MULIDIMENSIONAL OBSTACLES TO FOREIGN COMPETITION IN JAPAN'S FINANCIAL SERVICES

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ABSTRACT

"Multidimensional Barriers to Foreign Competition in Japan's Financial Services" reviews and analyzes difficulties facing foreign firms trying to enter and compete in Japan's financial service industries. The analysis, though, does not catalogue the many problems foreign firms face trying to operate in Japan's highly segmented and regulated financial markets. Rather, it focuses on specific large sectors where foreign firms have some advantage and where regulations, business practices, and attitudinal biases work singly or in concert to blunt or discourage such competition. This focus makes the most sense for developing policy because addressing every difficulty in all sectors dilutes the negotiating effort. Concentrating on issues and sectors where change in the business and regulatory environment could help foreign firms compete successfully and where the business potential is large increases the possible payoff. These services cover asset management, credit cards, insurance, derivatives, and purchasing foreign securities.

The analysis finds a broad array of practices that makes it difficult for foreign firms to enter or to fully compete despite expertise and market size. While many situations work against new Japanese entrants too, they operate disproportionately against foreigners who logically are almost always new entrants. Further, foreign firms do not have the established shareholder connections and collateral business to encourage existing clients to use their new services or to subsidize such activities for an extended period. The overriding difficulties cutting across all sectors are regulatory and industry practices that limit innovation both initially and subsequently and that impose unnecessary and burdensome cost requirements. While singly a particular barrier may not prevent entry, when taken in total they frequently do. This makes negotiating change difficult and time consuming with each subsector having to be dealt with separately rather than as part of a total financial services liberalization package. Regulations and other practices are often arbitrary with little relation to current reality. Further, they often do not permit modification even if the government's or industry's performance and financial solvency objectives are fully met, serving to discourage innovation and change while preserving the status quo.

To effectively deal with these multidimensional barriers and give foreign firms a chance to compete in the Japanese markets where they have technical or other competitive advantages, a positive initiative by the MOF will be required. In most cases, this will mean significant changes in the current system and necessitate moving to a registration as opposed to a licensing system and to a permitted in principle rather than a prohibited in principal regulatory environment. Further, performance measures not fixed arithmetic industry standards will be needed as well. It may even require that compensatory or "affirmative action" approval processes be developed for foreign firms. Unfortunately, such initiatives do not seem likely, arguing for increased frustration on the part of foreign firms and the possibility that financial services will again become a source of friction between the US and Europe on the one hand and Japan on the other.
Introduction

Having been relatively quiet as an international policy issue since the conclusion of the Yen/Dollar Accord in 1984, liberalization of financial services and the Japanese regulatory environment have once again emerged as potential sources of friction for Japan with Europe and the United States. Indeed, at a recent Senate confirmation hearing, Lawrence Summers commented that the Clinton Administration is targeting removal of Japan’s remaining financial barriers as a major policy goal (New York Times May 16, 1993) since the current arrangements continue to give Japanese firms an unfair capital cost advantage. This policy initiative has emerged because Japanese markets for certain financial services still discriminate against foreign firms’ participation in areas where they have clear global expertise. In addition, the Ministry of Finance (MOF) has tried to reregulate markets where foreign firms have competed too well.

However, before Mr. Summers undertakes his task, he should review past efforts in terms of how liberalization occurred, who gained from it, and which foreign strategies were successful. Because of these considerations, this paper will primarily examine liberalization policy from a strategic standpoint. It will thus not address all the rules, regulations, and industry practices that result in inefficient markets, poor investor returns, and limited innovation. Actually these have been recently listed in some detail (Quick Research Institute Corp. February 1993 and US Japan Business Council February 1993). However, such committee reports by their nature usually fail to discriminate between business opportunities or to emphasize specific negotiating criteria.

For these reasons, this paper will focus on identifying and analyzing those financial services where three conditions apply. One, existing or potential barriers make it difficult for foreign firms to fully compete. Two, the potential market and company returns appear sizable. Three, foreign firms have the potential not only to enter the market but to sustain competitive advantage over time. It will also argue for regulatory relief in certain other areas so as to reduce the economic rents gained by existing providers that are used to subsidize entry and competition in sectors where foreign firms would normally have an advantage. In addressing the problems in this way, one can understand those businesses where foreign competition is likely to result in the greatest long term gains in innovations and efficiencies. That is, foreign investors’ strategic goal should be to develop a long term profit opportunity not just to eliminate market inefficiencies except where the latter are used as cash sources to subsidize otherwise uncompetitive products. Without this selection screen, it is easy to confuse one time changes in market conditions that eliminate economic rents for existing participants as opening those markets to foreign investors.

However, the two are not the same. This is indicated by the fact that when the Japanese government bond market was opened to greater competition spreads narrowed, but the Big Four
(Nomura, Daiwa, Nikko, and Yamaichi) securities firms maintained their seventy-five percent market share. In order to better understand the likely effects of liberalization, though, it is necessary to examine past liberalization from at least three aspects: the nature of Japanese competition, the nature of the deregulation process in terms of the MOF’s relation to the industry being deregulated, and the nature of successful foreign competition in an open Japanese market. The first perspective is the nature of Japanese competition which in the manufacturing sector for most large successful firms have evolved from imported products and technology, to local market production, to product and production process improvement, to exports, first to less developed countries and then to more advanced ones.

This competitive development has been supported by rapid rates of investment and aggressive pricing to build volume and global market share given little ability to establish product differentiation in markets served by similar producers using similar technologies. The price pressures become very intense once growth slows domestically and abroad. This pattern has been repeated in a series of more and more sophisticated and higher value added industries starting with cotton textiles, extending to steel and ships, then to cars and earth moving equipment, and next to computers and semiconductors. (See for example Abegglen and Rapp 1970 and 1972, Abegglen and Stalk 1985, Baba 1989, Rapp 1992, and Rapp January 1993.)

Japanese competitors are thus quick and effective imitators (Baba 1989 and Rapp 1992), and are quite willing to use price as a competitive weapon. However, a careful analysis of certain industries indicates that this aggressive pricing may not be used uniformly across all products and market segments. Dumping suits in industries such as TVs, automobiles, semiconductors, steel, and textiles indicate that the domestic Japanese market has often been used to subsidize exports. Further, excessive protection in one part of a product/process chain may subsidize a series of related products and technologies including exports to third countries. This can be seen in ammonia fertilizers' support of the ammonia chemical chain or the caustic soda cartel's subsidization of the chlorine chemical chain including PVC (Rapp 1986).

However, Japanese firms generally offer a full range of products to their customers despite the fact it is usually more costly compared to a more limited product line (Abegglen and Stalk 1985). Firms appear able to keep these costs under control because most major Japanese auto and electrical manufacturers are primarily assemblers. They are less integrated than their US counterparts, and many use the same major subcontractors. It is therefore at the subcontractor level that market concentration occurs. While Toyota has larger volume and lower costs than Mazda and has more power vis a vis the major Japanese auto parts manufacturers, by buying from the same major subcontractors, Mazda can to a certain degree coattail Toyota's scale and efficiency. Toyota in turn benefits indirectly from this added volume to its major subcontractors.
(Smitka 1990 and Fruin 1992). What still seems strange from a US management viewpoint, however, is why they would want to maintain this diversified product line at all. That is, why are they willing to incur any additional cost in such a competitive and price sensitive environment?

The answer lies in the "competitive compulsion" described by Lifson (1987) and Ohmae (1991). In addition, the author (Rapp 1993) in examining Japanese foreign direct investment noted that a strong motivating factor in Japanese FDI has been Japanese firms' reluctance to risk another Japanese competitor gaining an advantage or access to a major customer abroad which could subsequently develop into a global relationship. Thus Japanese firms will often offer products or services with the purpose of protecting and maintain existing relationships and market share over making a profit. They will consciously use existing customer business to cross-subsidize this activity, frequently pricing at or below cost.

The competitive topology is a few profitable businesses and several ancillary products and services that encircle the customer where the firm is breaking even or losing money. The overall rate of return from the firm's total operation may be no different than for a US counterpart trying to equalize returns across a portfolio of businesses. The competitive behavior and allocation of resources, though, are quite different. In Japan there will be a disproportionate resource allocation to the core businesses where the firm will be quite competitive whereas the peripheral businesses will be run as Japanese "Service" or loss leaders. Market share in the core businesses will be substantial whereas for the peripheral businesses it will be minimal. The peripherals may even be sourced from neutral suppliers or industry-wide subcontractors. Customers and market share will be defended fiercely because the company is totally committed to its core businesses and to firm survival (Porter 1992 and Rapp 1992). Nevertheless, by such tactics one can keep pressure on a competitor's cash flow and easily exit the peripheral activity if it turns out to have been a temporary phenomena. While more research needs to be done on this paradigm (Rapp May 1993), the foreign investor still needs to deal with the Japanese competitive environment that seems to exist. This argues for a well articulated entry and investment strategy to define an advantage based on technology, market position, and cost.

While this paradigm is only being examined with respect to firm behavior, in many ways the description also reflects the functioning of the Japanese economy. This is because the steel industry chain, which also includes autos, ships, machinery, and earth moving equipment, plus the electronics industry chain account for over eighty percent of Japanese exports and direct manufacturing investment abroad. They thus support the rest of the economy, including the massive explicit and implicit subsidies to and protection of uncompetitive activities like rice cultivation and pulp and paper production.
In this paradigm competition in the peripheral areas is particularly severe except for the most efficient producers, and it is likely these products will be commodities since everyone feels the necessity to offer them to their customers. Because of this innate competitive environment, foreign firms who have invested in Japan can generally only succeed over an extended time period when they are able to offer a product or service which is new and not easily emulated by Japanese companies. This applies to financial services as well as other businesses (Kluchi 1993 and Rapp May 1993). If it is new, it will not infringe on an existing core business. If it is not easily emulated, then other Japanese firms will not offer the product or service. Therefore, it will not represent an entry threat by those firms to another Japanese firm’s customer base. Further, foreign firms are outside the Japanese business system and do not usually present a threat to which Japanese firms feel compelled to respond. Conversely, for a foreign firm that can establish and sustain a competitive position, it can be quite profitable. This is because market returns to Japanese companies are based on their overall environment whereas foreign firms are only expected to offer their specialty products. This situation allows the "gaisha" to retain most of their core profits without needing to give back much in "Service".

Still, for a foreign investor to create a sustainable advantage in the Japanese market requires that they not only establish a market but continue to define and influence its competitive development. Otherwise imitation and the inevitable price competition is always a risk. This goal is frequently achieved by the continuous introduction of innovations from outside Japan, provided they remain an important competitive element. This is especially necessary after market growth slows and price pressures increase. In those cases where emulation or substitution of the basic product or service by Japanese firms is relatively easy, though, and where innovations can be effectively imitated or are competitively less important, foreign firms tend to quickly lose their advantage. They then become much less profitable and indeed many are forced to exit the market at considerable expense because they cannot compete with large Japanese companies who are prepared to give the product or service away at or below cost. De facto standardization makes this result even more likely since the Japanese are excellent at imitation, volume production, and constant improvement.

Therefore, merely entering and competing in an already established or even a high growth Japanese market without a proprietary product, technology, or service is very difficult and rarely produces superior results. The net result is that a foreign competitor is usually on one side of the waterfall or the other, i.e. quite profitable or losing money. One sees this scenario repeated again and again for many firms and product areas. Further, since the Japanese clearly will compete on price, it is always important that the foreign firm keep its costs under control relative to any potential Japanese competition, even if one can sustain an advantage for other reasons.
Financial Services Industry

This description of how large Japanese firms compete is fully consistent with most aspects of Japanese financial service sector such as the main bank system. For example, under this paradigm, one would anticipate the results of Caves (1976) and Uekusa (1987) that main banks have higher returns on their core bank customer relations than with their peripheral customers. Similarly, given the fixed commission system for stocks and the fact that over 70% of shareholdings are by corporations and financial institutions, it might be expected that securities firms would be under severe pressure to reduce prices by returning some of these excess earnings in the form give backs or special services like rate of return guarantees (Zielinski and Holloway 1991). The hara-kiri swap is another manifestation of such pressures (Rapp May1993).

These currency swaps were a key element in many financial products such as synthetic securities, mixed credits, and Euro-bond issues. However, while the foreign banks and the US banks in particular dominated most swap markets, these Yen/$ swaps tended to be dominated by the Japanese banks. The reason for this was twofold. One, they were dealing in their own currency and had a large asset base to use to hedge their position. Two, they were willing to price them very aggressively often below their expected cost in order to buy business and/or to protect a valued customer, such as offering an attractive swap to become colead manager on a Euro-issue for an important client.

Similarly, during the Mergers and Acquisition (M&A) boom of the 1980s, almost all banks and securities firms had M&A departments no matter how small. Even regional banks offered their clients this service. However, only a few institutions, including IBJ, LTCB, and Mitsui Bank, were actively searching out transactions and charging fees. The others were passive in that they waited for a client to ask them to assist, and then would find an appropriate advisor, usually foreign, to help. In turn, they would usually wave any fees due them as "Service" to the customer. In this manner, they could always tell their clients they had an M&A capability, and their competitors were then prevented from soliciting business on the basis that this important service was missing. On the other hand, the passive players were not devoting the same time, money, and human resources to M&A as those who had decided to truly compete. One problem resulting from this situation, though, was that the latter's willingness to give away fees made it difficult for foreign bankers to collect money for the substantial start up time needed to develop a transaction.

For this reason, only those foreign firms with substantial deal flow who could show a Japanese customer a transaction as one of several clients approached could really do well. Further, unless a Japanese customer had already targeted a candidate, it was best to represent the
foreign seller. This is because the active Japanese banks will only talk with intermediaries having sell side mandates while the passive players want to keep fees to their clients low. The net result has been that only firms with a good flow of sell side transactions and a global reach are likely to sustain this business in a downturn such as the current recession or the collapse of the Bubble. Of the well established firms who entered Japan in order to broker the 1252 foreign acquisitions made by Japanese companies between 1985 and 1989 (Zielinski and Holloway), only Goldman Sachs, Morgan Stanley, and Merrill Lynch appear to fall into this category, and their business is apparently profitable despite the present environment.

The experience of foreign banks in Japan from the immediate postwar period until the early 1980s illustrates a similar competitive evolution. It also represents the first illustration of the liberalization process in Japan's financial markets as administered by the MOF. Right after the war and during the Occupation, four US banks set up in Japan, Citibank, renewing their prewar license, Bank of America, Chase, and Continental. Then, when the Occupation was over, the window to further entry was closed, and other foreign banks were only allowed to open representative offices. In this way, foreign banks were segregated and given their market niche in the same way as other financial services. Given Japan's high growth and capital shortage during this period, having a banking license was an opportunity to make enormous profits, which these four banks did. These profits combined with Japan's spectacular growth attracted the interest of other foreign banks both US and European who put pressure on Japan through their governments to liberalize the entry requirements.

Each bank naturally projected the existing four banks' returns on to its smaller balance sheet. Finally, beginning with Morgan Guaranty in 1969, several foreign banks were allowed to enter and open branches. Further, up until the Oil Shock in 1973, they made money because of Japan's continued high economic growth and demand for capital. At this time, around 78% of listed Japanese companies' demand for external funds was still satisfied by bank borrowings. Further, foreign banks were the only banks permitted to make "Impact Loans" or foreign currency loans to Japanese companies. In addition, only foreign banks were allowed a swap limit through which they could convert Euro-dollars to Yen spot and then sell the Yen forward into dollars creating a Yen funding pool they could loan to Japanese customers. The "Nixon Shock" in 1971-72 thus created a windfall for them since the foreign exchange markets anticipated further appreciation in the Yen. This meant that one could often sell the forward Yen for more dollars than one had borrowed to convert into Yen spot, creating a negative cost of funding for the foreign banks and incredible profits.

However, the Oil Shock dramatically slowed Japan's economic growth and the demand for borrowed funds dropped sharply while the weakening Yen meant that foreign banks' funding
cost rose. At the same time, the overall appreciation in the Yen after 1971-72 raised the cost in dollars to operate a Japanese office. The attractiveness to foreign banks of being in Japan started to unravel. Also, the Japanese banks and insurance companies were much more aggressive on price than the foreigners. Finally, instead of the percentage of foreign assets or foreign banking business expanding with the entry of more foreign banks as many had anticipated, it remained about the same or even shrunk a little (3% of loans and 1% of deposits - Shinkai 1987). Thus, the same amount of business was being divided among many more players. Therefore, despite the growth in the Japanese economy there was less to go around.

Responding to this situation, the Americans in particular felt that the key to their problems lay in liberalization of Japan's financial markets which remained highly segmented and controlled by the MOF (Brown 1986 and Garten 1991). Interest rate deregulation, for instance, would give them access to low cost deposits as an alternative to swaps. By the late 1970s, they found a ready ear for their complaints in the US Treasury, which for its own reasons wanted Japan to liberalize its financial markets in order to create more international demand for the Yen, thus strengthening the currency and taking pressure off US exporters.

To a degree this lobbying effort succeeded, and the first major laws to be changed were the Foreign Exchange Law in 1980 and the Banking Law in 1981. This new exchange law shifted regulation from a negative system to a positive system such that what was not prohibited was permitted. As a result, though, the Japanese banks were allowed to go into the "Impact Loan" business and to raise funds overseas. This combination of events took away foreign banks' advantage in swap funding and impact loans, and soon excessive competition in impact loans forced them from that market altogether. Then without a cheap source of Yen funding and no regulatory advantage in foreign currency lending, many foreign banks were forced to close their offices, Wells Fargo and Crocker among the first casualties. In addition, even large profitable operations like Bank of America were forced to close offices, going from five to one and a half branches between 1975 and 1988. Continental closed their office in Osaka altogether, though they had been one of the original four US banks in Japan. On the other hand, the foreign exchange business expanded dramatically, and the leading US and European banks were soon the major players. However, those without strong remittance or other customer business found that they were at a competitive disadvantage compared to those who did and the latter established their market leadership based on their ability to understand the direction of the market and to offer derivative services such as swaps and long-dated forwards.

Another aspect of the response to liberalization in the Foreign Exchange law in 1980 and the Yen/Dollar Accord in 1984 was that large corporations found that compared to domestic bank financing they could now raise funds more easily and cheaply overseas, especially in the
London based Euro markets. This was true even if the ultimate investors or buyers of the paper were Japanese financial institutions. At the same time, given the very high interest rates for dollar securities compared to Yen denominated assets, Japanese financial institutions were anxious to build their dollar based portfolios. They had not been permitted to do this very easily prior to the change in the exchange law. Yet the insurance companies in particular were immense institutions, often with billions of dollars to invest. Since they were starting from an almost zero investment base in foreign securities, the impact on the market was dramatic. This is because the reallocation of a portfolio’s assets frees up much more money than might be available on a normal cash flow basis from insurance premiums. The result was that in 1983 only 29% of new funds raised by listed Japanese corporations came from bank loans while 32% came from bonds and 39% from stock and convertibles (Brown 1986). Further, slower economic growth meant that internally generated funds, earnings plus depreciation, had risen from 32% to 49% of new funds available for investment. Japanese insurance companies in turn held $223 billion in foreign securities by 1986 (Shinkai 1987), testifying to their massive acquisition of foreign assets.

The drop in borrowings, especially by listed customers who were their primary client base, put more profit pressure on the foreign banks. It also made entry into the securities business in the 1980s very attractive. Indeed, there had been no foreign securities firms licensed in Japan in 1970, 2 in 1975, and only 4 in 1980. However, by 1985 the number had risen to 14 and to 52 by 1990. The inclusion of over 100 representative offices would further expand this number. Given that the number of Japanese firms had steadily decreased from 1127 in 1949 to 220 in 1990, this increase is truly dramatic with foreigners accounting for 20% of the licensed securities firms in Japan in 1990. Nevertheless, the experience of the foreign bank branches in Japan should have been instructive with respect to the potential risks and pitfalls, both to the newcomers and those responding to changes in conditions. These dangers at a minimum involved relying on continued regulation to protect a market, assuming the market would grow with increased foreign entrants, and believing that future dramatic market changes would not occur to force new strategic responses. Furthermore, very few entrants did their homework on how they might prepare for such eventualities. Generally, they assumed that they were global financial institutions and therefore had to participate in the third leg of the emerging global financial market and that their traditional foreign customers would direct their Japan related business through their new Japanese offices. The latter was a particularly dangerous assumption given the expanding global reach in all major world financial centers of Japanese securities companies and the securities operations of Japanese banks. Also, the big four Japanese brokerage firms since 1985 have maintained a concentration ratio above 90% in brokering foreign securities listed on Japanese exchanges despite the entry of so many foreign securities firms during that period (Kimura and Pugel 1992).
The liberalization lessons from the foreign bank experience were as follows:

- The most easily liberalized markets are those dominated by foreign institutions since there are no domestic interests to oppose such liberalization and given regulatory segmentation domestic firms are anxious to pick up any new business. Therefore, the MOF’s natural constituencies support such liberalization while opposing it for their own sectors. The net result is that liberalization occurs first in those sectors where foreign participation is high with the domestic Japanese firms each using their own protected markets to subsidize entry into the now unprotected market. The negative pricing and profit results for the foreign firms are dramatic unless the foreign firms have something other than "protection" to offer their Japanese clients. In the case of impact loans this was not the case since Japanese banks could raise Euro-dollar funds as cheaply as their Western counterparts and were willing to take a lower spread as well.

- Liberalization is a complex decision making process that requires consensus. However, in Japan consensus decision making can often mean "disconsensus" decision making in that anyone who is part of the consensus process can often exercise a veto by refusing to agree. The net result is that change is very difficult, and that industry interests can effectively oppose the liberalization of their turf (Blaker 1977 and Rapp 1992). Therefore in the end foreign firms lose their protected markets and gain little in return as the other markets are not truly liberalized.

- If new markets open, e.g. foreign exchange, foreign firms can do well provided they have a proprietary or technological advantage based on their participation in other international financial markets. In addition, they must be able to keep their costs under control and to cover these costs based on their core business activity rather than from consistently superior market participation.

- Further market liberalization can lead to excessive entry by both foreign and Japanese firms raising costs for scarce resources and spreading available business among too many players.

- Liberalization can liberalize customer options as well. This may mean that previous market opportunities may disappear as in the case of loan demand by large Japanese firms.

However, despite these warning signals, the dramatic growth in all aspects of the securities market during the eighties mesmerized almost everyone. Initially, and prior to the Plaza Accord, this was because one could easily buy US Treasury bills or European government bonds in volume. Thus, responding to high dollar interest rates and the desire to redistribute their assets towards higher yielding securities, Japanese insurance companies bought aggressively and
soon began to push their allocation ceilings from the MOF until one clever investment banker discovered that the restriction on buying foreign paper only referred to the borrower not the currency. Therefore, Eurodollar issues by Japanese corporations were not subject to the restriction. With this innovation began the headlong surge of innovative financing techniques, regulatory arbitrage, and the exploitation of market imperfections that has characterized the Japanese financial markets up to the present. In turn, because of the gradual liberalization of the Japanese markets and regulatory environment plus US and European political pressure, there was the rush of often ill-considered foreign investments into the Japanese securities industry. These firms' objective was to capture a share of the enormous profits coming from the opening of what had been a highly protected industry which still maintained fixed commissions. Yet, only a few arrived with any preconceived strategy or any real understanding of Japan, the Japanese competitive environment, or the Japanese securities business. Therefore, like many foreign investors before them in other industries, and especially very similar to the opening of the banking market in the late sixties and early seventies, of the many that entered into the initial boom, not all have survived and even fewer have prospered the ensuing changes in the market and the final collapse of the Bubble. Already between 1990 and 1992, the number of foreign registered securities firms has fallen from 52 to 45 (Kimura and Pugel 1992), and County NatWest most notably has recently announced it will be selling its seat on the Tokyo Stock Exchange (TSE) and departing.

From these situations and similar examples, one can begin to see that to compete effectively in the Japanese financial services sector, the foreign investor has to establish and maintain an advantage in a business the Japanese cannot emulate. Once emulation becomes possible, for example via deregulation, "excessive competition" emerges and the foreign financial firm's business becomes unprofitable. The Japan success paradigm for foreign and domestic firm alike therefore stresses the importance of defining, controlling, and defending profitable market segments by sharply differentiating a firm's profit expectations and resource allocation in its leadership products from those it offers as "Service". For example among the foreign firms who entered the Japanese securities and related industries during the liberalization of the 1980s, the most spectacular success has been those foreign firms that dominate the derivatives, options, and futures markets. Their strategic impact on the structure and institutional arrangements within the securities industry in turn has been immense.

**Liberalization, Derivatives, and the Bubble**

Liberalization of entry requirements enabled foreign securities companies to play a very active role in the *Bubble Economy* that developed in Japan in the late 1980s just as they had for banking in the early 1970s. The enormous profits they made attracted more investors. Similarly,
the subsequent collapse has put pressure on several, forcing them to leave or at least to scale back, just as foreign banks did in the earlier boom and collapse of the 1970s. Yet, because they entered principally during and due to the Bubble, analyzing this is critical to the analysis of their role in Japan’s financial markets and their ability to compete on a long term basis. Further, the origins and aftermath of the Bubble have fundamentally altered the structure of the financial markets and the traditional role of foreign securities firms within them. Indeed, these developments have resulted in certain firms establishing a competitive position which appears sustainable over an extended period of time. In essence by creating and stimulating the emergence of an important market segment and then dominating and controlling its development, these firms have been able to join a select group of foreign investors such as Exxon, IBM, Coca Cola, MacDonalds, Kentucky Fry and Weyerhaeuser who have been able to succeed in Japan despite the competitive challenge of Japanese companies. At the same time, they have invited deregulation by the MOF exposing an additional complication to the liberalization model.

Part of the origin of the Japanese Bubble is found in the excess liquidity that emerged in Japan in 1985 due to the combination of the existing trade surplus and the sharp appreciation of the Yen occurring after the Plaza Accord. In Japan’s case, the ballooning of the trade surplus had a sharp impact on the money supply as Japanese companies converted their dollars to Yen and the Bank of Japan allowed the money supply to increase in order to counteract the deflationary effects of a rapidly strengthening Yen and to moderate further appreciation. Since in the early 1980s, Japanese portfolio investors had stormed into dollar assets in response to higher rates, keeping the Yen weak, they now had billions of Yen in losses due to the Yen’s appreciation. They thus sought the safety in Yen denominated assets and began to hedge their dollar portfolios as well. This of course put additional upward pressure on the Yen. The net result was the excess liquidity found its primary outlet in Japanese government bonds, real estate and stocks with the investors being primarily large corporations, financial institutions, and wealthy individuals since they were the ones that experienced the increased liquidity as well as the negative impact on their dollar denominated assets. This was not a people’s boom, which is one reason that asset prices inflated rather than consumption goods. In essence, no longer having an attractive outlet abroad, Japan’s excess savings was chasing a shortage of domestic investment assets, driving up their prices.

However, bonds, real estate and stocks shared a common demand/supply phenomena. Historically, Japanese financial institutions had bought government bonds on a direct placement basis and had held them until maturity (Shinkai 1987 and Garten 1991). Similarly, people and particularly companies did not sell real estate because of high taxes and the fact that prices always went up (Frankel 1991 and Yamamura and Hanley 1992). Finally, firms did not sell stock because the market had over time always tended to go up and because of stable shareholder
relationships (Zielinski and Holloway 1991). Further, over time the proportion of stock owned by institutions had tended to rise since they were generally only buyers and never sellers. Thus, by the late 1980s unlike the US as much as 70% of stock in Japan was held by related companies and individuals for business purposes (Zielinski and Holloway 1991).

Given the phenomenal appreciation in stock and real estate values since the War of fifty to one hundred times, one might assume that Japanese companies who owned stock in related companies would resist having so much tied up in low yielding high value assets. But including capital appreciation, the yields have been quite good and liquidity is not a problem since banks have been prepared to lend against the collateral value. One could borrow 80 to 85% of market value as collateral rather than for its cash flow. Since corporate tax rates can run as much as 60% on profits and 75% on land appreciation, more cash could actually be realized on this basis than by selling. Conversely, the cost of carrying appreciated stock is nil and land taxes on use as opposed to disposal are also quite low (Yamamura and Hanley 1992). For these reasons, it is estimated that only about 10% of real estate actually turns over per year and only about 30% of stock. Also, for many years trading in the Japanese government bond market had been largely restricted to the "benchmark" bond which changed periodically to maintain a roughly ten year maturity. To provide liquidity, this bond was usually the largest recent monthly issue or sometimes two or three months issues were linked. Other government bonds were priced off the benchmark. However, this structure meant that the supply of tradable bonds in the market was much more restricted than the overall government debt or the total issue of bonds might imply.

In sum, the supply of bonds, stock and real estate was structurally restricted at the time of increased liquidity and financial liberalization. The increase in liquidity was then compounded by a further easing in monetary policy by the BOJ as it tried to keep the Yen from getting stronger as the trade surplus and the shift to Yen assets interacted with and increased the Yen's value, exacerbating both the J-Curve effect and the switch to Yen assets. The drop in interest rates in turn created capital gains for the holders of Yen assets, further stimulating demand.

This economic environment would in any case have forced prices up more than normal. But as stock and real estate prices rose, they created their own compounding effect, creating the engine for the sharp upward spiral in prices and the Bubble. The increase in bonds, real estate and stock prices resulted in investors valuing companies on the basis of their hidden real estate and financial assets, bidding up their shares (Frankel 1991). Investors then used the gains on their stock sales to buy real estate, either by selling the shares or by borrowing against the appreciated values. In turn, profits and loans on appreciated real estate were used to buy stocks and bonds, thus ratcheting both up on a continuous interactive basis as the Bubble became full blown. Since a price rise in bonds, stock, or real estate affects all holders, this phenomena extends well beyond
the immediate buyers and sellers to all class holders, lifting the borrowing capacity and the paper wealth within the economy enormously. These interactive phenomena of supply and demand for assets seem to be the source of the Bubble.

The first indication of possible weakness and the possibilities for financial collapse given a change in the underlying supply and demand dynamics came with the dramatic fall in the Government Bond Market in June of 1987. In this case, benchmark bond structure combined with the government's loose money policy to promote ramping of the market by a syndicate of Japanese banks and securities houses in a maneuver somewhat analogous to Salomon's attempt to corner the US two year note. More precisely, as interest rates fell and the money supply expanded, the opportunities for significant capital gains in government bonds did not escape the eye of various investors. Money poured into the market during the first and second quarter of 1987, and the price of the "benchmark" rose dramatically, leaping ahead of its traditional relationship to other government bonds. By June the yield approached 2%, even below the BOJ's official discount rate.

It was then rumored that this excessively rapid rise was due to a syndicate of banks and securities companies having largely cornered the somewhat limited supply of benchmark bonds, effectively restricting the supply of "tradable" bonds and forcing up the price to those in the market. Other brokers and dealers who were caught short complained. The MOF then moved quickly to deal with the problem by unilaterally expanding the issue, eliminating the corner. However, the ensuing collapse and the rapid retreat of rates back towards 4% showed what could happen when the pressure of too much money chasing too little supply was eased. Therefore, while the stock market recovered after the October 1987 Crash, the bond market did not because the institutional dynamics that had restricted supply had been permanently altered. After all there was no limit to the government's ability to supply the benchmark. In addition, by 1987 the appreciation of the Yen had begun to decrease the balance of payments surplus, and the BOJ began to tighten interest rates to control the economic expansion once it was clear the effects of the 1987 US Stock Crash on Japan were temporary.

Yet, this situation illustrated the anomalies in Japan's financial markets as you moved from a heavily regulated market to one where market forces were allowed to operate more freely at least in certain sectors. Previously, government bonds had been largely placed with Japanese banks and insurance companies who then held them until maturity. But during the 1980s, partially under pressure from the US Treasury and foreign bond houses like Salomon, this gradually shifted to a market system in which some were traded but many were still held under the old system. Thus, the possibility for a well capitalized group to "corner" the "benchmark" and influence the market became a possibility. The MOF then changed the rules of the game. The
role of the foreign securities firms and the Yen/dollar Accord in liberalizing this market were also apparent. These are aspects that one can see repeated in the stock market boom and its subsequent collapse.

Since the bond market did not recover but the stock market did, enriching those who invested at the bottom, the interactive upward price ratcheting in stock and real estate resumed with the speculative investment money that had been in bonds adding to the pool available for investment in stock and real estate. Also, banks and insurance companies who had now taken large losses in Japanese government bonds just as they had in US government and Eurodollar bonds naturally tended to put more of their investable funds into stock and real estate, generating further upward pressure on prices and therefore in their desire to invest. This added to market momentum. This was true even though the MOF permitted accounting changes that allowed these financial institutions to hide their foreign and Yen bond losses by continuing to carry the bonds on an investment or book basis. This is because investors still knew they had lost money.

Because of the excess liquidity and the hot stock market, traditional loans to large Japanese corporations lapsed even for Japanese banks. Listed companies found it more attractive to raise funds in the stock market or the equity linked bond markets. In 1987 this amounted to about 12 trillion Yen, 14 trillion in 1988, and 24 trillion in 1989 (Sheard 1992 and Zielinski and Holloway 1991). Therefore, Japanese banks increased their direct real estate loans, indirect real estate loans using securities as collateral (usually stock or bank CDs), and securities lending. They also became aggressive in overseas markets, including merchant banking and capital markets activities, often underwriting the equity linked debt issued abroad by their major customers. This expansion and seemingly unlimited financial power caused competitive concern among US and European banks who felt weakened by their LDC debt burdens, the after shocks of the 1987 stock market crash, and the fall in US real estate. This situation created the political climate in 1988 for the Bank for International Settlements (BIS) representing the major central banks to agree after two years of negotiation on capital limits for the major banks involved in international lending. The MOF and the BOJ, however, insisted that Japanese banks be allowed to count some portion of their hidden reserves from appreciated stock as part of their tier two capital. This was set at 45% to allow for the effect of taxes if realized as earnings. As a result banks now had a strong incentive to hedge their stock portfolios in a market downturn.

During this same time period, there was similar overseas pressure for the MOF to further liberalize and permit the development of a futures market that would allow US and European securities firms, who had entered the market to expand into this business based on their existing international experience. The MOF had an interest in this development as a way to improve liquidity in the Japanese government bond market given their desire to increase the market for
government bonds. This was seen as improving demand and liquidity for bonds as well as avoiding the previous supply problems that had led to the June bust, showing some appreciation of the effect of supply constraints on market booms. In any case, Japanese financial institutions had received permission to trade the Nikkei index offshore in May of 1987 and had been trading actively on the Simex whose contract began in 1986. Thus the MOF agreed to allow the introduction of futures trading partly to improve a government bond market still feeling the effects of the June crash and partly in response to foreign pressures. The Osaka 225 index began trading September 1988 and soon replaced Singapore as the volume leader with about ten times as many contracts and about twenty times as much volume. However, in this liberalization process, the MOF unknowingly uncoupled a key link in the chain of support for high stock prices and opened a true competitive window of opportunity for certain foreign securities firms.

The market structure was fundamentally altered because an index future increases the supply of a portfolio of stocks. Anyone can create a futures contract or option, and someone that wants to hold a group of stocks can purchase an index future or option as an alternative (Lim April 1992). Further, one can de facto sell the stocks without actually putting through an order on the cash exchange, i.e. the TSE, to sell the shares. Therefore, the development of the index futures market went way beyond what the expanded supply of stock, warrants, and convertible bonds issued by Japanese companies in the late 1980s might have done to increase the supply of Japanese equities, though these securities had certainly increased supply too. Additionally the holders of these new securities were potential users of futures as well. With the development of the Nikkei and Topix index futures, any amount of stock could now be created and sold or bought without the demand and supply constraints that had characterized the market for so many years. However, this restricted supply had contributed significantly to the vertical increase in share prices. (Sidney Fried in his book on warrants, options, and convertibles predicted that this phenomena would lead to a crash in the Japanese market [Fried 1989].)

The seller of futures could now be a "stable" shareholder who because of the presence and expertise of foreign securities firms would not have to go through established Japanese brokers to sell. They were thus no longer subject to the informal discipline of business relationships, the MOF, or the market. Further, the banks now had a capital preservation incentive to act accordingly. The insurance companies had a similar incentive after they had successfully pressed the MOF to be permitted to include up to 25% of their long term capital gains as policy income for reporting purposes. Interestingly, the MOF had been partly pressured into making this concession due to the high/low bonds created by Nomura and other securities firms that converted capital gains to income. In any case, they had a strong incentive to hedge too to preserve capital gains on their stock portfolios or Tokkins. The latter were special trust funds established to segregate insurance companies' and banks' investment stocks from their
relationship stocks. These by definition were now salable, and with respect to these shares these institutions had become "unstable" shareholders, undermining an important structural support for the market. The potential instability in the stock market due to these developments was first signaled in December 1988 when there was a downturn exacerbated by selling in the futures market. In the process some people were unable to settle in the cash market because of different closing times. Therefore, for not the last time, the MOF changed the times the futures exchange was open to allow for covering. Any large purchase of puts or sale of calls would now directly pressure the cash market and vice versa.

At about this same time, spiraling real estate prices finally forced the government to act. Under political pressure from people who could no longer buy homes except with 90 year mortgages, the government began to restrain bank real estate lending and activated the 1975 real estate pricing law. This did begin to rein in real estate. However, it also lead to a ballooning of loans to non-bank financial companies who continued to make real estate loans as well as to price control avoidance schemes such as inflated art sold along with the real estate or the use of fake CDs to get loans. In addition, it eliminated another prop for the high stock market since it meant that "undervalued" real estate related stocks would no longer appreciate in terms of their intrinsic worth. When interest rates finally started to rise in January 1990, and the stock market started to tumble in response to higher rates, less liquidity, and lower hidden values, the futures market supply kicked in from the "stable" shareholders as they sold index contracts, bought index puts or sold index calls. The market dropped precipitously. Those who sold puts to or bought calls from the hedgers would cover in the cash market, putting more downward pressure on prices. In addition, rising interest rates increased the premium in the futures contract over the cash equivalent, also increasing downward pressure on the cash market. The hedging shareholders included both financial institutions and corporations who had been investing in Tokkins or borrowing against their "stable" shares as collateral. Because of their extensive portfolios, the index provided a reasonably good proxy for these investors holdings, further stimulating its use.

The MOF and the big four securities firms have thus been right in seeing the effect of the futures market on stock values as influencing the collapse and to look at the foreign securities firms as having provided the vehicles for this activity. But this view avoids seeing the original problem in the stable shareholder relationships, heavy bank and insurance company regulations, and high real estate prices brought about by high tax rates and the government's and business' desire to avoid large foreign shareholdings. Further, the foreign brokers were not the large sellers of calls or buyers of puts even though they took some positions for their own account. Rather, the hedgers were the "stable" shareholders. In the end, however, many of the banks hurt themselves because much of their hidden reserves disappeared and with it much of their tier two capital. In
addition, several banks have had to use their hidden reserves to cover direct and indirect real estate lending losses. Mikuni has stated that some big banks now have negative hidden reserves, having sold and bought back shares at higher than current market prices to create earnings against which to take write-offs. Thus the banks were heavily affected by the collapse since as more than two trillion dollars in market and collateral value was lost during the crash plus additional amounts lost in the Yen government bond market as the BOJ drove interest and bond rates up to 7% to puncture speculative demand. Further, since they had many loans secured by stock and real estate, loan losses mounted too. In late 1991 and the first quarter of 1992, these difficulties were finally perceived by the market as well, which resulted in a bear run on banks stocks that propelled the Nikkei index down sharply below 20,000 (Goldman Sachs July 1992). The periodic financial scandals of course exacerbated the situation, and the activity in the index futures market reflected this. The volume traded via the index soon dwarfed the amount traded on the TSE by a factor of six or more.

However, those foreign securities firms who had developed a strong position in the futures and derivatives markets continued to do well even though the Japanese financial community was reeling. This was a function both of their ability to arbitrage the imperfections in the market and the strong demand for these products by institutional and corporate investors concerned about protecting to some degree their paper profits. Conversely, those foreign securities firms who had come to Japan with the idea of participating in the third major world financial center, being a player in the Euromarkets, providing superior stock analysis, getting their share of market turnover, brokering Japanese stocks for foreign clients, or providing a mix of their usual services to Japanese customers encountered significant difficulties and several have had to close down or leave. This group included commercial banks who envisioned salvaging their position in the Japanese market by a timely switch from branch banking into the securities business such as Chase, Chemical, NatWest, Continental, Citibank, and Security Pacific.

Based on reported profits coupled with other information one can determine the profiles of the apparent winning and losing strategies for many foreign firms that invested in the Japanese securities industry (Rapp May 1993). These competitive profiles indicate that successful strategies by foreign investors focused their major products and service offerings in the first of five major product categories. These categories are as follows:

• I. Technology or Market Position Advantage - These are products where the foreign firm's advantage is due to technology and/or market positioning. These should therefore be products the foreign firm can define, defend and sustain as a source of profits and ongoing business.
II. Regulatory or Variable Market Advantage - These are products where a foreign firm's advantage is due to a Japanese regulatory situation, which can therefore change if the regulations change, or to a specific market situation, which can also alter with time. The profits from these activities can be substantial, but the influence to sustain an advantage does not lie with the firm. Further, the more successful the product, the more pressure there may be on the MOF or other government agency to change the regulation either because of regulatory arbitrage or pressure from Japanese financial institutions. In the case of market based advantages, any change in market conditions can eliminate the product's appeal. Thus, the profits should be used to build market position and expertise in category one.

III. Widely Available or Easily Emulated - These are products widely offered by Japanese and foreign firms and neither has an advantage. Under these conditions, Japanese competitors will offer these services at or below cost, especially in the securities business because of the excess earnings Japanese companies receive on their core products (Kimura and Pugel 1992). Therefore, unless a foreign firm can achieve low costs coupled with other advantages, it is unlikely to sustain a competitive position in these product areas.

IV. Japanese Proprietary Products due to Regulations - These are products where MOF or other regulations prevent foreign firms from competing. If a foreign firm has a technical or other sustainable advantage in these areas, they should clearly press for deregulation. This should be true in mutual funds or investment advisory services. However, if no advantage exists, this can a waste of time unless the strategy is to compete away excess profits in this product to put pressure on a global competitor's cash flow.

V. Japanese Firms' Core Products or Services - These are where Japanese securities firms and related market players derive most of their profits. Because they are willing to defend these markets in depth, even if one is prepared to devote considerable resources to entering them, it is probably not a good strategy. Nevertheless, to the extent regulations maintain fixed pricing and commissions, it makes sense to push for change. This is not to compete actively for a major piece of the business but rather to decrease their cash flow, reducing the resources available to compete in category three and even more importantly category one businesses. As already noted, Japanese securities firms will compete on price when necessary to hold position as indicated by the lower spreads in Yen government bonds after the entry of Japanese banks and foreigners while the Big Four's share remained the same.

The most successful strategies rely heavily on supplying products in category one. Strategies putting reliance on category two can be quite profitable for a time but are subject to the risk of evaporating quickly if regulations or certain market conditions change just as
happened with impact loans. Competing in category three only works for a low cost supplier. This was difficult for foreign firms entering the market in the 1980s to achieve since they had to bid people away from the Japanese or other foreign firms at a significant premium, and space costs had soared along with real estate prices. In addition, the MOF imposed minimum and arbitrary staffing requirements raising the cost to smaller operations. Trying to make progress in category four only makes sense if one has the opportunity to change it to a category one product. Category five competition is only for the brave with unlimited resources. Most Western firms are not willing to sustain the costs of the latter strategy.

**Firm Strategies and Performance: Short-term Regulatory and Market Arbitrage vs. Long-term Competitive Positioning**

In same study (Rapp May 1993), the 1990-1992 reported profits of 50 separate foreign securities firms were grouped to identify the most successful companies and their strategies. In addition, the study examined the strategies and performance of some other previous and current industry participants, Smith Securities, Continental Bank, Bank of America, Chemical Bank, Security Pacific, Citibank, and Chase. This period was very tough for the Japanese securities markets and for most participants. All listed Japanese securities companies reported losses for the period ending March 1992 except for Nomura and Kokusai Securities, who reported profits of Yen 30 billion and Yen 500 million respectively down from 219 billion and 28 billion in 1990. However, for that reason, if a foreign firm could sustain or improve its position during this period, it would indicate competitive strength.

Out of the 50 firms listed, though, only six were positively profitable in all three years: Societe Generale, Salomon, Goldman Sachs, Barings, Bankers Trust, and Merrill Lynch. In terms of average profitability over the three years, 24 were profitable so that about half the firms were on average unprofitable during this period. But examining above average profitability, only eight exceeded the mean of Yen 318 million. Ranked by average profitability, they are: Salomon (Y933MM), Goldman Sachs (Y857MM), Swiss Bank Corporation International (Y853MM), Societe Generale (Y813MM), Barings (Y637MM), Bankers Trust (Y633MM), J P Morgan (Y603MM), and Morgan Stanley (Y337MM). Thus, of our consistent profit earners only Merrill drops out and SBCI, J P Morgan, and Morgan Stanley are added. This group of eight exceptional performers represent less than 20% of the total licensed foreign securities firms in Japan.

Merrill in turn is looking to reduce costs and have announced they are closing their Yokohama, Nagoya, Kobe, and Kyoto offices. Since these are retail branches, this is not surprising since this is a category three or five business and is thus unlikely to be profitable long term. Conversely, there are elements of their corporate business concentrated in Tokyo and
Osaka which should be sustainable. Indeed, it is reported they are expanding these areas. Barings while profitable has seen its profits declining steadily over the period. Thus, it has cut staff in Japan by 15% to 220 (Euromoney 1993). In addition, both they and Morgan Stanley have moved staff to Singapore to trade the Nikkei index on the Simex both reducing costs and responding to moves by the MOF and the major securities companies to restrict futures trading on the Osaka Exchange by raising fees, increasing margin requirements, and limiting hours. That these attempts have been counterproductive is indicated by the dramatic growth in the Simex contract as seen in the table below. Therefore, part of their drop in reported profits in Japan reflects the movement of some of their index trading to Singapore.

Of the seven firms considered preeminent in arbitrage and derivatives, six are in the profit leadership group: Goldman Sachs, Morgan Stanley, J P Morgan, Salomon, Societe Generale, and Barings. Further; only SBCI and Bankers fall outside of this group. However, Banker's product concentration in synthetic securities, portfolio repackaging, and structured finance still falls into the group one category. As for SBCI, traditionally the big Swiss banks have made money floating Swiss Franc bond issues for Japanese companies, a market they control. Since SBCI have been active and profitable as commission sellers of futures, this activity may be related to hedge strategies for the holders of their SF convertible and warrant bonds as well as to their recent acquisition of Conners in Chicago. It would then be an extension of their base business.

If one examines the market for the indices in greater detail subsequent to the start of trading on the Osaka exchange (OSE) in September 1988, one can see that volume was rather steady until the beginning of 1990 coinciding with the initial bursting of the Bubble. It then approximately doubled during 1990 and increased by fifty percent in 1991. Conversely, volume on the TSE dropped precipitously along with prices. The futures market in terms of value traded peaked in 1991 with trading substantially exceeding the Yen volume on the TSE even at the height of the 1989 boom. Therefore, while some of this activity was no doubt due to arbitrage between the cash and the index markets, much of it also reflected portfolio hedging since otherwise there should have been greater volumes traded in the cash market. Open interest has normally run about three days trading volume. In addition, there is a very large over-the-counter market for Nikkei options not reflected in data available on the OSE or Simex indices (Goldman Sachs August 1992). However, the numbers have fallen back to 1990 levels since the end of 1992 corresponding with the stock market rally. Two important strategic questions therefore are one, whether the spectacular development of the index market has been a temporary phenomena that will fade with a recovery in the stock market or that will give in to pressures from the MOF (Goldman Sachs July 1992)? Second, regardless of market changes, will the foreign firms be able to sustain their influence?
The answers to these key strategic questions appear to be that this is not a temporary phenomenon, the MOF will not succeed in controlling it, and that foreign firms will continue to dominate the market. The reasoning is that the use of index futures and options permits the major holders of Japanese stocks, corporations and financial institutions, significantly greater flexibility to redistribute their assets in response to economic and political events than they had before. This is true even if these investors have no desire to hedge in a rising stock market as they did in a declining one. In other words, this is not just a contrarian market that only grew due to the collapse of the Bubble. This is because one can hold any group of assets, i.e. Japanese stocks, US government bonds, or Deutsche Mark CDs and convert them in and out of Japanese stocks or several other assets on a worldwide basis through the use of index and foreign exchange futures.

For example, if one had invested heavily in US Treasury bonds and was reluctant to report a loss after the appreciation of the Yen but still wanted to increase one's exposure to Japanese stocks, previously you could do this only out of cash flow or by selling another asset. By using foreign exchange and index futures, however, to buy the Yen and Nikkei forward, one can accomplish this without having to sell the bonds. Conversely, if one did not want to pay taxes on appreciated Japanese stock, but wished to increase one's exposure to the US stock market instead of Japanese stocks, one could buy S&P futures or OEX options in conjunction with buying dollars forward. Alternatively, if one felt that German interest rates were about to fall and that German stock market would respond bullishly but that the Deutsche Mark was likely to depreciate, wiping out much of the gain, one could buy the DAX index but keep one's assets in Yen. Given that Japanese corporations and financial institutions now have a global portfolio and investment exposure in addition to their Japanese exposure, this ability to shift asset exposure without triggering long-term capital gains or losses has immense appeal. It is also heavily promoted by the foreign securities firms specializing in this business (Goldman Sachs April and August 1992).

In addition to flexibility, there is price and confidentiality. That is, to trade the same Yen volume using the index costs about one-third as much on the OSE as to trade the stocks on the TSE, it is even cheaper on the Simex, especially since the MOF forced the OSE to double their commissions on index futures and options in order to try to force trading back to the cash market. Of course, all they did was to promote the Simex. In addition, the margin requirements used to be much less for the index on the OSE than for the equivalent stocks on the TSE. But the recent rise to 30% has eliminated much of this advantage, again pushing trading towards the Simex which remains at 15% with no cash requirement. Instead of stimulating the cash market as the MOF had hoped, Simex trading growth more than doubled after the commission and margins changes, supporting the argument that index trading will persist in large volumes.
In addition to price is the fact that by using the foreign brokers and the index Japanese investors can keep their net trading in Japanese stocks more confidential since they do not have to report any stock sales, thus upsetting stable shareholder relationships. Nor do they have to use the TSE, thus tipping major Japanese brokers or the MOF to their activities. The latter can subject them to unofficial pressures and administrative guidance. This procedure in fact is very similar to their strategy in the late 1980s for meeting MOF pressures to subscribe actively at US Treasury auctions. They would prominently bid at the auction but would then simultaneously sell the bond index and the dollar forward on the CME and in the foreign exchange market respectively through the US banks, thus actually frustrating MOF objectives.

Finally, the investor can take a long-dated position in the index so that it remains quite suitable even for Japanese institutional or corporate investors with an extended time horizon. The fact that the Simex compared to the OSE has more long dated contracts (Goldman Sachs April 1992) and in turn a bigger open interest relative to total trading volume indicates that this can appeal to such investors over buying stocks when combined with the other factors already mentioned (Goldman Sachs July 1992). That this has occurred in a rising market demonstrates that index futures can lead stocks up as well. Similarly, the large volume of index options traded from June to November of 1989 shows that index options are an effective way to capture short-term market spurts. Therefore, there is no reason to believe that this business will not have a very long life span.

Given the eventual realization of this fact, though, by the MOF and the large Japanese securities firms, can the foreign houses maintain their market dominance? Past history in many other industries would argue that the answer to this question is not clear, and one would not be overly optimistic. However, there are institutional and structural considerations which may override the Japanese firms’ ability to emulate, catch up, and compete on price. First, everyone agrees that the easy arbitrage between the cash market and the index has disappeared (Euromoney 1993). Therefore, to make money in this product one needs to be able to extend beyond the Japanese market per se. A primary investor appeal thus becomes the international portfolio switching described above. This in turn requires that one have sophisticated technical and market capabilities including advisory services in all major markets of interest worldwide. This plays to the strength of the foreign firms and puts the Japanese firms at a distinct disadvantage, especially since the foreign houses will be able to achieve economies of scale in these other markets given their larger global customer base and will thus be low cost suppliers of these products to Japanese investors too. Indeed, they already have a significant presence in all these markets and are currently supplying such global advice to their clients (Goldman Sachs April and August 1992). In addition, they can reduce their Japanese costs as well by selling their expertise to their non-Japanese in addition to their Japanese clients, giving them a potentially
bigger client base than the Japanese houses. They also have an active presence in Singapore which currently seems to be taking share from the OSE. Allowing for the fact that the OSE contract is twice the size of the Simex contract, at the high point in March 1991, the OSE had a 99% market share in the Nikkei Index. By April 1993, this had fallen to 79%.

Second, confidentiality and price remain areas of investor concern. This gives foreign firms an advantage because institutional and corporate investors perceive Japanese companies as windows on their activities domestically and internationally. Close historical relations in this case are a competitive liability rather than an asset. This situation has not been helped by the recent scandals. With respect to price, if an index trade is an alternative to a TSE trade, then for every index trade the investor is substantially reducing its fixed commissions. In turn, the Japanese firms are reluctant to promote index trades because they have significant bricks and mortar as well as numerous personnel hired and trained under Japan's long-term employment system and committed to traditional stock brokerage. In fact, it was because of the pressures on small firms losing stock commission income that the MOF forced the OSE to raise its fees hoping to push some investors back to the cash market. Foreign firms do not face this dilemma since they have never captured a large share of the brokerage business which is a category five activity. Nor do they have an extensive branch network. Rather, they are in the enviable strategic position of being able to pressure the cash flow coming from this core business.

Finally, the derivatives appear to require substantial technical sophistication, including a significant previous and continuing software development worldwide, with contributions made from a variety of locations under global management. This activity appears difficult for Japanese companies to emulate from a management, compensation, and technical viewpoint even if they committed globally to the business and hired several experts in different locations. It would in any case exclude all but the very largest firms, putting the MOF in a difficult position as smaller firms were forced out of business. At the same time, not all of the foreign firms may be able to meet the survival criteria this type of global technology and product development requires to constantly define and influence the Japanese stock futures market. This global capability will become more critical after 1995 if the Nikkei actually moves to a market weighted as opposed to a price weighted index as the MOF proposes.

This is because the index will then be more useful to those wishing to invest in an instrument that more closely represents the market as opposed to those participating in arbitrage activities between the index and cash markets. The MOF again hopes this change will restrict trading in futures, but this is misguided. In the US where futures and stock markets are highly efficient, the most popular index future is the S&P which is market weighted not the Dow Jones which is price weighted. Nor has the popularity or the higher volume in the S&P than the cash
market been in anyway diminished over time. Indeed, since most experts agree that arbitrage possibilities in the Nikkei have largely disappeared, it may actually help the futures market by moving to a market weighted index. This is because it will increase the liquidity of the cash market related stocks as well as its appeal to those looking to transform assets in response to various events. As Goldman Sachs notes "fairer pricing of the futures should be good news for investors: It enables them to trade the market both ways without paying excessive premiums on the buy side or giving up substantial discounts on the sell side." Indeed, the recent TSE rally has been led by index trading, reflecting the willingness of firms to participate as long as they knew there was an easy exit if it failed. This insurance psychology has helped the rally to become self-sustaining. Therefore, the prospects for the foreign firms continuing to define and compete effectively in this important market segment appear quite good.

Nevertheless, as part of any US-Japan liberalization dialogue, a roll back of the OSE changes as well as liberalization of OTC equity options is important. This is because the former effectively represent a unilateral internal duty imposed on activities primarily affecting foreign firms with the clear purpose of curtailing their competitive advantage. The pressure on the exchange to increase its fees and margin requirements was not based on any economic evaluation of the exchange or of index trading. Similarly, there is no reason to restrict the creation and trading of equity options on the OTC after the recommendation of Securities and Exchange Counsel Study that they be permitted (Quick Research 1993). Rather, both situations were arbitrary responses to pressures by Japanese securities firms combined with the MOF's own concern that it did not have control over this market and the foreign securities firms who are its primary participants.

As the above analysis indicates, futures were not responsible for the Bubble or its collapse. Therefore such restrictions are totally contrary to the liberalization initiatives of the 1980s, and the MOF's firm assurances that while they move slowly there is no backsliding. In addition, these actions raise serious issues about the Japanese government's true willingness to accept the economic consequences of liberalization if it means the success of foreign firms and that Japanese firms are adversely affected. Given the US government's acceptance of equivalent or greater "market disruption" in many of its industries, the question of parity in a sector in which US firms are the global leaders seems an important policy precedent. This is true regardless of the fact that MOF's efforts were apparently misguided and not really effective. That is, in actuality futures have led the market rally due to their ability to attract institutional investors back into the market since they knew that could easily reverse course if the rally stalled. In turn, the government can now reflate the economy without concern that a limited supply of stock will rekindle the Bubble, though permitting equity options would further insure this result. Finally, investors' and traders' ability to switch to the Simex in any case frustrated the restrictions'
effectiveness, again illustrating that Japan's financial markets are now part of a global economy and that as the world's largest creditor such regulatory initiatives are less and less appropriate.

However, the MOF's extraterritorial attempt to get the Simex to also curtail trading in the Nikkei index seems completely inappropriate and without precedent. It also opens the Japanese government to justification of the kind of unilateral actions by the United States that are being discussed at this conference. In addition, derivatives expertise and trading are important potential ingredients in the competitive and innovative investment strategies of foreign asset managers and foreign insurance companies. As such they are a key aspect of the liberalization for these financial services assessed below. The Ministry's attitude towards these instruments is thus something that must be addressed since it will fundamentally affect the course of any future liberalization efforts and their competitive outcome for foreign firms.

**Nikkei Futures Average Monthly Contract Volume and Open Interest for Selected Periods: September 1988-April 1993, Osaka and Singapore Exchanges**

<table>
<thead>
<tr>
<th>Months</th>
<th>Average</th>
<th>Volume</th>
<th>Open</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Months</td>
<td>Singapore</td>
<td>Osaka</td>
<td>Simex</td>
</tr>
<tr>
<td>9/88-2/90</td>
<td>70,584</td>
<td>479,056</td>
<td>4,544</td>
<td>27,556</td>
</tr>
<tr>
<td>3/90-1/91</td>
<td>73,562</td>
<td>1,239,562</td>
<td>4,670</td>
<td>141,310</td>
</tr>
<tr>
<td>2/91-12/91</td>
<td>62,158</td>
<td>1,846,337</td>
<td>8,954</td>
<td>194,441</td>
</tr>
<tr>
<td>1/92-12/92</td>
<td>279,104</td>
<td>993,944</td>
<td>48,643</td>
<td>160,958</td>
</tr>
<tr>
<td>1/93-4/93</td>
<td>357,863</td>
<td>796,714</td>
<td>69,646</td>
<td>159,558</td>
</tr>
</tbody>
</table>

Source: Simex (Singapore International Monetary Exchange Limited)

However for those firms like DB Capital who are just now thinking about getting into the derivatives business (*Euromoney* 1993), it is probably much too late both in terms of their perception of the opportunity and what will be required to compete in the index futures market in Japan and globally. If they have not been in derivatives in Japan, then they have not been able to offer their clients the full spectrum of portfolio switching technologies. If they have not had clients with those interests, then they probably do not have the technology to compete in the Japanese market against those who do. This would thus appear a classic case of someone under profit pressure looking for a business making money without fully considering what will really be required to compete in that business currently and in the future. They are under pressure along
with the other German Bank related securities companies, Dresdner, Commerz, BV Capital, and Westdeutsche Landesbank, because they did not perceive in time that their initial strategy of primarily raising funds for Japanese companies in the German financial markets or selling Japanese securities to their German clients was subject to the risk of moving from a category one product to a category two and perhaps even a category three product. This is because the unification with East Germany created inflationary pressures that drove interest rates and the value of the Deutsche Mark up so that Japanese corporations had little interest in issuing DM bonds. Similarly, the collapse in the Tokyo market meant that German investors had little interest in Japanese stocks or warrants. In addition, most of the major Japanese securities companies had opened offices in West Germany and were thus able to offer the latter services at least as effectively as the German bank related security firms.

In this respect, the German banks experienced the same difficulty experienced as others who had thought they could survive by just participating in the Japanese securities business as an extension of their regular securities business elsewhere or believed that they had products or market position that could not be successfully emulated by their Japanese competitors. Other examples of such perceptual or strategic errors are Chemical Capital Market Corp., Hoare Govett when owned by Security Pacific, Citibank Scrimgeour Vickers International, Continental Bank's foreign exchange and options trading business, and Chase's investment banking operations. In all cases, strategic mistakes were accentuated by lack of cost control (Rapp May 1993).

While Chemical set up their securities company in 1987 in the manner DB Capital had in 1985 and J P Morgan somewhat later by creating a foreign investment bank at least 50% owned by non-financial institutions such as Chrysler, Citibank pioneered another route by initially buying the East Asian operations of a UK brokerage firm in 1983. This route was in turn followed by Security Pacific who bought a Hong Kong based securities firm and then by others such as Chase and UBS after the Big Bang in London in 1986 when banks, including US banks, were permitted to buy UK brokers. In the case of Chemical Capital Market Corp. Geneva S.A., it was opened with the idea of trading and underwriting Euro-products which by that time were category three commodity items. Apparently, Chemical's senior management also hoped to use the fact that the Japanese government had approved the branching of a bank owned foreign securities company as a wedge in encouraging US authorities to do the same. Neither of these objectives provided the strong product-market focus and strategy needed to succeed in the long-term. In addition, MOF requirements saddled them from the beginning with expensive operations and reporting staff, i.e. more space and people than they needed to trade and do market underwriting. The net result was that within a little over a year it was closed, confirming they had no special capability in this area. They subsequently closed their Euro-bond and London swap operations too.
Conversely, sustainable and profitable competitive advantage can be achieved by correct positioning that defines and influences a product or market especially when cost considerations and price based competition are maintained. Nor does a firm have to employ several hundred people like the eight top profit performers. This situation is well illustrated by both Bank of America and Smith Securities (Rapp May 1993). Bank of America while it applied for a securities license in Japan in 1985-86 along with several other US and European commercial banks, it used a combination of circumstance and strategic insight to withdraw its application in early 1987. The reasons were that MOF staff requirements would have required a tripling of head count without adding anyone to its trading capabilities over what it had using a representative office. The required additions would only have been operation and reporting staff and would have been expensive as they had to be experienced people whose cost was rising rapidly as other foreign firms bid for them too. In addition, because the trades would now be booked in Japan rather than in Hong Kong, London, or San Francisco, taxes on any profits would increase. Further, because the Bank's trading advantage was in US Government bonds and Agencies plus California state and municipal bonds, having access to the Japanese securities markets was of little value. They could already trade Yen government bonds through the branch, which had been allowed by the change in the Banking Law in 1981. With no equity experience or research, trading Japanese equities made little sense.

However, they continued to serve Japanese clients through their BA Asia representative office, providing information on a limited range of activities that covered core competencies in US Government and Agency securities, in one-sided swaps, and in real estate trust advisory services. The latter two products are in turn unique BofA services described in (Rapp May 1993). These core businesses provided a long-term revenue stream to cover expenses for the representative office plus some profit to BA Asia. Additionally, strategic alliances, M&A, defeasance leases, regular interest rates swaps, private placements, long-term currency hedges, Euro-bond sales, and some Euro-underwriting products were pursued on a situation by situation basis that in any year could supply attractive additional returns to the basic businesses. While the specialty areas used dedicated personnel, each specialist was also expected to be able to explain and to act as a representative for some of the more general products areas with specialists from the relevant overseas BofA product groups being used to complete any transaction. As part of this activity, the Japan representative office monitored various transactions in the market so that clients could be directed to the most appropriate vendor if the office did not feel it had the expertise to do a transaction. In this manner costs were controlled and a product/market focus maintained; yet the Bank could be responsive to clients’ requests. More importantly, the operation was kept small but profitable, and its activities could be sustained on a long-term basis.
Similarly, Smith Securities owned 30% by Rothschild has used a unique time based management approach in combination with stringent cost controls and effective use of their global network to successfully enter the Japanese equity securities market. In this way they were able to convert a category three type situation into a category one environment where they should be able to sustain advantage over a long period provided that Japan's securities industry does not seriously move away from a fixed commission system. What differentiates them from their Western competitors as well is the low cost and timeliness of their research. The net result of this sales oriented approach was that for 1992 they were both profitable and the number one firm in Japan in terms of volume and value among the 106 licensed securities houses that do not have a seat on an exchange (Rapp May 1993).

In summary, as a result of market liberalization in securities, the majority of foreign firms investing in Japan in the 1980s attracted by the lure of the Bubble have not done well and several have left. However, the licensed securities and representative offices of a handful of firms have done quite well. The criteria for success appear to depend on establishing and controlling a market/product segment through a combination of technology and expertise continually imported from abroad, successful local adaptation and improvement, and effective cost control. These segments have usually been in category one. Attempts to compete with Japanese firms in areas they control or can easily emulate have generally been ill advised. These criteria may appear common sense, but that few firms have done well implies that these principles are not easily perceived or are difficult to implement.

Finally, stock index futures and options as well as other derivatives seem to be an area that a small group of US and European houses will continue dominate in Japan and globally. Since the volumes traded will apparently continue to dwarf and influence the Japanese stock market, despite the efforts of the MOF and the Japanese securities firms to control and curtail them, the character and structure of Japan's financial markets and particularly its stock market appear to have been permanently changed. The interests and influence of the "stable" shareholders in particular have been altered immeasurably. These developments will thus have important and ongoing ramifications for Japanese financial institutions, Japanese financial markets, and Japan's relations with US and European governments well into the next century.

At the same time, there are several confirmations as well as additional lessons to be learned from these developments about Japan's financial services and the liberalization process.

- Again, to protect the status quo, liberalization took place in new areas where there were few vested Japanese interests, e.g. derivatives, while maintaining segmentation between Japanese competitors, e.g. banks and securities companies. Further, liberalization occurs when it
appears that domestic firms are fully prepared to meet the likely increased competition. This will often blunt foreign firms potential first mover advantage.

- Foreigners were allowed to compete in the new areas and in areas of overwhelming Japanese strength. However, to insure that they could not leverage off existing infrastructure, they were required to maintain separate personnel and space, and to hire several additional operating and reporting personnel. Total staff needed to be twenty to thirty people, regardless of actual requirements. This was a heavy burden on smaller companies and bank affiliates.

- The new firms were required to buy expensive specialized reporting software from one of the major Japanese securities companies in addition to their own existing packages. Their usefulness was in turn limited to the Japanese market.

- Japanese firms were prepared to compete on price as when they proposed the first reduction in fixed commissions based on volume with larger discounts for offshore investors, knowing that this would have a disproportionate impact on foreign firms.

- The criteria for success after deregulation has depended on establishing and controlling a market-product segment through a combination of technology and expertise continually imported from abroad, successful local adaptation and improvement, and effective cost control. However, any outside influences which undermine a firm's ability to pursue such a strategy will materially influence its long term potential for success.

- The government is not prepared to manage market disruption if in fact liberalization results in major changes benefiting foreign firms. Rather, it will try to reregulate the process to the disadvantage of foreign firms. In addition, the Ministry has now learned that this is most likely to occur when new products and services are free in principle rather than requiring specific approval, e.g. foreign exchange and derivatives. This is because innovation is naturally disruptive, and it takes time for Japanese firms to respond, during which period additional innovations may have been introduced. Foreign firms have little recourse against reregulation except to the market.

**The Next Wave of Financial Services and the Liberalization Heritage**

For many bureaucracies, public or private, past behavior is usually a good indicator of future behavior, especially if the basic institutional parameters and constraints remain in place. On this basis, what kind of liberalization process can be expected for the next wave of financial services such as asset management and insurance. First, liberalization will be concentrated in areas where a consensus on liberalization can be reached. These will be new areas, areas
currently open only to foreigners, or areas where for various reasons foreigners have a large market presence. Historical boundaries and legal separation between major Japanese financial institutions will be maintained. Two, staffing, reporting, and space requirements will be predetermined, and existing organizations will not be permitted to have their staff work for more than one organization regardless of actual performance or to utilize the same space. Given the high cost of specialized financial personnel and Tokyo office space, this severely undermines a firm's ability to control costs, an important strategic variable. They will also probably be required to obtain specialized reporting software from existing Japanese institutions, duplicating their existing systems, raising their costs, and contributing economic rents to their competitors.

Three, having learned from experience, new products and innovations will require prior Ministry approval, permitting Japanese firms an opportunity to catch up and avoiding market disruption. Thus, the returns to innovation and market entry will be severely curtailed. Four, Japanese firms will be prepared to compete on price. Therefore, rapid emulation by Japanese companies where they can also cross subsidize from areas of innate competitive strength will continue. Five, the government will be prepared to reregulate or to restrict prior liberalization if despite the many obstacles foreign firms are too successful and disrupt the status quo. From this standpoint, the MOF currently appears more ready to be reactionary than proactive.

Examining two recent reviews of the multifaceted obstacles to foreign financial services firms in Japan, we can see these anticipated problems clearly defined (US-Japan Business Council 1993 and Quick Research Institute Corp. 1993). These reports identify close Japanese business relationships often involving cross shareholdings as a formidable obstacle to soliciting new business. Yet, they are less clear on the reasons for this aside from the relationship itself. However, in reality there are economic reasons. First is the willingness of Japanese financial institutions to defend their core client relations even to the extent of taking a loss on a particular service. Conversely, because of such long standing relationships, clients are willing to try a new product or service without substantial marketing, making it easier for these keiretsu firms to capture the business at much lower cost. They are effectively maximizing returns to an existing marketing channel. This of course makes it very difficult for foreign firms to promote a "me-too" product or one that Japanese competitors have "anticipated".

In addition, if marketing a new service requires establishing a new company, they can absorb the additional cost as part of their overall relationship accounting as well as staff the operation with excess personnel or retirees from other operations. Retirees of course can be hired at a fraction of their former salaries. In this manner, the large established Japanese financial services companies can minimize start up costs for both marketing and staffing. In the case of funds managed by insurance companies, cost absorption may even take the form of mixing
returns with general policy funds even though this kind of direct subsidy is now illegal in the case of brokerage accounts as is the practice of tobashi.

In addition, there is uniform concern about regulatory transparency and a common tendency to discriminate de facto against foreign firms especially with respect to new products or other innovations. However, this is to be expected given disconsensus decision making combined with the MOF's desire for flexibility and control. If the Ministry had to explain its actions, then it would not be able to adjust its position later if things did not develop as expected. Innovations are particularly disturbing in this regard since their impact is unpredictable and in any case go against the interests of the status quo or the consensus. Since it is unlikely the MOF will alter its established behavior pattern, the only way to deal with this from a negotiating standpoint is to move towards a free in principle regulatory environment as opposed to a permission in principle approach. This would force the Ministry to state its views when it wished to restrict a particular action and would reduce its flexibility to prevent the introduction of new products, a critical competitive ingredient for foreign firms' long term competitive success. This procedure would also reduce the need for foreign firms to participate in various advisory bodies as well as their frustration with generally having their advice and concerns ignored because they go against the Japanese consensus. Given the MOF's experience with foreign exchange and derivatives, though, we cannot expect a ready acceptance of this position.

Insurance

More specifically in terms of insurance, product conformity has been a hallmark of the Ministry's regulatory history. Indeed, the MOF has enforced uniformity of both product and price. Therefore, innovation is likely to be a powerful competitive advantage. In fact, foreign firms have done very well in the "third" or gray area of insurance. This sector, "a phenomena unique to Japan, consists of products that do not clearly fall within the definitions of 'life' and 'non-life' and thus have been regulated at the discretion of the MOF since the 1960s. They can be categorized broadly as Personnel Accident, Sickness, Nursing Care, and Hospitalization covers. ... Foreign companies have built a strong position within the third area. In non-life, excluding maturity refund, the third area represents only 11.9% of total direct net premium but it is nevertheless more than 41% of foreign companies' business. Foreign life companies have 50% of their premiums coming from the third sector, although it only accounts for 1.9% of the domestic companies." (US-Japan Business Council 1993)

In addition, the market is immense, the second largest after the US. The casualty business is about one-third the US at $70 billion in 1990 premiums while the life insurance market is actually larger at $210 billion in 1990 premium income. The three criteria for liberalization are
thus clearly met. However, as might be expected from the liberalization paradigm, "liberalization of the third area may be undertaken by the MOF prior to liberalization of the primary sectors. ...\text{Given that the third area is significantly more important to foreign insurers than to local companies, any deregulation of the third area (cross entry, liberalization of rating, policy form approval, life agent multicompany licensing, etc.) without first liberalizing or removing the myriad of restrictions to free competition in the primary insurance areas, would constitute de facto targeting of foreign companies, that would seriously damage them and probably force some of them to leave the market.}" The foreign insurers are also concerned that "large/Keiretsu competitors will be free to fully exercise their structural advantages in 'captive' markets as levers ('subsidies') to squash small domestic and foreign companies in other market segments." (US-Japan Business Council 1993) Unfortunately, historical precedent makes these actions and outcomes from the liberalization process all too predictable.

From the foreign investor's standpoint, the keys to effective liberalization again are not mysteries and depend on innovation and cost control. The approval process for new products and ratings should be liberalized across all product areas on a permitted in principle approach that would replace the existing system. Further, to permit better investment performance and to allow foreign companies to tap their international expertise, the Japanese branches of foreign insurers should be allowed to invest on the same basis as their Japanese counterparts. These procedures would also encourage the MOF to improve its dialogue with foreign firms to keep abreast of the latest insurance products making transparency less of an issue. Finally, foreign firms should be allowed to use existing staff and space to enter related businesses like investment management.

\textbf{Asset Management}

Asset management is an immense area and growing. It covers pensions, investment trust management, investment advisory services, trust activities, and mutual funds. Pensions alone currently amount to $1.3 trillion and are expected to reach over $4.0 trillion by the end of the decade. Yet, there are many obstacles to foreign firms' participation, and Bill Brown in his paper covers in some detail entry and performance barriers in the two biggest sectors, investment trust management and pension fund management. Therefore, this paper will not cover the same ground except to note the repetition of certain regulatory and strategic actions. As in the case of manufacturing firms, hiring foreign funds management can be a way to acquire technology with the idea of improving on it domestically and then soliciting overseas business. Thus, "most of the assets which have been attracted come from financial intermediaries such as banks, insurance companies and investment trust managers. These are competitors and do not represent long-term clients. They hire U.S. managers merely to get technology." (ibid.) Further, as in other financial sectors, the goal is to maintain the status quo and to avoid market disruption. Therefore, "A
number of regulatory and structural barriers are preventing U.S. managers from developing relationships with real owners of capital, ... they are part of a general regulatory framework intended to maintain the status quo, i.e. to preserve the dominance of a few large firms. ... If a money manager chooses to pursue a Discretionary Investment Adviser license, preliminary application review and negotiation with the MOF can take six to twelve months. ... However, under current regulations the license is almost worthless as a license holder may only solicit new net cash flows into a pension fund. ... Alternatively, the U.S. manager who seeks to enter the Japanese pension business could consider obtaining a trust bank license. This would require the manager to enter the custody business as well as the money management business and would require massive outlays for staff and systems." Thus, one again sees the operation of "Catch 22" regulations combined with requirements for extra costs unrelated to performance in managing assets. "Similarly, asset allocation guidelines are imposed at the manager level rather than at the fund level preventing foreign fund managers from bringing specialized expertise to bear on behalf of the client and from competing for business on this basis. From a practical point of view, most U.S. money managers are thus barred from participating in the management of Japanese pension funds." (ibid.)

The result of course is that "The limitations on market access for foreign firms and resulting lack of competition ultimately costs the consumer by preventing investment decisions based on maximizing returns rather than on collateral institutional relationships." (ibid.) Unfortunately, the Japanese government has never shown itself to be particularly pro consumer and in fact the existing financial sector was created with the idea of funneling funds from households to the manufacturing sector (Garten 1991). As the economy grew and prospered, these restrictions limited assets available to consumers and created significant economic rents which have been redistributed among related companies in the form of low cost loans, foreign exchange transactions, and various fee business. This anachronistic environment is a root cause of the difficulties facing any liberalization initiative. At the same time, the government itself may be the actual ultimate consumer or payer of these rents rather than the household sector.

This is because the Japanese population and the labor force are aging rapidly. Within the next thirty years, Japan will have more people over sixty five than any other industrialized country and only 2.3 workers per non-worker compared to over five to one today (Frankel 1991). Thus, significant political power will combine with a strong and growing desire for entitlements. Therefore, it is likely that the government will have to meet any shortfall in pension expectations. This means the government should have a particular interest in actual performance, especially since even a seemingly small difference in results can be magnified enormously over a thirty year period. By way of illustration, the table below indicates the difference between a 5.5, 6.5, and 7.5 percent compound rate of return over twenty, twenty-five, and thirty years respectively.
<table>
<thead>
<tr>
<th>Period/Rate</th>
<th>a) 5.5%</th>
<th>b) 6.5%</th>
<th>c) 7.5%</th>
<th>(c) - (a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>twenty years</td>
<td>2.918 times</td>
<td>3.523</td>
<td>4.248</td>
<td>1.33</td>
</tr>
<tr>
<td>twenty-five years</td>
<td>3.814</td>
<td>4.826</td>
<td>6.1</td>
<td>2.286</td>
</tr>
<tr>
<td>thirty years</td>
<td>4.985</td>
<td>6.612</td>
<td>8.76</td>
<td>3.775 times</td>
</tr>
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Thus 1.3 dollars today will be 4.9 trillion dollars less thirty years from now if pension managers earn only 5.5% compounded compared to 7.5% per annum. In addition, the annual return from this pool of its assets to cover entitlements will be only $356 billion in the former case compared to $854 billion in the latter. This $498 billion difference ultimately may be borne by the government via increased government pension payments or lower taxes if corporations increase their payouts from pretax profits or have to curtail employees' wages to compensate retirees. However, the Ministry may not know how much will actually be necessary until the need arises. This is because the government has not yet replaced the current book reporting system with a market-oriented one which tracks actual market performance.

Investment Trusts, which were closed to foreign firms until April 1990 and can still only be organized by investment trust managers, are sold primarily at the retail level like mutual funds and entail the establishment of a separate company with separate space and personnel from the investment advisory services marketed to institutions (Quick Research 1993). There is no reason for this additional cost and duplication, even though it is to be expected from the MOF's past behavior. It is also curious that the twenty to thirty people required as minimum staffing is the same number as for the foreign securities firms, a totally different business with presumably different staffing needs, though the results are certainly similar in terms of cost burden. Further, there is no flexibility to allow for a more institutional focus where managers might wish to design a limited number of high-volume products for corporations and institutions which by their nature need more limited personnel, record keeping, and reporting requirements than those for individuals. The current system can mandate an annual outlay of $3.2 to $6.5 million before a single client is solicited. "The up-front costs are so large that most U.S. money managers have decided not to enter the Japanese market. ... it is not possible ... to enter the Japanese mutual funds business on a small scale, beginning with a small staff and adding to it as the business needs grow." (ibid.)
Further adding to this problem is the de facto limitation on the fees charged to the public of 80 basis points. Most foreign trust managers still find they must rely on brokerage firms for distribution, though direct marketing has been permitted since April 1992. These firms charge the subscribers 80 bp of which 10 bp goes to the Trust Bank, 35 bp to the securities firm, and 35 bp to the Investment Manager. However, the securities firm can increase their total return from the trust due to the commissions they charge on the securities purchased by the investment trust while the trust bank can get fees for then acting as a custodian for those securities. These related revenue sources are not available to the foreign fund manager. The net result is that they must have around $2 billion under management from the beginning just to break even.

The proposed solutions are logical and fair and would allow foreign firms to compete on the basis of performance without having to overcome multidimensional regulatory and business obstacles. They would also mean that existing firms could no longer rely on size and the sole right to manage existing pension business regardless of performance to keep their customers. The proposals are that there should be no distinction between Discretionary Investment Advisers and Investment Trust Managers with one entity allowed to pursue investment advisory and investment trust management. These investment advisers could be domiciled anywhere, could access all pension assets (tax qualified, sponsored, mutual aid, and employee insurance), and would be permitted to create, design, and market mutual funds, including specialized funds, to corporations and institutional investors.

The creation of such funds would be further assisted by encouraging greater development of securitized investment products and a relaxation in rules requiring special licenses under the Foreign Exchange and Foreign Trade Control Laws prior to private placement of initial offerings of securities in Japan. In general there should be no foreign exchange controls on the activities of investment advisors and trust managers. Foreign investment managers have considerable experience with such products which normally attract higher returns and improve performance. Reporting would be on a market value rather than a book basis, a change from the current anachronism that would permit managers and clients to understand their real position and that would facilitate the transfer of pension assets. Finally, there would be no arbitrary number of employees, but only what was required in terms of actual business. Similarly, no special or duplicate reporting system purchased from a Japanese competitor or service at great expense would be needed as long as records presented the information clients required. It would also help for fund managers as well as other financial institutions if some reports could be done electronically. As before, however, industry opposition and regulatory "concerns" over new product introduction and performance based competition are likely to be intense, making implementation extremely difficult. Conversely, continuing to undermine foreign firms' ability to
innovate and control costs whether intentional or not eats at the heart of their competitiveness.

Foreign firms' access to the Japanese market for asset management is also limited by restrictions surrounding the sale of foreign open end mutual funds to Japanese investors. While up until last year they could not be sold directly, this does not represent the greatest obstacle. Rather, they cannot be denominated in Yen. This is true even though existing hedging techniques and the economies of scale available to a fund permit combining asset diversification and higher returns across a global portfolio of securities to achieve better performance. This can also be a technique for reducing transaction costs. Both these approaches were outlined in the discussion of derivatives above. Similarly, current regulations mandate that no more than 50% of the assets of foreign organized mutual funds sold in Japan can be in Yen or Japanese assets even if the fund is denominated in dollars. Both these regulations serve to prevent effective and cost competitive funds managed abroad from being offered in the Japanese market. They thus represent a trade restraint to protect domestic interests just as much as any quota or tariff on a foreign good and cannot be justified. To facilitate the sale of US based funds, though, will require the US to waive the withholding tax payable by Japanese investors just as it has for those who have bought Eurosecurities or private placements issued in Japan by US corporations. In addition, Japanese subscribers should be permitted to receive their dividends in the form of additional shares or units in the fund since this will enable them to avoid paying Japanese taxes until they decide to cash the shares.

Crédit Cards

Credit cards are a gigantic multibillion dollar worldwide financial industry where US firms remain the dominant players. In the US particularly, there has been a high degree of innovation including affiliation cards, cash management accounts, promotions, direct marketing, and multiple use. Yet, until recently banks in Japan were not allowed to extend credit on their cards, and Citibank and American Express have found it difficult to obtain credit information. While some of these problems have been solved, there are still heavy restrictions by the FTC on the use of promotions and premiums which is an important tool of direct marketing. This in turn puts unnecessary restrictions on the services and products that can be offered to cardholders. It also means that foreign firms are restricted in using this large marketing route as a way to introduce and sell their products in the Japanese market without needing to use the cumbersome and inefficient Japanese distribution system. Therefore it is recommended that the current restrictions on premiums of the lesser of 10% of underlying value or ¥50,000 "be eliminated. They act as a serious impediment to companies relatively new to the market, particularly foreign companies, which rely on promotions as part of their corporate strategy for developing and maintaining market share." (US-Japan Business Council 1993) Similarly, there are residual
restrictions on group discounts for insurance sold to charge and credit cardholders which should be either eliminated or rationalized so that all credit card issuers are treated equally (ibid.).

Finally, in addition to regulatory restraints, there remain the de facto industry restraints which continue to be implicitly supported by the MOF. Thus, when American Express received permission from the Ministry to issue a charge card in affiliation with Nomura and in effect created a cash management account, there were strong complaints from the banks. However, rather than supporting American Express and a financial services innovation, the Ministry advised the company not to alienate the banks and the introduction was withdrawn. As seen so many times already and as probably will occur many times in the future, the Ministry in the end promoted the status quo and avoided potentially disruptive innovation. In addition, the system of prior approval resulted in technology leakage so that the banks had an opportunity to exercise their leverage prior to market introduction. Therefore, unless we see a major change in the Ministry's attitude, which currently seems unlikely, we can anticipate the pace of progress in Japan's financial markets will continue to lag the rest of the world. Thus Japanese consumers of financial services will continue to have a limited selection of relatively high priced products (Quick Research 1993). Foreign competition which potentially could offer attractive alternatives but would also disturb established business patterns will necessarily be restricted. Indeed, because foreign success is highly dependent on continuous innovation, cost control, and measured performance, the conditions required for their full participation in the market run directly counter to very consistent patterns of Japanese behavior reflecting forty years of bureaucratic control and the interests of the financial establishment (Garten 1991). In Japan especially, such changes in organization and administrative heritage usually prove extremely difficult.

**Summary**

Since Japanese financial liberalization began with banking in the 1970s, the MOF has followed a pattern of liberalizing primarily either new areas or areas where foreign firms enjoyed some advantage. This is because it was easy to reach a consensus within the industry. In turn, Japanese firms have entered these sectors on a cost basis using their core businesses as resources to cross subsidize these activities to maintain customer position. For this reason, foreign firms, first banks and then securities companies, have come under strong competitive pressure and several have had to withdraw from the market. Only those firms with a proprietary product or technology that can be continuously improved in combination with good cost controls have been able to succeed. The markets where this has happened are primarily derivatives and foreign exchange. Conversely, the traditional segregation between Japanese financial institutions which is a legacy of the immediate postwar period has largely persisted despite that fact that the
Japanese economy has been dramatically transformed. This protection has supported these institutions' core businesses and traditional business relations at the expense of innovation, flexibility, and cost reduction in marked contrast to the development and global competitiveness of Japan's manufacturing sector.

Unfortunately, the MOF has little current incentive and some reluctance to change this process since it believes that liberalization and the activities of foreign financial institutions are responsible for the severe collapse of the Bubble. Indeed, their current goals may not be innovation and performance but further rationalization and preservation of a status quo favoring the large firms and their keiretsu relationships. They are thus ignoring the reality that the Bubble's severity was due to Japan's economy and major corporations far outgrowing a financial system designed to regulate and assist a war ravaged, developing, capital short economic environment. A system originally designed by the MOF to limit financial assets and to facilitate their control of the economy was not able to accommodate the economy's earning power. Nevertheless, in the process of rapid growth, strong vested interests in the sizable economic rents associated with regulation and segmentation have developed. Indeed, these interests have been able to block via the consensus system any real invasion of their turf. The MOF has supported this explicitly and implicitly through a negative rather than a positive approval system partly out of a natural bureaucratic desire to preserve their control of the economy but also because of the economy's tremendous success. Why change something that has worked so well?

This view, though, has discouraged innovation and thus change in the status quo. It has also led to the creation of artificial and costly barriers to foreign firms which have denied these firms the ability to control their costs through focusing their activities and using their other staff and space resources to support new activities. This puts them at a disadvantage compared to their Japanese competitors that can do this via their keiretsu and retirement systems. Finally, in the areas under review there is a de facto policy to limit foreign firms' ability to innovate, introduce improvements, and control costs. This totally undercuts the competitive advantages that have been clearly demonstrated in other financial sectors as the ones foreign firms must develop for long term success.

Since the MOF is currently trying to reregulate the index futures market and is still limiting effective entry into certain attractive areas of insurance, funds management, and credit cards, it appears unlikely that true liberalization will occur. That is, liberalization will not favor foreign firms by allowing them to innovate, reduce their costs, and further develop derivative products. Therefore, growing frustration will cause many to seek a political solution which the current administration appears ready to provide. The MOF will then complain about gaiatsu or external pressure even though the source of the problem is naiatsu or internal pressures from the
established industry players. In this regard, another established pattern of international negotiation between governments will begin (Blaker 1977).

In the meanwhile, foreign firms who still have no political constituency in Japan would be well advised to push their proprietary technologies and to avoid liberalization of their areas alone. In the end perhaps the MOF will recognize that as the world’s largest creditor Japan needs to offer its savers a wider range of competitively priced assets and financial services so that there is no repeat of too much liquidity chasing a restricted supply of assets. More importantly, given the aging of Japan’s labor force, continued economic rents to Japanese financial institutions will ultimately cost the MOF dearly in terms of underfunded pensions and entitlements. So far, however, innovation and disturbance of the forty year status quo combined with loss of regulatory influence remain too high a bureaucratic price to pay. Therefore, gaiatsu remains a likely outcome. However, in taking this route Mr. Summers and his colleagues would do well to remember the lessons from past liberalization efforts.
References

1. While most of the data and information has been drawn from published sources, some has also been developed through conversations and interviews with former and current foreign investment bankers and money managers who have been directly involved in the Japanese securities and financial markets over a number of years. Their experiences, observations, and practical business knowledge have added greatly to this paper, and the author very much appreciates the interest of these former colleagues and competitors. However, he also takes full responsibility for his recording and interpretation of their remarks and for any errors of omission or commission in this paper as a whole.


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