Future Direction of Financial Liberalization in India

Lessons from Japan's 30 years

14 September 2010, New Delhi, India

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Lessons from Financial Liberalization in Japan: 1970s-2010

1. Timing of the financial liberalization
2. Interaction between currency internationalization and financial liberalization
3. Banking sector problem under the distorted financial liberalization
4. Achievements of the Japan's Financial 'Big Bang'

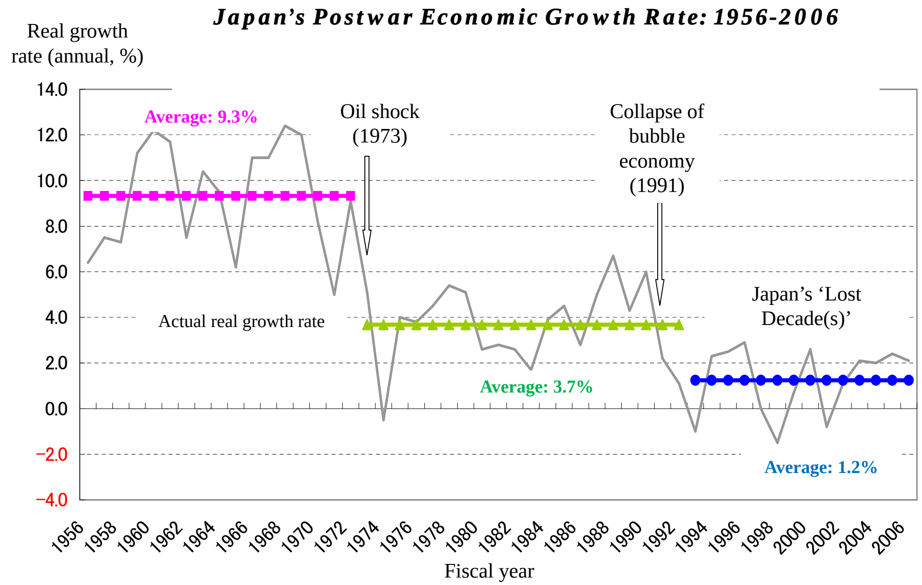
Lesson 1. What triggered Japan's financial liberalization

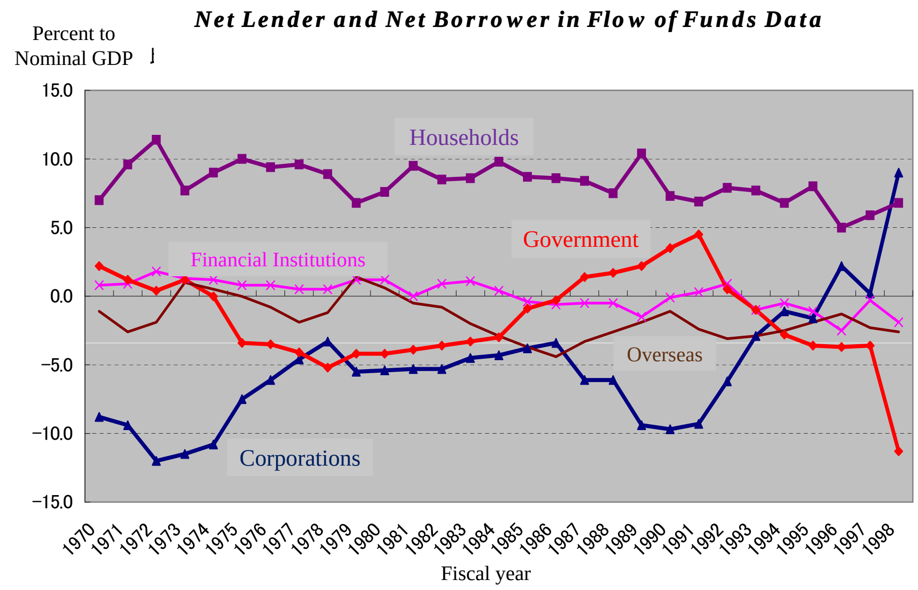
- Macroeconomic developments
  - Slowdown of economic growth rate
  - Reduction in corporate investment & financing needs
  - Government's fiscal expansion to offset the output decline mainly by expenditures related to public work and social security system

➔Needs to accommodate find a way to transfer household savings to the government

➔Liberalization of the government bond market began.

➔Then, liberalization of corporate bond market and interest rate decontrol followed.





Lesson 1. What triggered Japan's financial liberalization (2)

- Actual timing of financial liberalization
  - Slowdown in economic growth and changing corporate needs are fundamental
  - Significant shocks in 1973 like 'Oil shock' and the collapse of fixed exchange rate regime in global monetary system were crucial to determine the timing of financial liberalization
  - Government's own motivation played crucial role

➔ The actual timing does not necessarily match with optimal timing in microeconomic aspects for large corporations, financial institutions, and households.

Lesson 2: Interaction between currency internationalization & financial liberalization

- Enactment of the 1980 reform of the *Foreign Exchange and Trade Control Act* opened the door for foreign financing and investment opportunities.
  - With the revision, foreign exchanges transactions became "free unless prohibited."
- In 1984, abolition of the "real demand principle", which required that FX dealings be based on an actual need for payment for imports
- In 1986, Tokyo offshore market was opened.

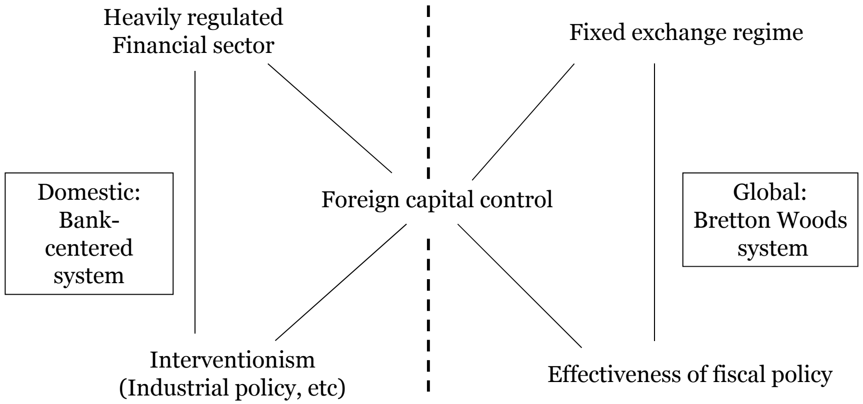
Lesson 2: Interaction between Currency internationalization & financial liberalization (2)

- As a result of abolition of capital control, Japanese corporations satisfying the relevant criteria shift to overseas financing, mostly bond markets, to avoid many regulations in domestic bond markets.
- Share of foreign bond issuance for Japanese corporations exceeded 50% in 1983. Dominance of foreign bonds against domestic bonds lasted until the early 1990s.

➔Domestic bond market had to be deregulated in order to survive

➔Internationalization necessitated deregulation of domestic market

Domestic and Global financial system in high growth era of Japan: 1950-1973



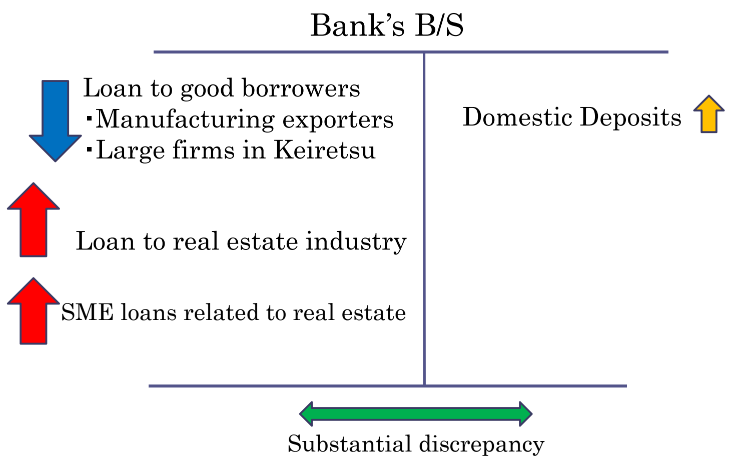
Lesson 3: Banking sector problem under the distorted financial liberalization

- Distortion in the process of financial deregulation in 1980s
  - Financial liberalization deregulated financing options of (large) corporations in the beginning of 1980s.
  - Deposit rates were decontrolled gradually during 1980s and 1990s from rates on large deposits and completely unrestricted by 1993
  - Banks' strategy diversifying their activities were hampered by the remaining regulatory framework.

➔Substantial disequilibrium between banks' asset side and liability side

➔Banks expanded real estate lending and SME loans.

Disequilibrium between both sides of balance sheet in domestic banks in 1980s



Lesson 3: Banking sector problem under the distorted financial liberalization (2)

- Banks increased exposure to real estate by the search for new borrowers in the wake of the exodus of traditional customers to the bond market.
- When stock and land prices dropped in the early 1990s, the exposure came close to huge amount of bad loans.
- Through the early 1990s, the options for savers were very restricted.

➔Japanese banks were the largest and least profitable in the world by the mid-1990s

- The same pattern of distorted liberalization precending a major financial crisis has been very common about many economies in the 1980s and 1990s.

Lesson 4: Achievements of the Japan's financial liberalization

- Japan's 'Big Bang' from 1996 to 2001 was the process to complete financial liberalization in Japan.
  - 1998 reform of the Foreign Exchange Control Act was revised.
  - Financial Supervisory Agency were newly created and Prompt Corrective Action (PCA) introduced.

Lesson 4: Achievements of the Japan's financial liberalization (2)

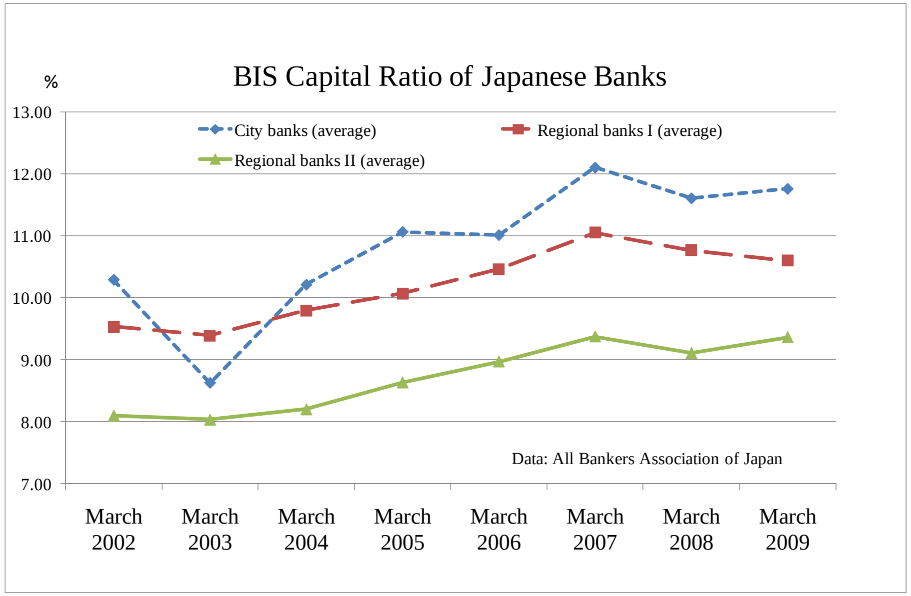
- What did Japan achieve from the financial liberalization over 30 years?
  - Yen became a fully convertible currency and is still the only currency in Asia that meets the full convertibility.
  - Japan has a single financial supervisory authority to cover entire financial markets and institutions.

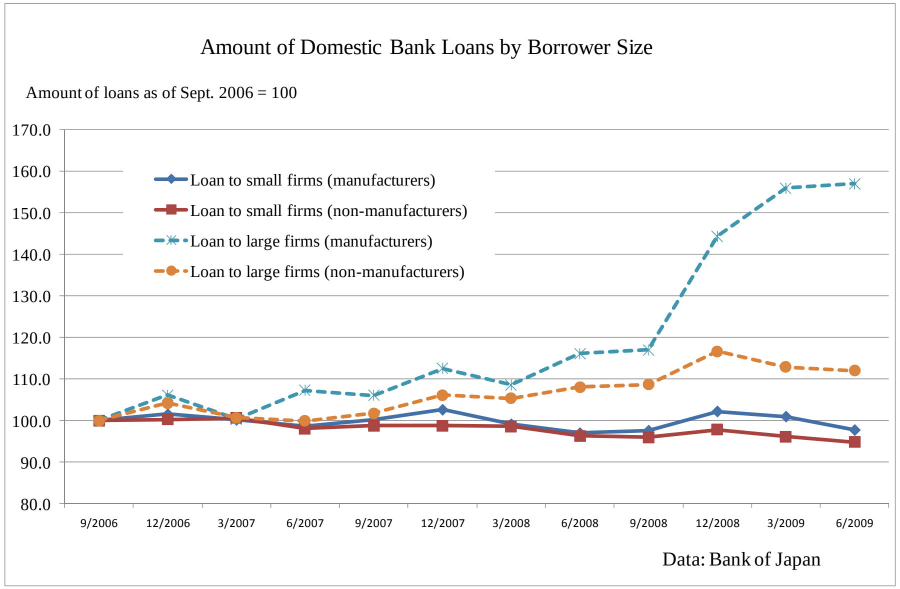
Impacts of Subprime Loan Crisis on Japanese financial sector

- Japanese economy under the recent Subprime Loan Crisis is viewed as an example to learn how the country with fully convertible currency, liberalized financial market, and high dependency to exports to crisis-hit advanced economies responded the world wide crisis.
- Japanese banking sector, different from US and European banks, did not suffer from direct holding of securities related to subprime loan in the US.
- As a result, Japan's banking sector had no substantial reduction of capital ratio.

Impacts of Subprime Loan Crisis on Japanese financial sector (2)

- Steep decrease of export demand and rapid appreciation of yen especially after the Lehman failure in Sept. 2008 made substantial losses on Japanese major exporting companies.
- Large companies that were also hit by collapse of CP and bond issuance markets jumped into bank loan markets after Sept. 2008.
- Banks responded the steep increase of loan demand by large corporations while keeping loans to small enterprise constant. No credit crunch were observed during the recent financial crisis.





Impacts of Subprime Loan Crisis on Japanese financial sector (3)

- Japanese banking sector did not play a role to amplify the real negative shock from the global crisis.
- Maintaining soundness of domestic banking sector is very important for the country open to the global economy. Therefore, a role of financial supervisory authority is one of most crucial factors.
- This can be achieved even if the country with fully convertible currency and liberalized financial markets.