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Financial Liberalization, Deregulation and Monitoring in Japan

Chie Kashiwabara

1. INTRODUCTION

Starting with the collapse of the 'bubble economy' in 1990, the Japanese financial sector and its operations have been negatively reported as the illegal practices of its financial institutions and their non-performing assets problems were successively revealed. Although the government of Japan announced a 'Total Plan for Financial Revitalization,' local and international market players remained suspicious of the financial sector, and soon after an international rating agency downgraded government bond.

Needless to say, we cannot fully explain the causes of the present financial stagnation in Japan only by the boom and burst cycles in the stock and real estate markets. It should be pointed out that financial institutions neglected to prudentially practice their business as fund operators. Although the Ministry of Finance (MOF) and other financial authorities were responsible for overseeing that situation, they failed to establish effective monitoring systems according to the promotion of financial deregulation and liberalization since the 1970s. MOF and the other authorities failed to check irrationally expanding financial activities throughout the period in question.

The purpose of this paper is to examine problems which arose between the process of financial deregulation and the monitoring system in Japan, as well as to analyze organizational and functional problems concerning the Financial Supervisory Agency (FSA), which is considered to be indispensable to the success of the Japanese 'big bang' reforms. On the other hand, the Asian financial crisis in 1997 forced some countries to introduce IMF programs, which include conditionalities, to strengthen monitoring systems and adjust their financial system to market-based principles, in order to enhance financial liberalization. Therefore, effective monitoring of financial institutions has become an important issue within those countries, and this in turn, has implications regarding the advantages and disadvantages of the FSA, which was established in 1998.

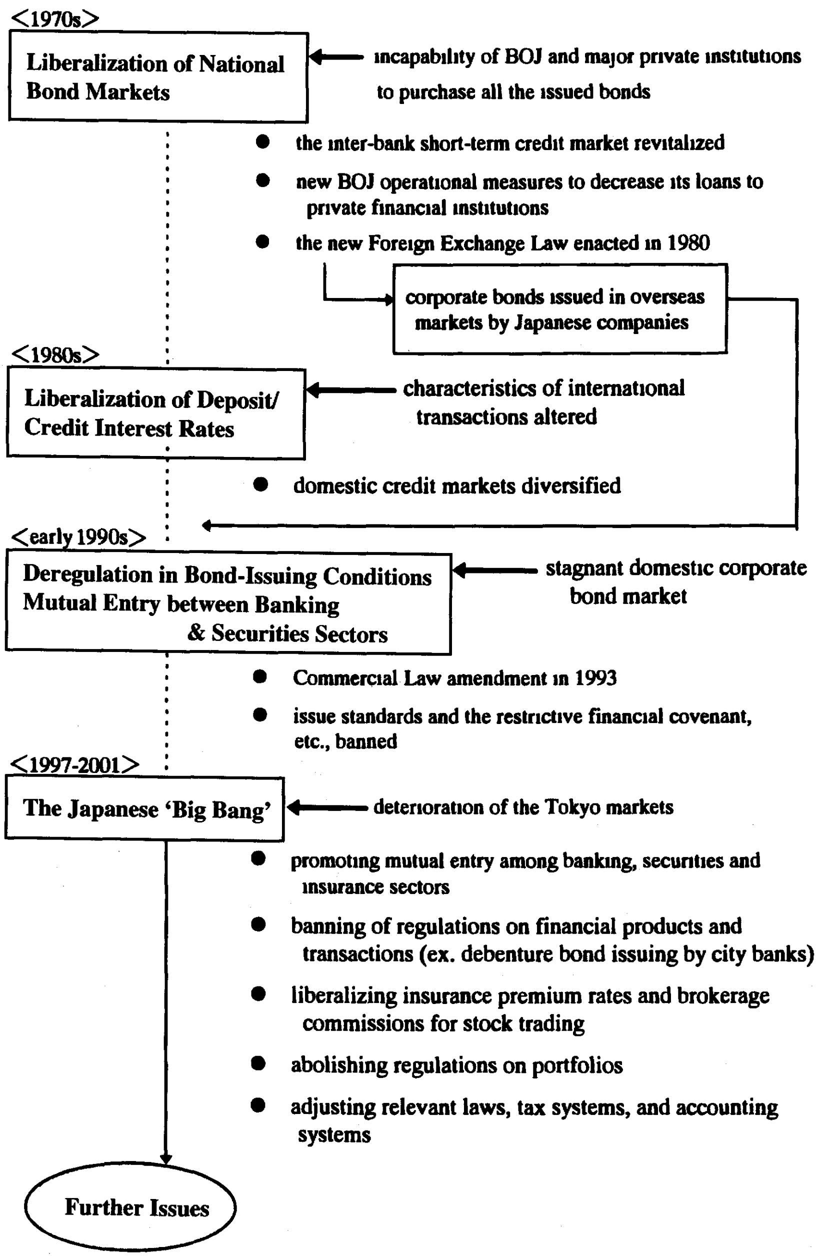
The remainder of the paper will be organized as follows. Firstly, a review of financial deregulation and liberalization in Japan. This is divided into two parts: (i) from the 1970s to the early 1990s, and (ii) the Japanese big bang reform scheduled to be completed by 2001. In section 3, problems postponed or neglected in the process of deregulation are described. (They seem to originate the present institutional discrepancies in the Japanese financial sector.) The FSA is examined as the main monitoring authority in section 4, and its organizational and functional problems are depicted. The last section provides implications and concluding remarks.

2. PROCESSES OF FINANCIAL LIBERALIZATION AND DEREGULATION

2.1. From the 1970s to the Early 1990s: Liberalization of Deposit Interest Rates and Deregulation of the Domestic Bond Markets

The characteristics of the system of financial regulation in the era of high economic growth are summarized as follows: (1) restraining deposit rates low with keeping real deposit rates positive; (2) limiting eligibility of bond issuing to large firms and controlling development of the second bond market; (3) restricting new entry to the banking sector and keeping banks out of underwriting and intermediation business in the securities market.[1]

Figure 3.1 Liberalization and Deregulation Process in the Japanese Financial Sector



Financial deregulation actually accelerated in the late 1980s (see Figure 3.1). It was backed up by policy changes carried out by the administration,[2] but actually, two factors in reality forced revision of the competition-restrictive regulations: changes in the financial environment and the fact that growth of the Japanese economy stabilized. The following three areas are the major changes in regulation in this period.

2.1.1. The Expansion of National Bond Markets and Its Influence

The Japanese financial structure from 1955 till the early 1970s provided abundant funds to main industries and to supported export- and investment-oriented economic growth. For this purpose, the government set regulations restricting competitions on operation and interests, prohibiting access to overseas markets and bond issuing without coordination. These regulations also aimed to intensively collect individuals' deposits to domestic financial institutions. Consequently, indirect financing developed with the support of these regulations.[3] In the public sector, the government enlarged fiscal expenditures to uphold business conditions.

Yet, as the result that the growth in tax revenues became stable since 1975, fiscal deficits in the public sector expanded and those deficits were financed by the massive issuing of government bonds. Accordingly, as the amount exceeded private financial institutions' and the central bank's capacity to purchase,[4] the expansion of national bond markets was promoted, that is, financial deregulation had started. Until then, the government had severely restricted selling national bonds by the consortium, but in April 1977, national bond auctions were approved except for those issued within a year. Deregulation in the bond markets encouraged both flexibility in issuing conditions, for example, introduction of market-based coupon rates of government bonds, and liberalization in the interbank markets. Furthermore, long- and short-term open markets were opened to non-financial institutions.

2.1.2. Liberalization of Deposit Interest Rates and Introduction of Market-Based Credit Rates

Liberalization of national bond markets gave birth to new financial products which offered higher interest than those of banks' regulated deposits. It promoted liberalization of deposit interest rates, but was not generalized until 1985, when Money Market Certificate (MMC) and liberalization of interest rates for time deposits over 1 billion yen were introduced. The process was gradually carried out through extending exceptions of regulations based on the Temporary Money Rates Adjustment Law. By October 1989 complete liberalization of interest rates for large-amount time deposits (over 10 million yen) was finished, while those for petty deposits (less than 10 million yen) started in June 1989. Finally, the liberalization process for liquid deposits was completed in October 1994, except for current deposits.

Given the results of deposit interest rate liberalization, credit interest rates also accompanied the trend. Until the end of 1988, banks could decrease their funding costs as deposit-rate liberalization was realized in the period of monetary ease (from 1976 to 1988, except in 1980). However, as liquid deposits increased sensitivity to market interest rates, costs for banks' liability side accordingly increased. As a result, financial institutions were forced to shift their credit policies from those based on the official discount rate and in January 1989, they introduced a new short-term prime rate based on their funding costs. That meant disconnection between short-term credit interest and the official discount rate, and enabled banks to reflect both changes in market trends and structural changes of their funding on loan interests.

As for long-term credits, banks began to decide interest rates with margins added on the new short-term prime rate according to credit terms or current maturity. This measure has been retained up until now.

2.1.3. Loosening Bond Issuing Covenants

As described in the beginning of this section 2.1., corporate bond markets were eligible only to large companies according to the government's direction. This originated from regulations on bond issuing in the domestic financial markets: (1) a company which issues corporate bonds should contract with an assignee bank, (2) the corporate bond market was managed by the principle of collateral, and only companies in good standing could exceptionally issue without collateral. Based on these regulations, the commission for the assignee bank (the issuing cost), the costs of securities transaction tax, and withholding tax in the Tokyo market made bond issuing much costlier than in overseas markets. Thus the market remained stagnant, lagged behind expansion of the national bond market. In the late 1980s, since no assignee bank was needed in the Euro market, Japanese corporations started to finance their large needs in

London, fleeing from the strictly regulated Tokyo market.

Under these circumstances, deregulation was realized in 1993, with revision of the Commercial Law, including the assignee bank system. In 1996, the law was revised again, where issuing standards and the restrictive financial covenant were abolished.

On the other hand, limitation on interlocking between banks (including trust banks) and securities companies was partially abolished by the comprehensive reform of the financial system operated in 1992. Banks and securities firms were enabled to enter each other's businesses, although with some restrictions, by establishing subsidiaries. For example, bank subsidiaries doing securities business cannot operate sock dealing consignment. MOF's reason for taking this measure was in order not to destabilize the existing order.

2.2. The Japanese Big Bang Reform

Financial liberalization and deregulation until the mid-1990s was concluded leaving fundamental restrictions unchanged thus supporting a policy of gradualism in order not to dissolve the 'convoy-guard' system. The on-going big bang reform intends a hard-landing compared to former reforms.

2.2.1. Contents of the Japanese Big Bang

The Japanese economy is currently struggling with reforms in financial administration and the financial system. The Japanese big bang reform was planned to solve the latter problem. In November 1996 then Prime Minister Hashimoto initiated the big bang agenda by telling his minister of finance and minister of justice to organize those reforms for the purpose of revitalizing Tokyo markets by the year 2001 to be comparable to other international markets, such as New York and London. In June 1996, relevant councils[6] finished formulating a plan for reform measures. The plan indicates the basic concepts for reform of the financial system and clarifies the schedule to realize the three principles of that reform; 'liberal market under market principle,' 'transparent and reliable market,' and 'international and advanced market.' Its major points are as follows:

- promoting mutual entry among banking, securities and insurance sectors

- banning of regulations on financial products and transactions, for example, lifting of the ban on debenture bond issuing by city banks
- liberalizing premium rates in the insurance sector and brokerage commissions for stock trading
- abolishing regulations on portfolios (investment trust and pension funds, etc.)
- adjusting relevant laws, tax systems, and accounting systems to those of the US and UK.

The government intends by these reforms to abandon the 'convoy-guard system' on the premise of remedying financial institutions, and to monitor market principles promoting liberalization and competition among participants. It further projects not to neglect financial reforms while it struggles with non-performing asset problems. On the other hand, relevant financial laws and tax systems have been revised or amended according to the reforms in progress. (For the big bang schedule and revisions of related laws, see Tables 3.1 and 3.2.)

2.2.2. *Issues for the Future*

The Financial System Reform Consulting Committee admits that some issues must be settled in order to realize reform: (1) various systems are to be developed without delay through necessary revisions to laws and ordinances, (2) to identify the way how the best financial activities could be, taxation on financial transaction and activities should be reviewed, (3) consideration to establish the Financial Service Law is inevitable from the medium-term perspective.

As stated above in point (2), the most urgent issue is reform of the tax system on financial transactions, but even in the big bang plans, it is still postponed. From the perspective of globalization, which is one of the three principles for financial market reforms, corporate tax rates and taxation on capital gains would be demerits to participate in Tokyo markets. Documentary stamp tax is also an obstacle for increasing transactions. According to the government's schedule, discussions on political issues related to taxation on securities transactions, derivatives and capital gains will start in 1999. Revisions and amendments of laws related to the tax system are expected to start actually in the next century, therefore the delay may decrease the big bang effect to some extent.

Table 3.1: The Schedule of the Japanese Big Bang

The FY 1997	• introducing unit stock options • starting multiple purpose securities account • lifting of the ban on trading and intermidiation of unlisted and unregistered stock transactions for brokers • improving and strengthening penalties of Prompt Corrective Action • abolishing regulations on employment of private pension plans and insurance system
The FY 1998	• utilization of holding companies • liberalizing Foreign Exchange Law: abolishing approval system • transferring from licensing system to registering system of securities firms • deregulation on brokerage commissions for stock trading over ¥50 million • authorization for banks to sell securities investment trusts and insurance • lifting the ban on competitions of insurance premium rates • specialization of monitoring functions among ministries and agencies
The FY 1999	• complete liberalization of transaction fees • liberalizing issuing debenture bonds by banks in the domestic bond market • abolishing barriers to mutual entry among banks, securities firms and trust banks • transferring from book-value method to current cost method in stock evaluation held by companies • starting discussions on issues related to tax policies, such as stock brokerage, derivative transactions and capital gains
After the FY2000	• abolishing barriers to mutual entry among banks, insurance firms and securities firms through subsidiaries • lifting the ban on window sales of insurance products by banks

Source: http://www.mof.go.jp/big-bang/bb31.htm

3. PROBLEMS REMAIN UNSOLVED DURING THE PROCESS OF FINANCIAL DEREGULATION

When a financial institution faces collapse, *ex-post* settlements with the support of other private banks or financial institutions, or relief through mergers/takeovers have been generalized as administrative measures in Japan. This has been done to avoid explicit bankruptcies of financial institutions. Furthermore, financial authorities, particularly MOF, played an important role to arrange or conciliate such *ex-post* settlements in the

Table 3.2: Contents of Revised / Enacted Laws

Revision of Foreign Exchange and Foreign Trade Control Law (enforced in April, 1998)	• liberalizing the foreign exchange business and abolishing authorization of foreign exchange banks • utilizing electronic money and offshore markets • adjusting laws for soundness of the foreign exchange business
Establishment of Financial Supervisory Agency (law enacted in June, 1997, establishment in July, 1998)	• separating the financial administration from MOF • merging Securities and Exchange Surveillance Commission • settlement of failing financial institutions
Revision of Bank of Japan Act (enforced in April, 1998)	• securing the autonomy and independence of BOJ • separating the management of BOJ from MOF jurisdiction • enhancing accountability of BOJ
Revision of the tax system related to financial transactions	• cutting securities transaction tax and bourse tax in half • revising measures of corporate income tax in view of lifting the ban on establishment of holding companies by banks

Source: Same as Table 3.1.

system, as it held and operated broad political influence on financial institutions.

Therefore, both the authorities and financial institutions have not recognized the importance of three factors described below while they deregulated and liberalized their activities and the variety of products.

3.1. Safety-Nets

Financial safety-nets in Japan have two characteristics. Firstly, not only depositors but also other creditors could be exempted from their losses from bankruptcies because the system does not have the pay-off system, except banks deeply involved with a problem institution. Secondly, in the process of failing settlements, only a few of the parties concerned could access the problem institution's managerial information as MOF attached importance to its discretional administration. Consequently, outsiders had difficulties assessing the adequacy of the authorities' judgment on an *ex-post* settlement and responsibility for the shortcomings of a failing institution was not elucidated, nor all of the reasons of bankruptcy.

It is theoretically understood that the combination of safety-nets and *ex-ante* regulations on banks' risk-choices, i.e., prudential regulations, is a rational solution for preventing financial crises. But in reality, the Japanese financial authorities had thought little of prudential regulations until the late 1980s. It can be said that the present financial system in Japan was established on a combination of safety-nets — which involved all-inclusive risk sharing, and prudential regulations without effectiveness. In this sense, the potential fragility of the system was known, so it is quite natural that reform of the system became an urgent issue as non-performing asset problems became apparent.

Capital adequacy requirement (CAR) is a typical measure for prudential regulations. Capital-to-asset ratios of Japanese banks have gradually fallen as financial liberalization and their business expansion proceeded. The ratios which had leveled at 6-7% in the 1960s went down throughout the 1970s, and in the 1980s, they fell to less than 4%.[7] One of the reasons for this decline was related to the fact that asset growth was higher than the rate of equity retention — that is, profitability was too low to support the asset growth. In 1986, MOF revised CAR accompanied by amendments of accounting provisions for banks. However, those revisions meant that MOF's administrative direction could only be realized by down-grading the requirements rather than strengthening CAR to enhance its effectiveness, that is, the revised CAR was regulated at 4% of gross assets.

On the other hand, functions and measures of application of a deposit insurance organization had not been seriously discussed in spite of its existence, because MOF retained its policy of 'no bank goes bankrupt' as described above. But the collapse of the bubble economy caused a change in that situation. MOF faced serious difficulties in arranging relief mergers based on the former measures of supporting financial institutions. The reason why those difficulties occurred was that the rent — which meant purchasing banks could absorb failing institutions' employees and branch networks — had vanished, or mergers could not afford to absorb them any more owing to downtrends in the economy. Since the case where the Toho Sogo Bank was consolidated by the Iyo Bank in 1992, it became a common practice of relief mergers/consolidation takeovers among banks that the deposit insurance organization provided supporting funds to purchasing banks.[8] Ironically, this fund-supplying enabled people to know for the first time, although only partially, the social costs related to bankruptcy settlements of financial institutions, and to consider the consequences of this cost-sharing. Nonetheless, the government decided to suspend employing clarified application measures of the organization.[9]

3.2. Monitoring

On December 24, 1997, the Management and Coordination Agency (MCA) made a recommendation to MOF, the ministry of agriculture, forestry and fishery (MAFF), and the ministry of labor, based on the results of its inspection concerning administrative monitoring of financial institutions (see Table 3.3).

MCA considered that a series of failings and illegal activities pertaining to financial institutions and the consequent deteriorated credibility of the financial system revealed serious problems regarding administrative monitoring. Given the increasing necessity of settling problems on administrative reform and establishing a highly transparent financial system, it is crucial to improve the effectiveness of monitoring and expand disclosure both of private sector and the authorities' activities, such as approvals. Major problems related to financial monitoring indicated in the recommendation are as follows.

- *Inflexibility of intervals between inspections*: The bigger a financial institution is, the more stable inspection periodicity tends to be (see Table 3.4). Financial institutions can easily presuppose timings

Table 3.3: Number of Authorities Inspected by MCA in 1997

(%)

Ministry*	Bureaus	Perfectural Offices	Private Financial Institutions**	Banks	Credit Banks
3 (100)	19 (80)	55 (33)	154 (3)	36 (21)	118 (3)

Notes: * Ministry of Finance, Ministry of Agriculture, Forestry, and Fishery, and Ministry of Labor.
** Of all financial institutions operating deposit business.
Source: http://www.somucho.go.jp/kansatsu/kinyu-s.htm.

Table 3.4: Interval Between Inspections

	average	shortest interval	longest interval
large banks	4 years and 2months	4 years	4 years and 2 months
regional banks	2 years and 10 months	2 years and 3 months	3 years and 4 months
shinkin banks	2 years	1 year and 9 months	2 years and 6 months

Source: Same as Table 3.3.

of inspections, as MOF inspections used to be conducted conventionally regardless of previous results. Furthermore, about half of the reviews compared with the previous one advise on the same matters, such as asset structure, internal audit standards, etc. It shows conventionalization of the authorities' inspections as well as a lack of the financial institutions' eagerness to improve.[10]

- *Lack of cooperation among authorities to improve effectiveness of inspections*: Credit associations for agriculture and fisheries are under the jurisdiction of MAFF. MOF and MAFF have no arrangements regarding how they cooperate in managing inspections, nor have they cooperated with responsible rural bureaus. MCA points out that manuals and checklists at the prefectural level are outdated and do not reflect actual financial activities because the ministries failed to provide those materials to them in a timely and proper manner.
- *L ack of coordination with the BOJ's 'on-site examinations'*: Like MOF inspections, the BOJ conducts 'on-site examinations' where it sends its staff to visit and receives financial reports from financial institutions having current accounts with the BOJ. Examinations involve checking the quality of loans and other assets, and the risk-management system, etc., to maintain provision of measures for settlements and the overall stability of the financial system. Then BOJ provides guidance and advice based on the findings of the financial and management conditions where necessary, thereby to ensure soundness of financial institutions. Although BOJ examinations and MOF inspections contain the same checkpoints and measures, they lack cooperation.[11]

Of the above points, the last is the most important. BOJ is expected to function as the monitor of transactions after direct regulations are loosened by the big bang reform, therefore, its responsibility and importance will be increased. In order to enable it to fulfill its functions, both BOJ's independence as the central bank and its roles as the core of the financial system were strengthened by the New Bank of Japan Act, enforced in April 1998.

Furthermore, BOJ should maintain the financial system as the lender of last resort, operating offset settlements among its client institutions. In order to maintain the sound functioning of the settlement system, the monitoring of banks should be sufficient. However, some concerns have been voiced about duplication of inspections, but by promoting cooperation with other financial authorities and inspection organizations through establishing new measures, for example, unifying material forms to be submitted by financial institutions and increases effectiveness of monitoring, these concerns can be checked. As Horiuchi [1998] puts it, "... encouraging competition among regulation authorities under some circumstances will enable them to expand the coverage of inspections and increase their stringency."

3.3. Disclosure

Under the present relevant laws, financial institutions have duties to disclose their business conditions at least in three forms: (1) disclosure booklets for the public under articles 20 and 21 of the Bank Act,[12] (2) financial statements for shareholders and auditor's reports for creditors under article 281 of the Commercial Law, and (3) financial reports for the public under article 24 of the Securities Exchange Act.

These reports vary in timings for disclosure, contents and penal regulations. MCA inspections report as follows:

- Of 154 financial institutions inspected, 28 institutions did not publish disclosure booklets of the fiscal year 1996.
- Only about 10% of institutions made positive disclosure surpassing the uniform standards applied by the Federations of Bankers Associations (FBA).
- Discrepancies of disclosed figures between financial statements and disclosure booklets were found in 21 institutions, and no disclosure booklet contained auditor's reports by certified public accountants, which were attached to those in English for overseas customers. On the whole, systems to prove the quality, such as the third party's certificate, seldom exist.
- Monitoring authorities do not emphatically collect disclosure booklets or confirm exactness of their contents.

Recently the FBA itself started disclosure in the form of an autonomous standard. Concerning the Bank Act, MOF revised it to institutionalize disclosure as a compulsory duty for the first time in March 1998. But the revised act has two critical defects: (1) it does not indicate the contents to be reported, and (2) it lacks penal regulations for false statements. On the former defect, the FBA applied the uniform disclosure standards divided by two sections, i.e., 'essential disclosure items' and 'voluntary disclosure items'. But on the latter no progress has been made up until now.

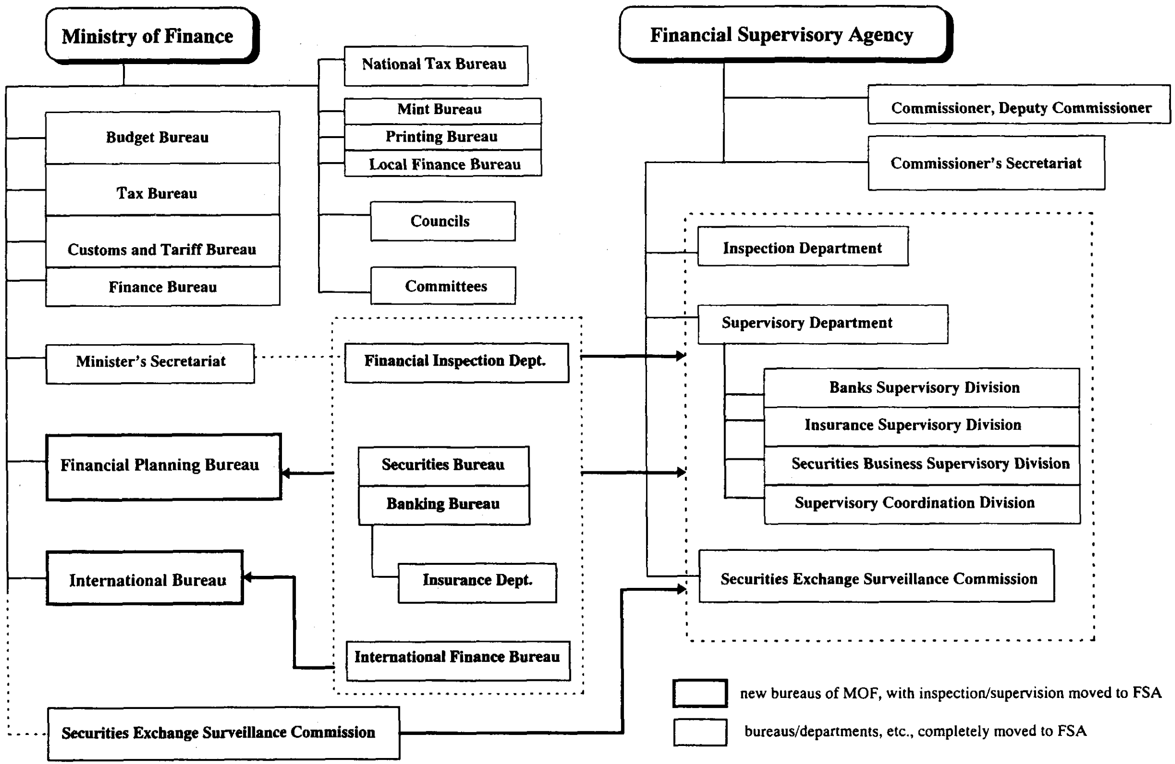
On the other hand, disclosure is deeply related to the operating measures of the deposit insurance organization. As described in section 3.1., safety-nets have allowed depositors and creditors to be exempted from losses of bankruptcy. Therefore, no incentive to deliberately monitor banks' business and managerial conditions has existed, and the parties concerned have never realized the necessity of disclosing detailed information on their business to depositors and creditors. As a consequence, regarding settlements of failing financial institutions, it was hard to put a part of the losses on depositors and investors when disclosure is not realized properly. Accordingly, introduction of the pay-off system was actually impossible.[13] Fukao [1998a] describes the reasons which have prevented disclosures from being actualized as follows: (1) as the accounting conventions in Japan have submitted to and have been highly influenced by regulations of tax systems giving careful considerations to increasing tax revenues, the conventions failed to deal with changes in economic situations, (2) auditing has become conventionalized, therefore, accountants have not taken their full responsibility, (3) systems of internal inspections were faulty as some securities firms converted profits in customers' accounts to their own accounts.[14]

4. FINANCIAL SUPERVISORY AGENCY (FSA)

Confronted with financial fragility and the non-performing asset problem, the government established FSA in June 22, 1998, to take responsibility for operating transparent and fair monitoring. It also aims to conduct thorough changes from discretionary administration represented by *ex-ante* directions to that of *ex-post* checks without opaqueness.

Based on the former administrative structure, one ministry, i.e., MOF, had decisive power on both fiscal and financial policies. It is well known that MOF allowed financial institutions to avoid deficits in term-ends by suspending write-offs, and was reluctant to ban the securities transaction tax, which hindered securities markets from being revitalized. Those measures were applied for maintaining tax revenues from corporate tax. Now the government's intentions will be assessed both domestically and internationally by whether establishment of FSA eliminates the massive MOF influence on financial institutions.

Figure 3.2: Oraganizational Structure of Financial Supervisory Agency and New Ministry of Finance



Source: Nakano and Yoda [1998], p. 22, 24, 36, 70.

4.1. Organizational Framework of FSA

The number of regular staff at FSA is 403, of which 373 members were transferred from MOF bureaus[15] (see Figure 3.2). Supervision and monitoring as the basis of financial administration are now the jurisdiction of FSA, including giving and abolishing licenses of financial institutions, ordering suspension of business concerning bankruptcy settlement, approvals for establishing branches and selling new products, etc. On the other hand, MOF retains broad control for designing and planning financial policies. The sharing of functions between FSA and MOF thereby seems to be formally clarified.

The government's intention to abolish discretional administration appeared in the form of disclosure philosophy of administrative information. For example, when FSA disapprove an application to sell a new financial product, it has to officially announce the reason for disapproval as well as all materials related to its decision-making process. This will lessen administrative intervention and dissolve the former style based on private decisions. In the end, disclosure of administrative information supports the 'transparency' discipline of the big bang reform.

4.2. Further Issues of FSA

As seen in the above section, FSA is expected to play a crucial role in financial system reform, and its importance will be further increased in accordance with the process of liberalization and deregulation. However, the agency has some problems both in its organizational framework and the limitations of its functions.

4.2.1. Organizational Problems

1. In spite of the initial intention, the government could not establish FSA as an 'article 3 committee', such as the Fair Trade Commission, based on the National Administrative Organization Law. The article 3 committee title gives an administrative organization higher independence, as even a jurisdictional minister cannot intervene into decisions that the committee makes, this contrasts with the standing of an ordinary 'article 3 organization', which has to submit to directions of the minister concerned. The FSA belongs to the latter. This resulted from a political compromise between considerations to the

on-going administrative reform and securing the FSA's independence from MOF.

2. The FSA has to utilize MOF's Local Finance Bureaus in actual monitoring when it conducts inspections in local areas, because it has no branch offices. Although 'financial administrators' and 'financial management supervisors' are appointed from FSA to such bureaus, it is difficult to deny that the system is distorted to some extent, raising some doubts about keeping secure information on inspections and monitoring.
3. Standards for consolidated financial statements and disclosure are the core issue of the financial system reform, the transparency discipline of the big bang and strengthened supervision/monitoring, and financial institutions' consolidated financial statements which must be submitted from the term-end of March 1999. FSA is responsible for enactment of relevant laws and ordinances, but the issue is actually under the jurisdiction of the Financial Planning Bureau, MOF. Concerning these statements, financial institutions are behind other companies in the industrial sector, and dispersion of responsibility within the administrative decision-making process causes confusion among financial institutions.

4.2.2. Functional Problems

1. In the FSA Act it is emphasized that FSA is to consult and cooperate with MOF when monitoring failing institutions. Nevertheless, this cooperation should be conducted with BOJ whose independence and autonomy has been strengthened by the new BOJ Act. As relief mergers/takeovers are hardly realized and MOF is not responsible for arranging them at present, only BOJ can operate necessary measures actively in the short-term concerning how to settle failing institutions.
2. Concerning indispensable regulations to inspections/supervisions and monitoring, which organization, among FSA, MOF and BOJ, should hold the leading role is not clarified. For example, failing settlement is under the jurisdiction of FSA and BOJ. Nevertheless, the deposit insurance organization, which provides funds in cases of bankruptcy, is to be under the control of MOF.

5. IMPLICATIONS AND CONCLUDING REMARKS

Whether financial liberalization and deregulation can further develop a country's financial sector is highly dependent on its economic condition and the state of its financial system when liberalization is realized. In this sense, it can be said that in the case of Japan many difficulties existed from its starting point.

First, resolving non-performing asset problems and furthering financial liberalization are basically incompatible with each other, and the latter can hardly succeed when the economy is unstable or holds problems. The government of Japan has to promote financial liberalization and deregulation, reform the financial system and functions of monitoring, concurrently restructuring the financial and corporate sector while taking business stimulating measures. In a case like this, financial institutions as well as monitoring authorities will be forced to bear heavy burdens. Some distortion and confusion between the liberalization and deregulation process and the financial system reform will be accordingly expected.

Second, for financial liberalization, effective prudential regulations and a monitoring authority to check financial institutions are indispensable for sound financial institutions and credit worthiness. However, it should be stated here that at least the FSA is under construction from this point of view. Not only are the monitoring functions but also reform-planning and operating departments are to be completely moved from MOF to the FSA.

Third, as the most basic issue, concerned authorities must fully recognize that financial liberalization and deregulation does not only mean loosening or abolishing existing regulations and de facto rules. Rather, the process has to include revision of related systems and supporting areas, such as tax and accounting convention, or the effectiveness of the procedure will decrease.

On the contrary, the intention to eliminate the former 'discretional administration' led by MOF should be positively evaluated as a first step, leaving aside whether the big bang reforms succeed in an era of economic instability. The removal of MOF's influence would be helpful to the monitoring administration only if FSA clarifies its directing system and strengthens its administrative coordination with BOJ. Thereby, the possibility of FSA functioning as an independent financial authority will increase.

Notes

[1] For details, see IMES [1995], Kaizuka and Ueda [1994], and Hoshi [1997], etc.

[2] Various reports were issued and revised laws were enacted as follows: the New Bank Act in April 1982, "Japanese Yen—US Dollar Committee Report" in May 1984, and "Reviews and Prospects on Financial Liberalization and Internationalization of Yen" by MOF in May 1984.

[3] Throughout the era of high economic growth, indirect financing continuously held about 90% of the total credit, and over 60% of that was occupied by private enterprises. So, private financial institutions were always in the position of over-borrowing, which highly depended on loans from the central bank (BOJ).

[4] Under article 65 of the Securities Exchange Act of 1934, banks were prohibited to make over-the-counter sales of public bonds. All they could do was to purchase and hold them on the asset side.

[5] Concerning deposit interest rates, differentials between those provided by private financial institutions and those by postal savings has been an outstanding problem. Privatization of businesses of the ministry of posts and telecommunications (MPT), including the postal savings bureau, was once discussed in the Diet. However, as those savings are manipulated as treasury investments and loans, the government postponed settlement of the problem, caring its political management for business expansion. In April 1994, MOF and MPT agreed to link ordinary interest rates of postal savings with those of private banks, but the ministries have not reached a final decision.

[6] There are five councils: the Securities and Exchange Council, the Business Accounting Council, the Financial System Research Council, the Insurance Council and the Committee on Foreign Exchange and Order Transactions. Additionally, in order to promote the reform process in a unified scheme, the Financial System Reform Consultative Committee, consisting of representatives from each council, was set up to discuss issues crossing each council's scope.

[7] Not only in Japan but in the US, the banking sector had this tendency. According to Gart [1994], "capital-to-asset ratios of the US banks also declined from 15% in the mid-1930s, to 7% in the current banking environment. This presented more than a 50-percent decline in the capital-to-asset ratio. Another example of increased risk at banks is the large increase in loan-to-asset ratios over the same period." (p.118)

[8] In the case of the Toho Sogo Bank, the Iyo Bank received a low-interest loan. As another example, Sanwa Bank received a donation of 20 billion yen when it acquired the Toyo Shinkin Bank in October 1992.

[9] Taking into account the seriousness of the non-performing asset problem,

the government decided to postpone the introduction of the pay-off system till 2001.

[10] Concerning the advisory report, MCA also points out that, in 52 of all 179 inspection cases, MOF spent over 100 days to deliver the reports (The longest case needed 171 days.) to financial institutions. This indicates another example of conventionalization, although the advice included in the reports should be improved as soon as possible.

[11] In the financial sector, institutions should be monitored by the industry group and certified public accountants. Such monitoring has not been utilized in MOF inspections, either.

[12] Long-term credit banks submit article 17 of the Long-Term Credit Bank Act, and shinkin banks are under article 89 of the Shinkin Bank Act.

[13] For details about the *Jusen* problem as an example, see Goodhart et al. [1998], p. 124-126.

[14] Fukao [1998a], p. 11-12.

[15] National police agency (3) and ministry of justice (1) also transferred their regular staff. Of 373 staff from MOF, 77 were from the banking bureau, 30 from the securities bureau, 175 from the minister's secretariat (of them, 150 from the banking inspection department) and 91 from the securities and exchange surveillance commission. The rest 26 are the increased personnel.

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