New Dimensions of Financial Liberalization in Japan

DIFFERENCES BETWEEN THE FINANCIAL STRUCTURES OF JAPAN AND THE UNITED STATES ARE LIKELY TO PERSIST.

By Masaharu Takenaka

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This article contrasts the development of Japanese financial institutions over the past 50 years to that of the United States and compares the two countries' household savings behavior. Although reform and liberalization is driving the Japanese financial sector to become more open and more sophisticated, there are powerful reasons for the Japanese system and Japanese asset-holding behavior to remain divergent from that of the United States. One major factor is that income and wealth in Japan are distributed much more evenly than in the United States. Since wealthy households are more sophisticated and better able to accommodate risk, the concentration of wealth in the United States means that, compared to Japan, there are more high income/high wealth households that are willing to take on risk from equity and bond holdings. In Japan, in contrast, there is a much heavier reliance on bank deposits. Even though financial institutions in the two countries are becoming more similar, the persistent differences in income distribution are likely to lead to persistent differences in asset holding and the composition of capital markets in the two countries.

Japan's industries and financial markets are changing rapidly to address some of the issues they faced in the 1990s. Japan's stereotype image over the last decade has been one of stagnation, with heavy nonperforming loans and falling share prices; but this image fails to recognize Japan's changing realities. An issue that symbolizes the changes occurring in Japan's financial and fiscal systems, the Postal Reform Bill to privatize the postal service, finally passed in the Diet in 2005, following a landslide victory for now-retired Prime Minister Koizumi in the last election.

Although the changes in the Japanese financial system have been significant, there has still been a lag in Japanese financial liberalization since the 1970s compared to that of the United States. This paper will consider some elements that have caused the differences in the process of liberalization between Japan and the United States The first element is the conservative and gradual approach toward financial liberalization taken by the old Ministry of Finance (MOF), which maintained strong influence until the mid 1990s. The second is the paucity of investors in Japan with appetite for high risk. I will demonstrate that the relatively equal distribution of wealth among Japanese households compared to that of the United States is an important factor to explain this fact. The third element is the huge share of the Postal Savings System of Japan Post, which has played the role of funding source for the "quasi-socialistic financial system" in Japan. The fourth is that the mutual funds, called "investment trust funds" in Japan, have failed to become popular in the past.

The first, third, and fourth elements are commonly acknowledged; but the second one is not understood properly, although it explains a substantial degree of the difference in financial portfolios between Japanese and U.S. households. The conservative approach of the government toward the financial liberalization has changed drastically since the late 1990s. Also, the share of the Postal Savings Accounts has been decreasing rapidly; and a further decrease is inevitable. The popularity of mutual funds has recovered rapidly since the improvement of the mutual funds market's competitive environment. However, my view is that the second element—rooted in the relatively even distribution of wealth among Japanese households—will remain the factor causing the difference between the financial structures of the United States and Japan. I will also focus on the changing realities of Japan's financial market and touch on the more comprehensive question of whether Japan is heading toward the same financial model as the United States or toward a new Japanese model.

TABLE 1

LIABILITIES AND EQUITIES OF THE CORPORATE SECTOR IN JAPAN AND THE UNITED STATES, 2004 (PERCENT)

Japanese Category	Japan	United States	U.S. Category
Loans by private financial institutions	23.7	2.8	Bank loans
Loans by public financial institutions	3.4	3.3	Other loans and advances
Loan by non-financial sector	2.6	3.1	Mortgages
Corporate bonds	5.7	14.0	Corporate bonds
CP	1.2	0.5	CP
	0.0	0.8	Municipal securities
Trade credit	15.9	7.5	Trade payables
		0.4	Tax payables
Others	9.8	16.1	Miscellaneous
Equities	37.7	51.4	Equities outstanding
Total	100.0	100.0	Total

Source:Flow of Funds, BOJ, FRB.

Why Development of Capital Markets Lagged in Japan

To start with a well-established fact, the share of bank lending in Japan's financial market has been far larger than that of corporate bonds, in sharp contrast to the United States Table 1 shows a breakdown of debt and equity of the corporate sector. In the United States, corporate bonds and commercial paper (CP) account for 14.5 percent, while loans (bank loans, other loans, and mortgages) account for only 9.3 percent. In Japan, corporate bonds and CP account for only 6.9 percent, and loans by private and public financial institutions account for 29.7 percent.

Why is there such a sharp difference between the financial structures of Japan and the United States? What hindered the development of the capital market in Japan? Is there any specific factor that boosted the development of the capital market in the United States?

In most developed countries, capital markets (mainly for corporate bonds and equities) developed through financial liberalization, and the share of bank lending declined. On the other hand, bank lending is dominant over capital markets in developing countries, generally for two reasons:

- The development of capital markets requires a well-prepared financial infrastructure, including disclosure rules, independent rating agencies, bankruptcy laws, and regulatory authorities (such as the U.S. Securities and Exchange Commission), which are usually lacking or insufficient in developing counties.
- Average household savings in developing countries are so small compared to developed countries that most are below the minimum required to become an investor in capital markets.

However, the development of a capital market in Japan lagged relative to other developed countries even after Japan developed an effective financial infrastructure and high savings rates. For example, the rapid expansion of the capital market in the United States began in the 1970s. According to the Federal Reserve Board, the ratio of loans (including mortgages) to corporate bonds and CP was nearly equal in 1970, at 1.1 to 1.0. The corporate bond market (including junk bonds) began to expand rapidly in the 1980s, so that this ratio was 0.6 to 1.0 by 2004. In Japan, the ratio of loans to corporate bonds and CP in the corporate sector was 10.8 to 1.0 in 1980, an overwhelmingly loan-dominant market. Due to the development of the capital market since the 1980s, this ratio declined to 4.6 to 1.0 by 2004; but loans still hold a significantly larger share.

The current Japanese financial system emerged after the war, following the state-controlled system of the wartime period. While the structure of the zaibatsu (the old major corporate groups) was liquidated rather drastically and the financial system in the postwar occupation was reconstructed based upon the structure of the U.S. banking system (i.e., the Glass-Steagall separation of debt and equity businesses), the core structure of the financial and banking system was retained from the wartime system, established in 1930-45. This semi-state-controlled financial system, centered on the banks, adjusted itself very well to the economic environment after the war, when economic resources were scarce.

The Japanese Minstry of Finance thought that the U.S. savings and loan crisis was the result of too-rapid deregulation.

This financial system was deregulated gradually thereafter. Some important deregulations were achieved in the 1970s and the 1980s. However, the MOF—the control tower of this financial system—exercised very strong power to oversee how credit was used through its close oversight of banks. Almost no competing industries that could create credit were permitted to develop. That led to the conservative political stance of the government, especially the MOF, regarding financial liberalization until the early 1990s.

The MOF strictly adhered to retaining the regulated interest rates structure and was very wary of the rapid expansion of free credit-market instruments and financial liberalization. It is true that, "the bureaucrats' inclinations to distrust markets and profit motives continued to influence written and unwritten regulation and guidance until recently (the 1990s)" (Alexander, 2003). Thus, the slower development of the capital market in Japan was due to the conservative stance of the MOF, while financial liberalization in the United States has advanced rapidly since the 1970s. The MOF's policy inclination was motivated somewhat by the self-interest of bureaucrats. However, it is not fair to attribute the gradual approach on the financial liberalization only to their self interest. The MOF thought that the financial turmoil that accompanied the crisis of savings and loan associations and some big commercial banks in the United States in the 1980s was the result of a too-rapid deregulation in the financial system, thus justifying the MOF's gradual approach.

One enormously politically powerful group—Japan's huge multinational corporations—were gradually able to escape the clutches of the MOF during the 1980s. After foreign-exchange controls were ended, the multinational corporations—slowly at first—were able to raise funds in the overseas capital and money markets through the use of instruments that were not permitted in the home Japanese market. Hence, the largest and most successful corporations weaned themselves from tight financial controls by the domestic Japanese banks and turned, instead, to the use of the eurodollar market in London, New York, and elsewhere for the capital they needed for growth.

By contrast, purely domestic Japanese companies lacked such overseas escape hatches and were held hostage to the ability and willingness of the commercial banks to extend credit. When the banks themselves hit credit and capital restraints in the 1990s and began to fail, the flow of credit to nonfinancial corporations began to contract, and these companies collapsed by the thousands.

The Beginning of Financial Reform in Japan

However, my purpose here is not to justify the MOF's policy but to pay attention to the economic and political background of this policy. Any policy which is against the interests of the dominant social class cannot be sustainable for long, so there must have been a background difference between Japanese and U.S. economic and political interests. In fact, there was a demand for financial liberalization in the United States that became strong in the 1970s when the regulations of interest rate on deposits became inconsistent with the higher inflation rate and households began to shift their financial assets from bank deposits to capital-market instruments. In contrast, in Japan the demand for financial liberalization was relatively weak until recently. What caused the different economic and political climates in the two countries?

Before addressing this question, let me summarize the changes in the 1990s when Japanese government policies changed substantially. The new MOF was much reduced in power, and a new Financial Services Agency (FSA) became the key bureaucracy. Suppressive policies for free credit-market instruments were substantially eliminated. The Japanese "Financial Big Bang Act" in 1998 abolished the business wall between the capital markets and banking and allowed financial holding companies to hold commercial banks, securities companies, trust banks, and the other nonbank financial institutions. The conflict over the privatization of Japan Post was a significant phase in the political battle over the government's role in the financial market. These changes during the 1990s were considered necessary for the following reasons.

First, financial losses caused by the burst of the economic bubble of the 1980s were concentrated in Japan's banking sector in the 1990s, which gave rise to a systemic risk of bankruptcy or even a collapse of the financial system. The risk of the financial structure, with most of the money flows and credits concentrated in the banking system, became obvious. The United States also experienced a decade of financial turmoil from the early 1980s to the mid-1990s, but when the information technology bubble burst in 2000 the result was very different. Although the losses—including the decrease of the total capitalization of the stock market—were in the trillions of dollars, risks and losses were so diversified through equities, corporate bonds, and bank lending that the United States was able to avoid a systemic financial crisis.

Another source of problems within Japan's bank-lending-centric structure is that excess competition in lending keeps the lending spread of banks constantly depressed below the level rationalized by risk and return. This is the main reason for the low profitability of Japan's banking sector.

Second, the MOF had failed in its role to protect the financial system in the 1990s. Its failure created substantial distrust in its authority and brought about political changes. The old MOF used to try to save and maintain the financial system without letting any bank fail (through its use of the so-called "convoy system," in which the speed of the industry was set to the maximum speed of the slowest or weakest institution). But such a traditional approach itself was now thought to be the source of inefficiency and rigidity within the financial system.

These are the very common explanations for the changes and reforms of the financial system during 1990s. They are correct but incomplete. I want to focus on other changes that took place in the background of the policy changes and thus paved the way for the current transformation in Japan.

TABLE 2

FINANCIAL ASSETS OF HOUSEHOLDS AS OF THE END OF 2004
(Exchange Rate $1=yen 105)

	Gross*	Net*	Gross per capita**	Net per capita**
Japan	13,486.2	9,776.0	107.9	78.2
United States	36,619.5	25,900.4	124.1	87.8

* billions of U.S. dollars
** thousands of U.S. dollars

Note: Unites States: Households and non-profit organization; Japan: Households including personal business

Source: BOJ, FRB.

A Significant Difference between Japan and the United States: Household Financial Portfolios

While Table 2 shows that there is no substantial difference in the amount of financial assets per capita between Japan and the United States, the allocation in the two counties—shown in Table 3—is very different. Japanese households show a strong preference for deposits in financial institutions, while U.S. households have the opposite preference. This is the other side of the coin of the larger share of bank lending in Japan. More surprisingly, the share of deposits of Japanese households has hardly changed for the last 20 years. The ratio of Japan's gross financial assets to its nominal GDP increased remarkably from 1.9 to 1 to 2.8 to 1 between 1980 and 2004. Exactly the same change occurred in the United States where this ratio rose from 1.65 to 1 to 2.8 to 1 during the same period. Yet there is a sharp contrast in the portfolio change of financial assets of households between the two countries. U.S. households increased the share of capital market instruments and decreased the share of deposits, but Japanese households did not.[1]

Why Japanese Households Show a Strong Preference for Deposits

The most conventional explanation for this difference is that Japanese households have a strong aversion to risk, but such a quasi-sociological explanation should be viewed with quite a bit of skepticism. I cannot find any empirical study to convince us that the Japanese have a stronger aversion to risk intrinsically. It seems more likely that economic behavior is better explained by the mutual interdependence of institutional environments and habitual behavior.

Another explanation is that there had been a lack of financial alternatives mainly due to the government's conservative policy toward financial liberalization. But this is circular reasoning: which is first, the policy or the demand?

[1]The statistical categories of flow-of-funds accounts by the FRB and the BOJ are not exactly the same. The BOJ's data include personal businesses along with households, while the FRB's data do not but rather include non-profit organizations.

We have to first question why the demand for the financial liberalization was weaker in Japan. In addition, as a result of the financial reforms during the 1990s, there is no longer a substantial difference in available investment instruments between Japan and the United States. Does this mean the portfolios of Japanese households will become similar to those of the United States? There is no doubt that the ongoing financial liberalization in Japan will advance further to catch up with the global trend of financial liberalization. However, there are some reasons why I believe the end results of this liberalization process will be somewhat different from those of the United States.

TABLE 3

FINANCIAL PORTFOLIO OF THE HOUSEHOLD SECTOR IN JAPAN AND THE UNITED STATES

(Percent)

	2004		
	Japan	**United States**	
Deposits & Cash	54.8	15.2	Deposits
Securities Other Than Shares	2.8	5.9	Credit Market Instruments
Shares & Other Equities	8.6	18.0	Corporate Equity
		16.4	Equity of Non-Corporate Business
Mutual Fund (Trust Fund)	2.7	9.6	Mutual Fund
Insurance Reserves	16.3	3.0	Life Insurance Reserves
Pension Fund Reserves	10.2	26.3	Pension Fund Reserves
Others	4.6	5.6	Others
Total	100.0	100.0	Total
Ratio of Liabilities to Assets	27.5	29.3	
1985			
	Japan	**United States**	
Deposits & Cash	52.3	24.8	Deposits
Securities Other Than Shares	8.4	8.5	Credit Market Instruments
Shares & Other Equities	15.9	10.6	Corporate Equity
		25.0	Equity of Non-Corporate Business
Mutual Fund (Trust Fund)	2.2	2.0	Mutual Fund
Insurance Reserves	11.9	2.6	Life Insurance Reserves
Pension Fund Reserves	4.3	20.8	Pension Fund Reserves
Others	5.0	5.6	Others
Total	100.0	100.0	Total
Ratio of Liabilities to Assets	32.2	23.7	

Source: BOJ, FRB.

The Effect of More Equal Distribution of Wealth in Japan

One reason for portfolio holdings to differ between Japan and the United States is a significant difference in asset distribution, as shown in Table 4. In Japan, the top 20 percent of households distributed by income hold only 33 percent of all net wealth, while in the United States the top 20 percent holds 68 percent of net wealth, and the top ten percent holds 56 percent. Figures for most EU countries fall between those of Japan and the United States. The average amount of gross financial assets of the top 20 percent of U.S. households is \$1.08 million, while that of Japanese households is only \$0.27 million. Nonetheless, it is common in both countries that the higher-income classes with larger financial assets show more preference to hold risky assets, particularly equity assets, because higher-income people naturally have a higher tolerance for financial risk.

TABLE 4

SHARE OF THE FINANCIAL ASSETS OF HOUSEHOLDERS BY INCOME PERCENTILE

Income Percentile	Japan–1999 (%)	United States–2001 (%)
Bottom 20	13.3	2.7
20-40	16.1	5.8%
40-60	16.9	8.1
60-80	20.2	14.8
80-90	13.0	11.5
Top 10	20.5	57.1
Total	100.0	100.0

Sources: Japanese Ministry of Internal Affairs and Communication and FRB.

The concentration of income and wealth to the wealthiest classes in the United States has been one of the most remarkable political-economic trends over the past few decades. For example, Figure 1 shows the increase of family income by quintiles and the top five percent since 1967. The increasing concentration of income in the top income classes is obvious. These facts suggest that the development of the U.S. capital markets was to some extent a result of the concentration of income and financial wealth in the wealthiest classes, which have a strong preference for investing in capital market instruments. To meet these investment demands, hedge funds, equity funds, and venture funds flourished. The concept of “shareholder supremacy” became more dominant, reflecting the interest of wealthy people who invested heavily in equities.

However, the distribution of wealth is not the only factor to cause portfolio holdings to differ between the United States and Japan. Using government survey information, I estimated how the ratio of stock-and-bond holdings to total financial assets would change if the distribution of wealth in Japan was the same as in the United States. According to my estimate, the average ratio of stock-and-bond holdings of Japanese households would rise from 11.6 percent to 21.3 percent, compared to the U.S. ratio of 26.2 percent.

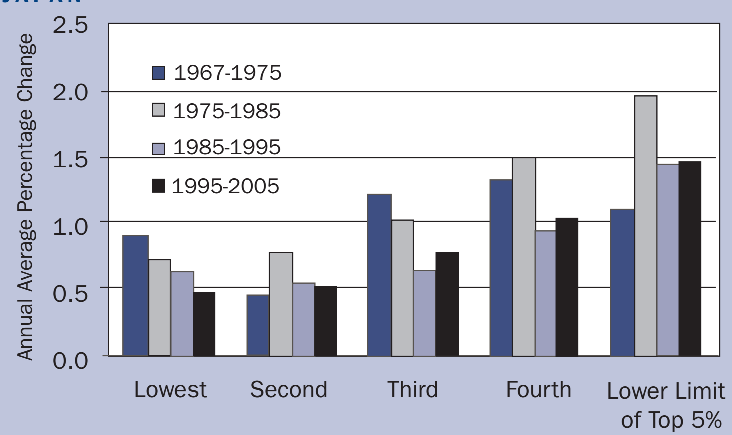
Reasons for Japanese Households' Strong Preference for Holding Deposits

Figure 2 shows that in Japan there is no clear relationship between the share of financial assets of each income class and the ratio of deposits to their financial assets. Some simulation results suggest that if Japan had the same distribution of wealth as the United States, the deposit ratio would decline only from 58 percent to 47.2 percent, still much higher than the United States' 14.6 percent. Thus, the distribution of wealth alone explains only 25 percent of the difference between the two countries. Japanese households show a strong preference to hold deposits regardless of the size of their financial assets.

There must be a unique reason for the strong preference for holding deposits in Japanese households. On this point it is important to note the huge size and unique character of Japan's Postal Savings System, which is by far the world's largest financial institution. Japan's share of postal savings to total time deposits increased from around 20 percent in the 1960s to more than 40 percent in the late 1990s. The main reason for this increase is its special interest provision that private financial institutions could not provide. Postal savings accounts offered

FIGURE 1

PERCENTAGE CHANGES IN REAL INCOME LIMITS FOR EACH FIFTH AND TOP 5 PERCENT OF HOUSEHOLDS IN JAPAN



Derived from
U.S. Census Bureau, Table H-1, Income Limits for Each Fifth and Top 5 Percent of Households, All Races: 1967 to 2005 (2005 $), http://www.census.gov/hhes/www/income/histinc/h01ar.html.

FIGURE 2

RELATIONSHIP BETWEEN DEPOSIT JAPANESE HOLDINGS AND INCOME: OF 1999

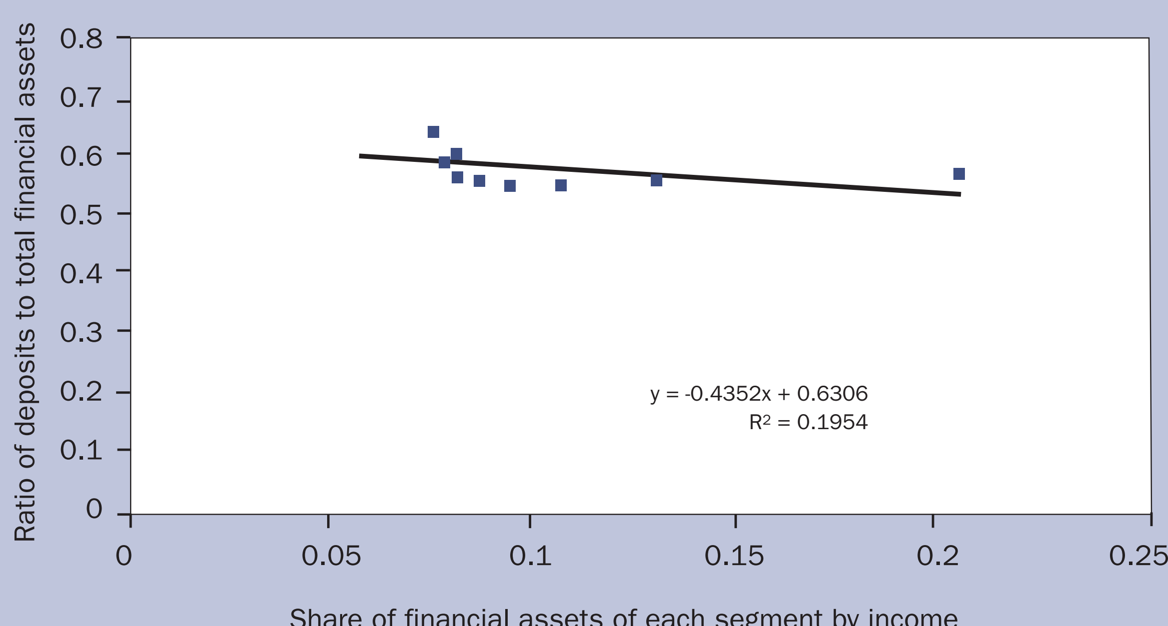
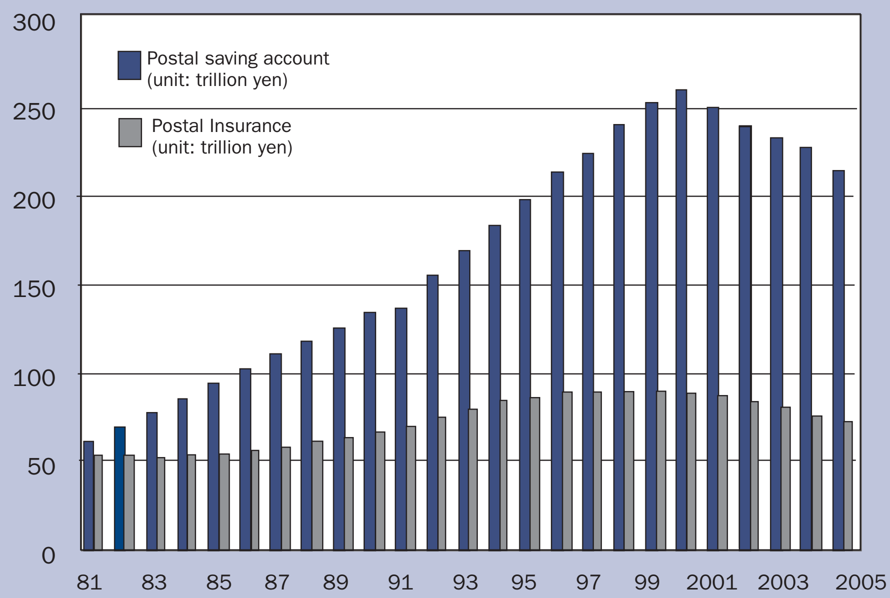


FIGURE 3

BALANCE OF JAPAN'S POSTAL SAVING ACCOUNT AND POSTAL INSURANCE unit: trillion yen



rather high ten-year fixed interest rates, and depositors could withdraw their money after only the first six-month period yet receive the ten-year fixed rate without any penalty. Postal savings could provide such irrationally favorable interest conditions because its return on assets was guaranteed by the yield of long-term government bonds plus 0.2 percent as an additional margin contributed by the government without any prepayment risk. It was therefore a rational choice for Japanese households to increase deposits in postal savings in the early 1990s, as shown in Figure 3, when it became obvious that interest rates would fall after the burst of the financial bubble.

It is difficult to estimate how much postal savings expanded due to this special interest condition. Recall, the share of postal savings out of total time deposits was 20 percent in the 1960s, rising to about 40 percent today. It might return to 20 percent if special interest conditions were abolished, with ¥120 trillion (roughly $1 trillion)—about 8.5 percent of the total financial assets of Japanese households—shifting to other financial instruments.

Adding this estimate to the previous simulation results, the difference in the deposit ratio between Japan and the United States can be explained by 25 percent due to the differences of wealth distribution and by another 20 percent due to the especially favorable interest conditions of Japan's postal savings. The cause of the remaining 55 percent of the difference in deposit ratio is still unknown but may lie in the performance of investment instruments in the past.

Low Popularity of Mutual Funds in Japan

Another remarkable difference in the financial-asset allocations of households in Japan and the United States is the share of mutual funds, which are known as "investment trust funds" in Japan. In the United States, the share of mutual funds in household financial assets increased from 2.0 percent in 1985 to 9.6 percent in 2004, while in Japan it remained at less than 3.0 percent. The total net assets of mutual funds in the United States are now about $9 trillion while only $535 billion in Japan.

Mutual funds are an appropriate instrument for the diversification of risks, and in the United States they are strongly preferred by both the wealthy and middle classes. Even though mutual funds are strongly compatible with the objectives of small- and medium-sized Japanese personal investors, their savings did not shift to them.

One major reason that mutual funds failed to gain popularity in Japan is related to the sales practices and ethics of Japanese securities brokers. They worked hardest to sell such mutual funds from which they could earn the highest fees, even though most of the actual returns of these funds were lower than the market's performance. They also encouraged their clients to shift from one fund to another very frequently in order to profit from the related fees. It is also said that in the 1980s, fund-management companies excessively increased the trading turnover of their fund portfolios, just to pay more trading fees to their parent securities companies. Until the 1990s, Japanese securities companies had no concept of risk diversification in sales.

Mutual funds failed to gain popularity in Japan as a result of these bad practices. If this sector recovers the trust of investors, it will gain a big growth potential because it can provide asset diversification to small and medium-sized individual investors. Signs of this are emerging and will be discussed later.

Let us now take a look at Japan's "quasi-socialistic" financial system, which has been a big obstacle to the development of capital markets there.

Japan's Quasi-Socialistic Financial System

It is generally interpreted that the landslide victory of Junichiro Koizumi and the LDP in the last general election means that the majority of Japanese have chosen smaller government through the symbolic issue of the Postal Reform Bill. Compared with the United States, however, the Japanese government is not big in terms of the number of public employees nor in the ratio of tax and social security costs to total GDP. In what sense can we say that the Japanese government is too big?

It becomes clear when we look at the balance sheet of the government sector. The Japanese central government sector has a disproportionately large amount of assets, totaling $7.3 trillion, while the U.S. federal government had only $1.5 trillion in 2004. According to the consolidated balance sheet of the Japanese government sector, including government corporations, in fiscal 2002 its total assets were ¥822 trillion ($7.8 trillion), which was more than 160 percent of total GDP.

There is a huge loan balance of ¥291 trillion on the consolidated balance sheet of the government sector, and is the biggest item on the assets side. It can be seen how large this is by comparing it with the total loan balance of private banks, at about ¥414 trillion as of the end of 2004. Government loan assets consist of the lending assets of many government corporations whose major funding sources are postal savings (¥233 trillion) and their own bonds held by the private sector (¥39 trillion).

This is the core structure of Japan's quasi-socialistic financial system. By providing finance, the government sector has a huge, direct involvement in the economy and has too strong an influence on the private sector. The more serious problem, however, is that this system has no actual "commander" who is responsible for its efficiency. However, the budgets of government corporations and special accounts have begun to shrink as a result of former Prime Minister Koizumi 's initiatives and now seems to be on an irreversible downward trend.

Changing Aspects of the Japanese Financial Market

Privatization and Prospects of Japan Post

Now let us focus on the changing aspects of the Japanese financial market. The first is about the future outlook for Japan Post and its savings and insurance arms, which are the basis for Japan's quasi-socialistic financial system. The Postal Reform Bill, which will privatize Japan Post from 2007 to 2017, was finally passed in the Diet at the end of 2005. Ten years seems too long for this process, but actual changes will probably occur much faster. The reason is that downsizing of postal savings is inevitable because postal savings accounts, which are the main instrument that have attracted huge savings, are not sustainable if deflation ends and interest rates begin to rise.

In the past, postal savings could provide irrationally favorable interest rates because their return on assets was secured by the yield of long-term government bonds, plus the additional 0.2 percent margin provided by the government. This rule was changed in 2001, before Koizumi became prime minister. In 2001, the postal saving system started the transition to a fully autonomous asset management by 2008. Under these conditions, it is not difficult to imagine what will happen when interest rates rise. Depositors will withdraw their funds after six months and redeposit them at the higher interest rate in postal savings or at other banks. If the postal savings continues investing in government bonds, it will face a gap between rising funding costs and the fixed rate of its bond investment and will finally invert its return-on-assets and funding costs.

TABLE 6

ASSETS UNDER MANAGEMENT BY INVESTMENT ADVISERS IN JAPAN

(Market Value as of the End Of March, Unit: Trillion Yen)

	Total	Domestic Clients	Overseas Clients
1995	38.2	21.3	16.9
2000	90.7	64.8	25.9
2001	91.1	73.3	17.8
2002	88.8	74.5	14.3
2003	83.7	70.6	13.1
2004	93.2	75.8	17.4
2005	107.9	87.5	20.4
2006	145.2	112.3	32.9

Source: Japan Securities Investment Advisers Association.

There are two ways to avoid such problems. One is to give up postal savings accounts and introduce an ordinary time deposit that is the same as at commercial banks, while the other is to set the postal savings interest rate low enough to reflect interest rate risk. Both of these options eliminate the features that made postal savings attractive in the past, and so their downsizing is inevitable. Actually, the balance of postal savings is already decreasing gradually, a trend that will accelerate as interest rates rise. The Postal Saving Bank is also expecting to start lending to increase its return on assets, but it is overly optimistic to think that it can be competitive in providing finance compared with other financial institutions because it has neither the experience nor the expertise.

Figure 3 shows that the balance of postal savings and postal insurance has decreased since its 1999 peak. This money has been shifting to equities, mutual funds, and government bonds, as shown in Figure 4. In October 2005, Japan Post started to sell mutual funds provided by other private financial institutions in order to offset the decreasing revenue from deposits. This will cause another positive

TABLE 5

TOTAL NET ASSETS OF PUBLICLY OFFERED INVESTMENT TRUST
(Market Value at End of the Year)

	Total (Trillion Yen)	Stock Investment Trust (Trillion Yen)	Bond Investment Trust (Trillion Yen)	Other Assets	Purchased Through Securities Companies (%)	Purchased Through Banks (%)	Direct Marketing (%)
2002	36.0	9.2	18.0	8.8	NA	NA	NA
2003	37.4	10.9	18.7	7.8	72.0	27.4	0.6
2004	41.0	12.3	19.6	9.1	65.4	33.8	0.8
2005	55.3	17.0	25.5	12.8	61.8	37.6	0.6
2006 (Aug)	61.5	19.7	27.0	14.8	58.0	41.3	0.7

Source: The Investment Trust Association Japan

change, because it will accelerate the downsizing of the money flows of the quasi-socialistic financial system.

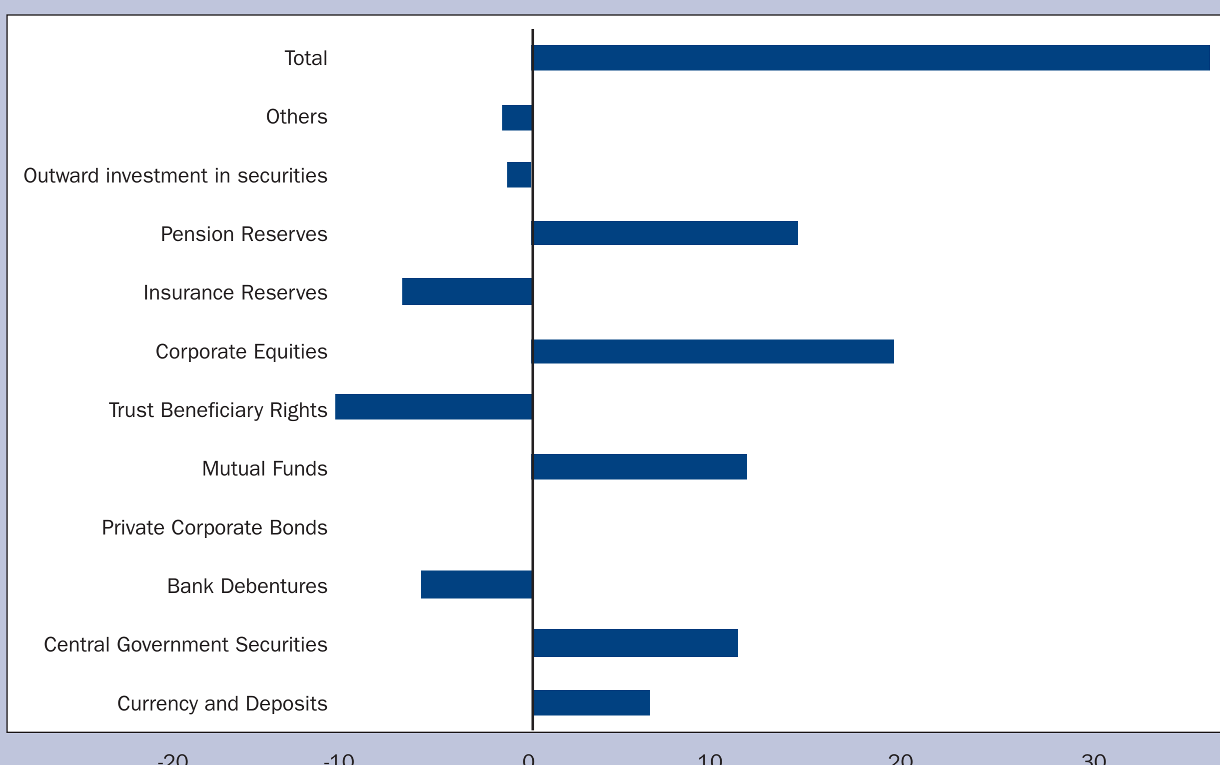
Growing Independent Institutional Investors: the Driving Force for Financial Liberalization

Japanese mutual funds failed to gain popularity in the past, but as shown in Table 5, there were three encouraging changes to this in the 1990s. First, sales of mutual funds offered by foreign asset-management companies were allowed in 1990. The entry of foreign companies made the market environment more competitive. Now, 36 of the 62 trust fund management companies in Japan are foreign institutions (or joint companies with domestic institutions) and account for 16 percent of total net assets. Their share is smaller than that of domestic institutions, but their role as competitors is not negligible.

Second, following the so-called financial big bang of 1998, mutual-fund sales by banks were allowed in 1999, which caused a substantial shift of sales players. Now, 41 percent of outstanding mutual funds (publicly offered investment funds) are sold through banks, and the banks' share is still increasing. Banks' intermediation of mutual funds seems to be caus-

FIGURE 4

PORTFOLIO CHANGES IN JAPANESE HOUSEHOLDS' FINANCIAL ASSETS DURING 2002/2Q-2005/2Q (Unit: Trillion Yen)



ing a significant increase in their popularity, which could be a unique feature of the new Japanese financial market.

Third, with the spread of Internet use since the late 1990s, investors have become able to easily compare the performance, fees, and risks of different funds, without the assistance of securities-company salesmen. This change has also made the mutual fund market more competitive and efficient.

The recent growth of the total net assets of Japanese mutual funds is remarkable. It increased ¥61 trillion ($530 billion) as of August in 2006 from ¥46 trillion in 2005, as shown in Table 5. But mutual fund holdings in Japan are still far smaller in the United States, at $9 trillion, which accounts for about 50 percent of all mutual funds in the world. Nonetheless, the environment of mutual funds in Japan has become very competitive. Supported by the changes in the 1990s and by the substantial profit recovery in the corporate sector since 2003, the balance of mutual funds (especially investment funds in equity and foreign assets) has been increasing remarkably.

Japan seems to be entering an investment fund era.

Sales of "individual variable annuities" started in 1999, and their outstanding balance had increased rapidly to ¥5.7 trillion by March 2005, from less than ¥1 trillion when sales through banks were allowed. Individual variable annuities are counted as pensions in macro-economic data, but their basis is mutual funds. Therefore, including individual variable annuities, increases of mutual funds in Japan are becoming more rapid. Accompanied by the expansion of various private funds and corporate-type investment trusts, Japan seems to be entering an investment fund era. It is ironic that the diminishing role of conventional domestic securities brokers caused these favorable changes.

Another rapidly growing investment sector in Japan is the asset advisory business. Table 6 shows that total net assets of asset-management companies have tripled in the last ten years, reaching ¥145 trillion ($1.26 trillion) as of March 2006. There are now more than 800 domestic and foreign asset-management companies, and nearly half of their assets are accounted for by public and private pension funds.

Those independent institutional investors as well as foreign investors, have been demanding higher returns on investment and the introduction of innovations in finance and investments. Also, they have become the driving force of the financial liberalization in Japan. Japanese business leaders are now making greater efforts to raise ROE and capital efficiency, both of which received little attention until the 1990s. Increasing demand for capital efficiency by investors is also an inevitable trend in Japan. Those investors are also firm supporters for dismantling the quasi-socialistic financial system, including postal savings and insurance.

Is Japan Heading for the Same Financial Business Model as the United States?

The final issue in this paper is whether Japan is heading for the same financial business model as the United States. The privatization and downsizing of Japan Post and the other government financial institutions will have a substantial effect toward developing the capital market in Japan. The money flow withdrawn from postal savings will probably be ¥100 trillion or more in the next several years, a large portion of which will shift to capital-market instruments and activate the market. There is no doubt that these ongoing changes in Japan will advance further to catch up with the global trend of financial liberalization. Nonetheless, there are powerful reasons for Japan's financial business model to continue to differ from that of the United States.

Persistence of a Relatively Flat Distribution of Income and Wealth

My analysis in this paper suggests that as long as a relatively equal distribution of income and wealth is maintained, the future course of Japan's financial system will be somewhat different from that of the United States, where the distribution of income and wealth is highly skewed.

The inequality of Japan's income distribution has increased gradually since the 1970s, but it is much more moderate. Further, the more egalitarian structure of asset distribution seems strongly rooted. The origin of this structure was the postwar reforms that began in 1945 when the classes of landlords and zaibatsu capitalists were dismantled. Today, there is the impression among ordinary people that Japan is heading toward a more unequal society, but the many empirical studies by experts tell us that the data indicating a widening income gap among Japanese households in the 1990s are not real.

Considering the distribution of income after taxes and social security, most of the increase in inequality since the 1990s is explained by increases of single-family households; increasing differences in the number of members per household; and increases of senior-citizen households, which tend to have higher incomes. Although it will not be treated in this paper, it is interesting that despite the empirical evidence, most people feel that Japan is rapidly becoming a more unequal society. This fact itself seems to suggest that the Japanese society is more sensitive or cautious about any signs of increasing income inequality.

Persistence of Bank Deposits Relative to Capital Market Instruments

In addition to the likelihood of maintaining a more equal distribution of income and wealth than in the United States, there are three additional points concerning the manner in which Japan will or should be different from the U.S. type of financial model. First, although further development of Japan's capital market is necessary and inevitable, it is likely that much greater reliance will continue to be placed on bank deposits than is the case in the United States. Actually, it is very encouraging that the formerly distrusted Japanese mutual funds seem to be recovering trust and that more are sold at banks. If this trend develops successfully, it will decrease the concentration of money to the banking sector and also contribute to the development of the capital market. The banking sector will also establish its new role as an intermediator between household savings and the capital market.

However, the concentration of household savings in the banking sector is to some extent a result of Japan's more equal wealth distribution. As long as this fundamental condition remains, a relatively larger portion of bank deposits relative to capital market instruments is likely to remain. This is not a discouraging conclusion if the banking sector is regulated under pro-competition, transparent rules.

On the question of what kind of rules for the banking sector can work, the resemblance between Japan and the United States is bigger than the difference. The MOF failed to appropriately regulate the banking sector in the 1990s, just as U.S. regulatory authorities failed to do in the 1980s. The common lesson from the resulting financial turmoil was that regulatory authorities should not have wide discretionary power because they have a strong tendency to bail out banks to avoid any financial turmoil. Ironically, such a bailout policy fostered the public's belief that banks would not fail and that their deposits were ultimately protected by the government. Thus, poorly performing banks continued to collect money and expand their potential bad loans up to a fatal level.

One area in which there is increasing convergence between the United States and Japan is that the principal policies of regulation have already changed to include rules and regulations for prompt corrective action. If the capital ratio of depository institutions declines to a certain level, the regulatory authorities are supposed to require improvement of these institutions' fiscal position and profitability. If banks cannot meet the required improvements, they are forced to enter a dissolution phase before their fiscal positions deteriorate fatally. This new regulatory framework is consistent with a financial liberalization environment and was established in the United States by the early 1990s and in Japan by the early 2000s. The old MOF was downsized, and the FSA was founded in 1998.

Protection for Small and Medium-Sized Financial Investors and Borrowers

In addition to tightening regulation to insure soundness, there is increasing regulatory protection for investors and borrowers. The government is moving to provide tougher regulatory rules for the sale of financial instruments to individuals in order to protect them from inappropriate sales. The FSA has prepared a very comprehensive law for that purpose. Also, there is a new rule on consumer loans to cap lending interest rates in order to protect individual borrowers from predatory lending practices. This is a popular example of the government's efforts to provide some protection for small-sized financial users.

Will "Shareholders' Supremacy" Be Dominant in Japan?

It is also important to note that Japanese corporate governance is changing toward giving priority to the interests of shareholders. Nowadays, about 25 percent of the total shares of the listed companies is held by foreign investors, and there will be no substantial setback in this trend. However, U.S.-style "shareholder supremacy" seems to remain unpopular in Japan. Japanese corporate governance is probably being restructured to give consideration to multiple stakeholders. Those who aggressively advocate "shareholder supremacy" are likely to continue to be seen as extremists. The broader class of small- and medium-sized investors in Japan, who have interests both as investors and as workers, is the base that will produce the difference in political priority and corporate governance between Japan and the United States

It is inevitable that in an era of economic liberalization, companies and institutions will face stronger competition; and the divergence between winners and losers is widening in Japan as well as elsewhere. This trend is accelerated by further financial liberalization. Nonetheless, a divergence between companies is one thing, and a wider income gap among households is another. The polarization of income and wealth can be avoided if the social safety net and education system are well maintained. The latest changes in Japan seem to suggest that they will be. The more equal wealth distribution in Japan is the primary factor that delayed the development of the capital market and financial liberalization, but it also gives hope for the reconstruction of the financial system into one that is more fair and efficient, based on broader middle-class interests in Japan. ■

REFERENCE

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