

The Japanese Economy, Banking Industry and Securities Markets at the Turn of the Millennium

by Lee Branstetter, *Associate Professor of Finance and Economics; Director of the International Business Program, Columbia Business School*

The Paradox of Japan

By the late 1990s, Japan represented something of a paradox to financial professionals based outside the country. Despite nearly a decade of economic stagnation, Japan remained one of the world's wealthiest countries. The stock of financial wealth accumulated by Japan's frugal households had grown to more than \$10 trillion by 1998. Yet the largest fraction of this enormous wealth was stashed away in bank accounts earning very low rates of return. Less than 10 percent of household wealth was directly invested in stocks or the Japanese equivalent of mutual funds (Royama 2000). Meanwhile, Japanese stock prices languished at levels more than 50 percent below their 1989 peak.¹ (Exhibit 1 tracks Japan's expanding household wealth and its allocation across different investments.) If there was even a modest degree of convergence between the level of ownership in Japan and elsewhere in the OECD (Japanese households' holding of equities and the level of stock ownership that had become commonplace), then this would seem sufficient enough to drive up Japanese stock prices and create enormous opportunities for financial service firms. Why had this convergence not yet occurred by the late 1990s? Why were Japan's well-educated, industrious households persisting in a pattern of asset allocation that defied every rule of prudent investing followed outside its borders?

Growth under Regulatory Constraints

The evolution of the postwar Japanese securities industry reflected the heavily regulated nature of Japanese financial markets. These markets were long characterized by a Glass-Steagall-style regulatory regime that segmented financial services into separate markets served by separate firms (Hoshi and Patrick 2000). For decades following the end of World War II, insurance providers, commercial banks and securities firms were forbidden from competing with one another. The rationale was to prevent conflicts of interest on the part of financial services providers, but it had the impact of limiting competition within each of the financial services market segments. Competition was further limited by the regulatory constraints placed by the authorities on innovation in financial markets. The process for approval of a new financial product or service was typically lengthy—many financial transactions and products that were commonplace in American or British financial markets did not make their way into Japan until much later. The Ministry of Finance would often delay regulatory approval of a new product or service until a large number of incumbent firms were ready to sell it. In this sort of regulatory environment, there was little incentive to pioneer new products or services (Weinstein 1997).

¹ Exhibits 1 and 6 document these trends and provide the original data sources.

Until the 1980s, Japanese corporate finance was dominated by bank lending. This represented a striking departure from prewar trends in Japanese corporate finance, and it stemmed primarily from government regulations that limited the volume and restricted the terms of bond and equity issuance. These regulations would remain in place until the end of the 1970s (Hoshi and Patrick 2000). For securities firms in Japan, this meant that the opportunities to generate revenue through the underwriting of equity issuance, IPOs and bond issuance would be limited in Japan relative to that available in more open financial markets. On the other hand, commissions earned by securities firms on trades executed for individual and institutional customers were set by regulatory authorities. These commissions remained regulated in Japan long after they had been deregulated elsewhere, which meant that the competitive pressures that had driven transactions prices to very low levels in the United States and the United Kingdom by the 1980s were effectively ruled out by Japanese securities laws (Suto 1993).

Another significant feature of the postwar environment in Japanese securities markets was the widely observed pattern of cross-shareholding. Following World War II, Japan's American occupiers had sought to break up the prewar industrial conglomerates known as *zaibatsu* and distribute the ownership of stock in industrial companies widely among the general population. Not surprisingly, Japanese households had relatively little interest in holding onto risky securities in the uncertain economic environment of the late 1940s and early 1950s. Over time, as Japanese firms and financial institutions began buying each other's shares as a way of cementing business ties, stockholding came to be highly concentrated in the portfolios of industrial companies and financial firms. (This trend is illustrated in Exhibit 2 and was quite far along by the early 1960s (Weinstein 1997)). Because much of the equity in a typical Japanese industrial company was in the hands of "friendly" firms, American-style hostile takeovers were extremely rare events, and for much of the postwar period, M&A transactions were less frequent and smaller than in the U.S. Cross-shareholding practices helped insulate Japanese managers from pressure to maximize either share price appreciation or dividend payments. Partly as a consequence, dividend payments by Japanese firms tended to be quite low by international standards.

Given that Japanese securities firms evolved in a market characterized by limited opportunities for the underwriting of bond and equity issues, limited U.S.-style M&A activity and regulated commissions, it is not surprising that the firms depended so heavily on trading commission into the 1980s. (Exhibit 3 shows the sources of revenue for Japanese securities firms and compares this to the breakdown of revenue for their American counterparts.) Even in the late 1990s, after partial deregulation of commissions had taken place, industry observers believed that trading commissions still accounted for as much as 80 percent of the revenue of the Japanese "Big Four," the four largest securities firms.

Crash and Cartelization

By the mid- to late 1950s, the Japanese economy was taking off. This would later be designated by economic historians as the beginning of Japan—a period that would stretch into the early 1970s. In these years, Japan grew faster than any other economy in recorded history. For investors in Japan's fledgling securities markets, caution turned quickly to a sense of optimism regarding Japan's prospects. By the early 1960s, this optimism had started to transform into the kind of mass investor

euphoria that Alan Greenspan would later famously deride as “irrational exuberance.” Feverish speculation began to drive the stock prices of Japanese companies far beyond any reasonable valuation (Alletzhauser 1990).

In a pattern familiar to students of financial history, Japan’s securities firms found it impossible to resist the temptation to exploit this sentiment. The dominant brokerages soon were involved in transactions riddled with conflicts of interest, working both sides of a transaction and using their sales forces to bid up the price of stocks in which they held a large interest. Stocks of dubious quality were recommended enthusiastically to the public and to institutional investors, then unloaded quickly by the sponsoring brokerages (Alletzhauser 1990). Regulators and investors largely looked the other way while the market was soaring, but eventually the inevitable happened. The stock market collapsed in 1964, leaving the market leader, Yamaichi Securities, exposed to huge losses. Fearing that a Yamaichi bankruptcy would rattle markets even further, the Bank of Japan rescued it and other firms with emergency loans. A special government entity was established to purchase stocks with public funds in an attempt to shore up the market. While the impact on the overall economy was limited, it took decades before the levels of stock market capitalization achieved in the early 1960s, relative to the size of the economy, were attained again.² Exhibit 4 shows the magnitude of the early 1960s bubble and collapse, relative to Japan’s GDP (Suto 1993; Weinstein 1997).

Public outrage over the collapse of the market drove the Ministry of Finance to tighten its regulation of the retail securities business. The regulations imposed had the effect of raising barriers to entry into the industry and speeding the exit of all but the largest and financially strongest firms. By the time the dust had cleared, Japan’s securities industry was an oligopoly dominated by four firms—Nomura, Daiwa, Nikko and Yamaichi (Suto 1993). Exhibit 5 illustrates the impact of more stringent regulation on the number of firms in the securities industry. By 1970, the “Big Four” had a combined market share of more than 82 percent in stock underwriting, nearly 66 percent in bond transactions, nearly 48 percent in secondary market stock transactions, and they collectively accounted for over 53 percent of total profits earned in the securities industry—a level of oligopolistic dominance that would persist through the mid-1990s (Suto 1993). Each of the Big Four firms had links to smaller affiliated brokerages, extending their control over the market. In addition, each of the Big Four firms established affiliated management companies to guide the investment strategies of so-called investment trusts—Japan’s answer to U.S.-style mutual funds. The lingering impact of the 1964 crash on Yamaichi left Nomura as the undisputed market leader.³

The Bubble Economy of the 1980s

The Japanese securities business grew with the overall economy through the late 1960s and 1970s. However, in the 1980s, growth in the industry surged in a way not seen since the stock price bubble of the early 1960s. This time, the growth was driven by progress in the long-delayed deregulation of Japanese financial markets. Responding to a combination of external and internal pressures, Japanese regulations were relaxed to allow Japanese industrial firms greater access to

² The economy did not contract, but it recorded one of the sharpest slowdowns of the high-growth era as the impact of the stock market crash reverberated through the economy.

³ Alletzhauser (1990) provides an entertaining account of Nomura’s rise to dominance in this era.

domestic and international bond and equity markets. The firms responded by dramatically reducing their bank lending and shifting *en masse* to bond and equity finance (Hoshi and Patrick 2000). This led to an explosion of stock and bond issuance, as shown in Exhibit 6.

Japan's securities oligopoly was in an enviable position. The four leading firms had developed close relationships with Japan's leading industrial firms over the long period of heavy regulation in which they had the Japanese market to themselves. It was all but impossible for foreign firms to compete on equal terms for the exploding corporate finance business of Japan's industrial giants. By the late 1980s, Nomura Securities was generating a larger flow of profits than Toyota Motors, and the global influence of Japan's securities firms was growing rapidly (Alletzhauser 1990). Unfortunately, in the midst of this prosperity, Japanese stocks and other asset prices were once again becoming unhinged from any reasonable valuation. By the late 1980s, the price-to-earnings ratio for stocks listed on the first section of the Tokyo Stock Exchange had hit a high of more than 70 (Takagi 1993).

Crash, Scandal and Deregulation

After peaking at nearly 40,000 at the end of 1989, the Nikkei stock price index plunged below 16,000 in 1992 before stabilizing at somewhat higher levels. The fall in equity prices and the plunge in trading volume, shown in Exhibit 7, took its toll on the revenues of the leading Japanese securities firms. Over the next few years, a series of scandals emerged involving the leading securities firms. Some of these scandals involved the provision of "hot" stocks to influential politicians on a preferential basis. Other scandals involved the use of the funds of small-scale investors to compensate large customers for losses sustained in the stock price collapse, in violation of Japanese securities laws.

Most observers expected Japanese economic growth—and an appreciation of share prices—to resume quickly in the early 1990s. Initial efforts by the Ministry of Finance to prop up share prices by investing public funds into the stock market and placing an informal freeze on new equity issues seemed to meet with limited success in the early 1990s. However, as the decade wore on, economic growth failed to recover. Exhibit 8 illustrates the economic stagnation of Japan in the 1990s. Export growth, an important source of overall economic growth in earlier decades, was limited for much of the 1990s by dramatic fluctuations in the value of the Japanese yen, illustrated in Exhibit 9. Reflecting the lackluster performance of the real economy, Japanese share prices fluctuated within a range of 40 percent to 60 percent of peak values for much of the decade. The price of commercial and residential real estate—the collateral on which much of the lending in the late 1980s was based—continued to decline. Cracks began to appear in the banking system, starting with the collapse of specialized financial institutions called *Jusen*. In the end, the *Jusen* problem was resolved only with a large injection of taxpayer funds (Hoshi and Patrick 2000).

Japan's anemic economic growth and financial weaknesses presented a stark contrast with more robust growth (and rapidly appreciating stock markets) in the United States and elsewhere. The superior performance of less regulated markets outside Japan and the implication of both Japanese financial institutions and their regulators in a steady stream of financial scandals in the late 1980s and 1990s began to generate pressure for a more thorough deregulation of Japanese financial markets. Adding to this domestic pressure was the growing realization among Japanese

that the allocation of capital in the economy had been relatively inefficient during the years of rapid growth in the 1980s. Accounting rates of return on equity in Japan lagged well below those registered in the United States throughout the boom years of 1980–89, and the gap widened precipitously during the low-growth 1990s, as shown in Exhibit 10. Given the link between corporate earnings and equity prices, it is perhaps not surprising that the stock market return on equity in Japan also lagged well below that of the United States in this period. Gibson calculates that these rates of return were less than half of U.S. levels during the 1980–98 periods. Measured relative to the rate of return in a risk-free asset, Japanese rates of return were less than one-third U.S. levels (Gibson 2000).

The returns realized by individual Japanese investors were even lower than these market-based figures would indicate. Japanese households who invested in the Japanese equivalent of mutual funds (so-called “investment trusts”) received an average rate of return of only 1.74 percent per year between 1981 and 1992—a period during which the market rate of return was 9.28 percent (Cai, Chan and Yamada 1997). Regardless of performance measures, Japanese investment trusts underperformed their benchmark indices by between 3.6 percent and 10.8 percent per year in this period. Many of the management companies running investment trusts’ portfolios were subsidiaries of Japan’s securities companies and earned substantial commission income for their parents by churning their asset portfolios. The turnover ratio in these investment trusts’ portfolios was more than twice the Tokyo market average. Japanese law prevented investment trust managers from comparing their performance with rivals in advertisements, making it harder for retail investors to identify investment trusts managed in the interests of the investors rather than the interests of the management companies’ corporate parents (Cai, Chan and Yamada 1997). As the market plunged, the performance of investment trusts worsened even further. A deep sense of disillusionment with the equity market set in among Japanese households. The continual calls for further deregulation that had come from Japan’s trading partners for years began to resonate more strongly with Japanese voters.

In November 1996, the administration of Prime Minister Ryutaro Hashimoto set out its plans for comprehensive reform of Japan’s financial markets—a reform package that came to be known as the “Big Bang.” Exhibit 11 identifies some of the key elements of this reform program. The fundamental aim of the reforms was to bring Japanese financial markets closer to the norms that existed in the United States and the United Kingdom, open them to greater competition, raise the efficiency with which Japan’s capital was allocated, and replace the discretionary oversight of the Ministry of Finance with a more rules-based approach to financial supervision (Horiuchi 2000; Royama 2000; Kanda 2000). Even as these policies were being debated, market participants could not fail to notice the growing importance of foreigners in Japanese securities markets. Financially pressed Japanese companies were slowly unwinding their cross-shareholdings. The weakness of domestic financial institutions, the disillusionment of Japanese retail investors and the requirement for U.S./European asset managers to diversify their portfolios meant that foreign institutional investors were becoming a significant source of net purchases of shares. By the late 1990s, the ownership share of foreigners in the Japanese stock market had risen to around 20 percent.

References

- Alletzhauser, Al. 1990. *The house of Nomura: The rise to supremacy of the world's most powerful company*. London: Bloomsbury Press.
- Cai, Jun, K. C. Chan and Takeshi Yamada. 1997. The performance of Japanese mutual funds. *Review of Financial Studies* 10, no. 2: 237–73.
- Gibson, Michael. 2000. Big Bang deregulation and Japanese corporate governance: A survey of the issues. In *Crisis and change in the Japanese financial system*, edited by T. Hoshi and H. Patrick. Boston: Kluwer.
- Horiuchi, Akiyoshi. 2000. The big bang: Idea and reality. In *Crisis and change in the Japanese financial system*, edited by T. Hoshi and H. Patrick. Boston: Kluwer.
- Hoshi, Takeo, and Hugh Patrick. 2000. The Japanese financial system: An introductory overview. In *Crisis and change in the Japanese financial system*, edited by T. Hoshi and H. Patrick. Boston: Kluwer.
- Kanda, Hideki. 2000. Japan's financial big bang: Its impact on the legal system and corporate governance. In *Crisis and change in the Japanese financial system*, edited by T. Hoshi and H. Patrick. Boston: Kluwer.
- Royama, Shoichi. 2000. The big bang in Japanese securities markets. In *Crisis and change in the Japanese financial system*, edited by T. Hoshi and H. Patrick. Boston: Kluwer.
- Nikko Securities. 1998. Annual Report.
- Suto, Megumi. 1993. The securities industry in Japan. In *Japanese capital markets: New developments in regulations and institutions*, edited by S. Takagi. Cambridge: Blackwell.
- Takagi, Shinji. 1993. Introduction. In *Japanese capital markets: New developments in regulations and institutions*, edited by S. Takagi. Cambridge: Blackwell.
- Weinstein, David. 1997. Foreign direct investment and *keiretsu*: Rethinking U.S. and Japanese policy. In *The effects of U.S. trade protection and promotion policies*, edited by R. Feenstra. Chicago: NBER and University of Chicago Press.

EXHIBIT 1. Financial Assets in Japan / Allocation Across Asset Classes, 1964–98

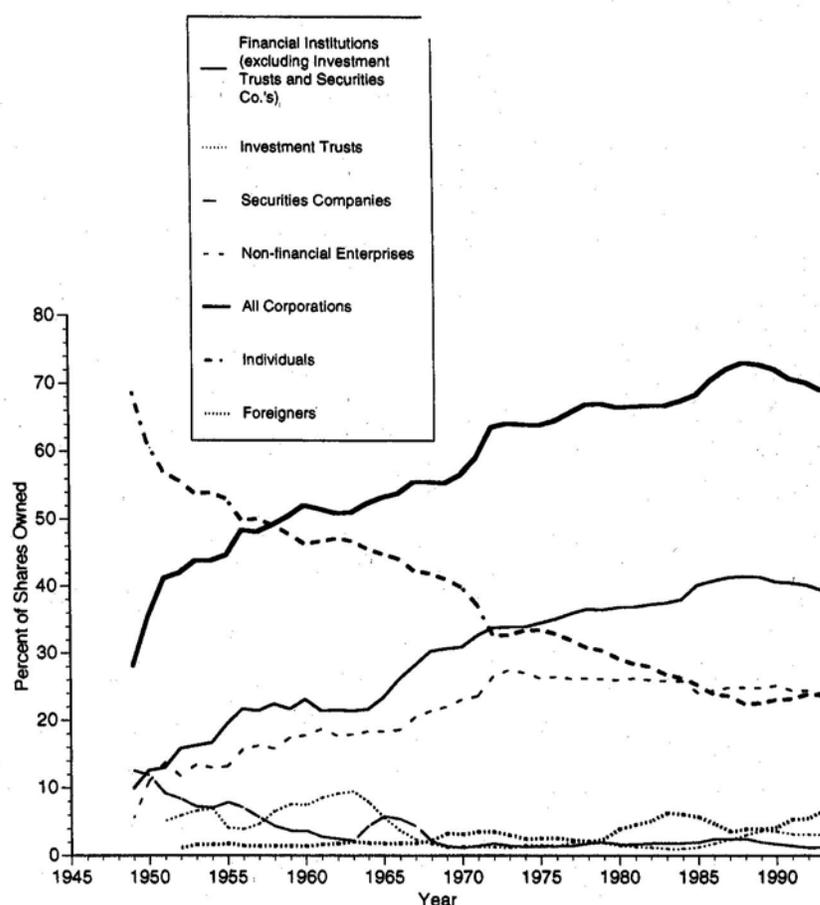
End of Year	Total Financial Assets (100 Million Yen)	Cash and Deposits	Trust Accounts	Insurance and Pension	Securities Investment Trust	Stocks	Other Securities
1964	268923	59.4%	4.1%	11.5%	4.6%	17.1%	3.3%
1965	312634	60.1%	4.6%	11.6%	3.4%	16.5%	3.8%
1966	368622	60.8%	5.0%	11.8%	2.6%	15.1%	4.7%
1967	427524	62.6%	5.4%	12.1%	2.0%	12.6%	5.3%
1968	511181	61.8%	5.5%	12.2%	1.6%	13.5%	5.4%
1969	627386	60.8%	5.3%	11.9%	1.6%	14.9%	5.5%
1970	716600	62.6%	5.6%	12.6%	1.7%	11.8%	5.7%
1971	855700	62.0%	5.6%	12.7%	1.7%	11.8%	6.2%
1972	1113458	60.1%	5.4%	11.6%	1.5%	15.5%	5.8%
1973	1277312	64.7%	5.6%	11.9%	1.6%	10.2%	6.0%
1974	1482031	65.5%	5.7%	12.2%	1.8%	8.9%	5.9%
1975	1784637	64.3%	5.8%	12.0%	1.7%	9.9%	6.3%
1976	2086751	64.2%	6.0%	12.1%	1.7%	9.0%	7.0%
1977	2383784	64.5%	6.2%	12.3%	1.8%	7.8%	7.4%
1978	2761873	64.0%	6.0%	12.3%	1.8%	8.3%	7.6%
1979	3098572	64.4%	6.1%	12.7%	1.7%	7.7%	7.5%
1980	3440324	64.3%	6.0%	13.2%	1.5%	7.4%	7.6%
1981	3859283	63.8%	6.3%	13.5%	1.6%	7.1%	7.8%
1982	4277128	62.8%	6.6%	13.9%	1.8%	6.8%	8.0%
1983	4776162	60.7%	6.7%	14.2%	2.5%	7.9%	8.0%
1984	5267657	59.2%	6.8%	14.7%	2.9%	8.5%	7.9%
1985	5721344	58.5%	6.9%	15.5%	3.0%	8.5%	7.6%
1986	6422768	56.1%	6.5%	16.3%	3.6%	10.9%	6.6%
1987	6963165	55.7%	6.3%	17.6%	4.7%	10.0%	5.6%
1988	7857442	52.7%	6.4%	18.6%	4.9%	12.6%	4.8%
1989	8934421	51.7%	6.3%	19.2%	4.6%	13.9%	4.3%
1990	9246119	53.9%	7.0%	21.0%	4.2%	9.0%	4.9%
1991	9809059	54.9%	7.1%	21.7%	3.5%	8.1%	4.7%
1992	10178181	55.4%	7.4%	23.0%	3.7%	6.2%	4.3%
1993	10751453	55.1%	7.3%	24.0%	3.3%	6.6%	3.7%
1994	11309336	55.3%	7.1%	24.7%	2.8%	6.6%	3.6%
1995	11816068	55.7%	6.7%	24.8%	2.8%	6.8%	3.2%
1996	12091513	56.9%	6.4%	25.1%	2.6%	6.1%	2.9%
1997	12293513	58.8%	5.9%	25.6%	2.3%	4.8%	2.5%
1998	13056563	55.2%	2.8%	27.8%	2.1%	7.2%	5.0%

Source of original data: Bank of Japan, flow of funds statistics.

Note: 1998 numbers are based on new flow of funds statistics that the BOJ started to publish in 1999 and are not exactly comparable to the earlier figures. For example, trust accounts held by pension funds on behalf of households were classified in "Trusts" in the old statistics and "Insurance and Pension" in the new statistics.

Taken from Royama 2000.

EXHIBIT 2. Patterns of Shareholding in Japan, 1949–93



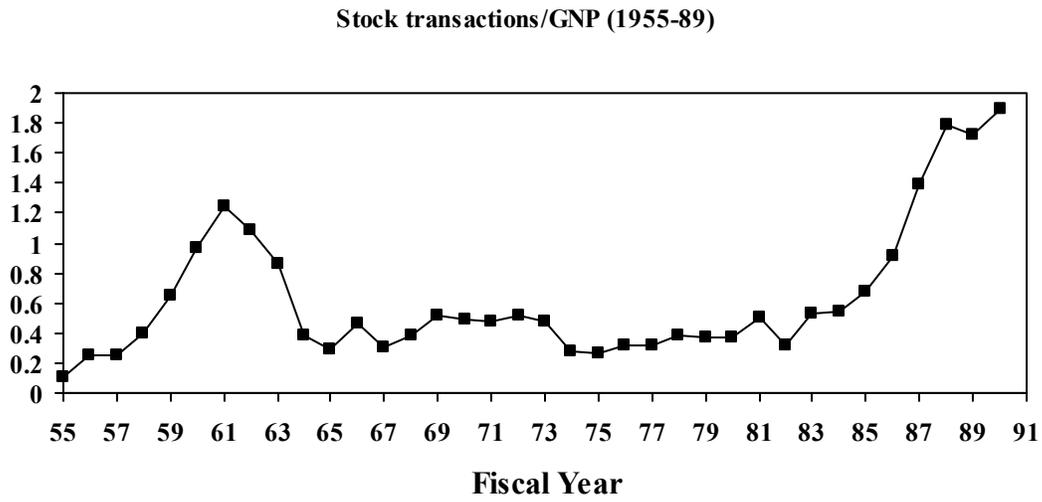
Source: Weinstein 1997.

EXHIBIT 3. Composition of Securities Industry Revenue

	1965	1970	1975	1980	1985	1990
Japan						
Commission	41.9	53.5	42.5	51.8	50.7	58.1
Distribution fees	10.4	7.9	13.0	9.9	9.1	7.0
Underwriting	4.1	4.7	7.5	7.6	5.6	7.4
Trading gains	2.2	2.8	8.7	5.0	12.6	9.2
Other revenues	41.4	31.1	28.3	25.7	22.0	18.3
USA						
Commission	60.9	49.8	49.9	35.4	21.3	17.0
Underwriting	7.2	11.9	13.3	8.3	11.0	6.9
Trading, investments	8.8	15.1	15.6	23.1	28.5	21.6
Other revenues	23.1	23.2	21.2	33.2	39.2	54.5

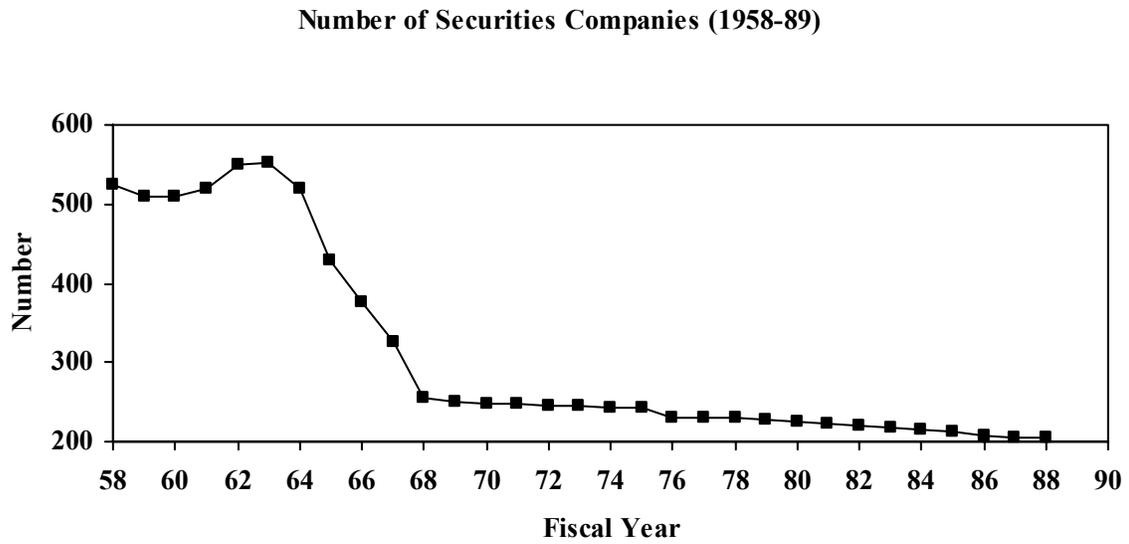
Source: Suto 1993, Table 4.19. Data taken from Ministry of Finance, Annual Report of the Securities Bureau, annual issues; Securities Industry Association, SIA Trends, Dec. 1988 and May 1990.

EXHIBIT 4. The Japanese Stock Market Crash of 1964 in Historical Perspective



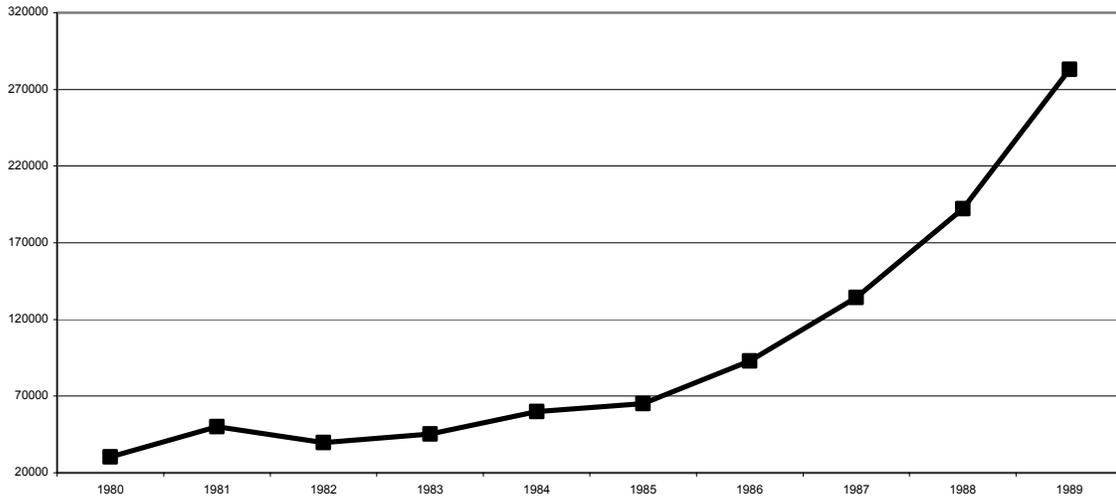
Source: Suto 1993.

EXHIBIT 5. Decline in Number of Stock Brokerages in Japan



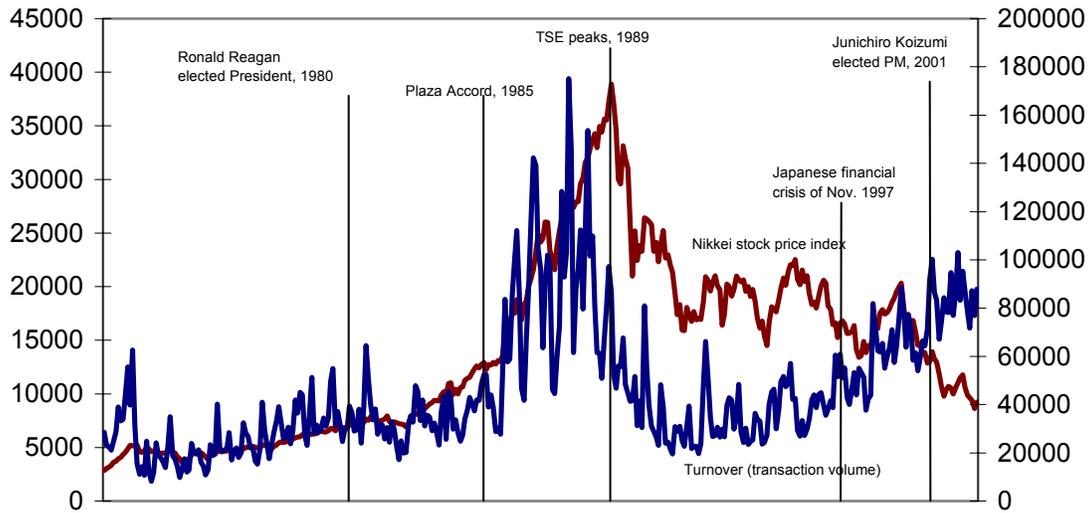
Source: Suto 1993.

EXHIBIT 6. Increase in Equity/Bond Issuance in Japan, 1980–89



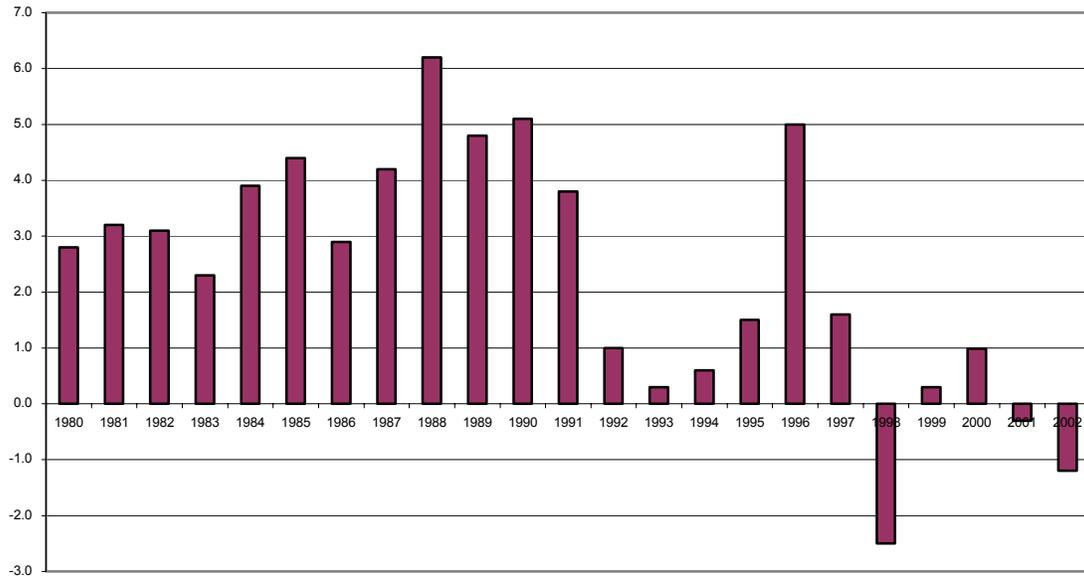
Source: Suto 1993. Data taken from Government and Corporate Bonds Underwriting Association, *Kosbasai Nenkan* (Annual Report), 1989. Units are in hundred million yen.

EXHIBIT 7. Stock Price and Turnover in Japan, 1972–2002



Source: Bank of Japan. The left axis tracks the price of the Nikkei 225 stock price index in yen. The right axis tracks the volume of turnover on the TSE, in units of 10,000 shares.

EXHIBIT 8. GDP Growth in Japan, 1980–2002, Percent Change



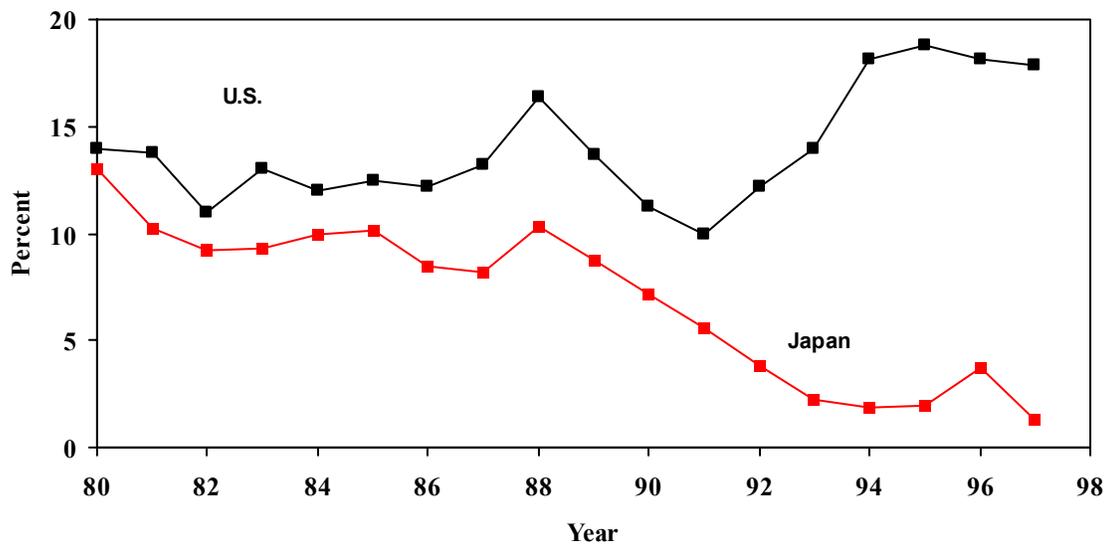
Sources: Economic Planning Agency, Bank of Japan, J. P. Morgan Chase.

EXHIBIT 9. Movements in the Real Effective Exchange Rate of the Japanese Yen, 1972–2002



Source: Bank of Japan. The real effective exchange rate is a weighted average of the yen's value against 25 major currencies.

EXHIBIT 10. Accounting Return on Equity in Japan and the United States, 1980–98



Source: Gibson 2000. Accounting return is defined as earnings divided by book value. The accounting return for a given year uses the most recent fiscal year's data available in June of the following year (to capture data from Japanese fiscal years that end in March). The accounting return is actually computed as $(P/BV)/(P/E)$, where both P/BV and P/E are taken from the MCSI database. The MSCI indices contain firms covering approximately 60 percent of a country's stock market capitalization.

Exhibit 11. Significant Financial Reforms Enacted as Part of Japan's "Big Bang"

Lifting the ban on pure holding companies (effective December 1997 for nonfinancial firms; March 1998 for financial institutions). This allowed for the emergence of a financial group in which banking, insurance and securities businesses are offered through subsidiaries under centralized management of a holding company. Daiwa Securities Group established such a holding company in 1999. Nomura and Nikko followed suit shortly thereafter.

Abolishment of remaining foreign exchange controls (effective April 1, 1998). The Foreign Exchange Act was substantially amended to allow for easy establishment of bank accounts outside Japan, easy movement of financial assets outside Japan by individuals, and the right of any person or firm to engage in currency exchange services.

Establishment of the Financial Supervisory Agency (effective June 22, 1998). The power to regulate banks, securities firms and insurance companies was stripped away from the Ministry of Finance and given to new agencies, the Financial Supervisory Agency (FSA) and the Financial Reconstruction Commission (FRC). The FRC was created to sit atop the FSA and take responsibility for licensing of entrants and other regulatory activities. The FSA implements financial regulation. This was a manifestation of Japan's attempt to move from bureaucratic discretion in financial market regulation to a rules-based regulatory structure.

Abolishment of the fixed commission system of securities brokers (made effective in stages, 1998–99).

Measures to "desegment" Japanese financial markets (made effective in stages, 1998–99). Laws were amended to allow for easier entry into the securities business, to allow securities firms to engage in nonsecurities activity, to allow nonsecurities firms to enter the securities industry, to allow for the sale of mutual funds by banks and to allow for the provision of asset management services by securities firms. Combined with the lifting of the ban on holding companies, these measures allowed, in principle, for the establishment of financial groups in Japan whose operations spanned the entire range of financial services.

Improvement in accounting (originally to be made effective in 1999, but partially deferred for several years). This measure was meant to require consolidated accounting with a "mark-to-market" rule for the valuation of financial assets. Corporate accounting in financial services firms was to be made consistent with global accounting standards.

Securitization of loans, receivables and real property (effective 1998). Special legislation permitted a low cost method of securitizing financial assets and the secondary markets for nonequity securities were liberalized to allow these securitized assets to trade freely.

Source: Kanda 2000.