demonstrate accountability in the way they invest it.

If direct financing is to develop in Japan, it will not be enough simply to change the country's laws. What is needed (and increasingly likely to be expected) is for the various economic agents to set about changing the attitude to banks and bank deposits that is so deeply engrained in Japanese society.