Section 2　Monetary and Financial Policy

1　Start of Financial Liberalization and Increased Flexibility

A Request to Japan from the United States. The new Banking Law was promulgated on June 1, 1981, and enforced on April 1, 1982. In line with this new law, the annual “Measures for the Liberalization and Increased Flexibility of Financial Regulations” started from FY1981 (the first year) to FY 1985 (the sixth year). The Financial System Research Council also proceeded with a basic review of the liberalization and globalization of financial administration. This was further promoted by an external force: a request of Japan from the United States, which gained attention from autumn 1983.

The request was made suddenly, before President Reagan’s official visit to Japan, in November 1983. In response, Prime Minister Yasuhiro Nakasone requested the secretariat to make a specific schedule for financial liberalization. During President Reagan’s visit, both countries agreed to establish the Joint Japan-U.S. Ad Hoc Group on the Yen-Dollar Exchange Rate, and Financial and Capital Market Issues (the so-called “Japan-U.S. Yen-Dollar Committee”). The group then published its “Report by the Working Group of Joint Japan-U.S. Ad Hoc Group on Yen/Dollar Exchange Rate, Financial and Capital Market Issues” (known as the “Yen-Dollar meeting report”). At the same time, the Ministry of Finance of Japan published a document entitled, “The Current Status and Future Prospects for the Liberalization of Financial and Capital Markets, and the Internationalization of the Yen” (known as “Current Status and Future Prospects”). Follow-up meetings were also conducted continuously. This activity can be said to have had an effect of accelerating the timetable of liberalization, or the timing of its implementation.

In the Working Group of Japan-U.S. Yen-Dollar Committee, the background to the United States’ stance was as follows. It saw Japan’s financial and capital market as exclusive, and the internationalization of the yen as still insufficient, so that there was still low demand on the yen and the yen’s rate was at an unfair level, which had eventually led to the imbalance of current accounts between Japan and the United States. The MOF of Japan disagreed with this logic and insisted that the dollar appreciation and yen depreciation were related to the United States’ high interest rate and considerable amount of fiscal deficit. From the viewpoint of economics, the MOF of Japan’s objection seems to have been fair. The exchange rate is determined upon the demand and supply of the currencies of various countries (currency-denominated assets). It is hard to determine how the demand and supply of currencies or the exchange rate would be affected by a country's financial and capital market conditions, or how closed or open it is. For instance, if the yen were to be further internationalized, the demand for the yen may increase in the international market, but it could also lead to an increase in its supply in the market, therefore, there would be no conclusive result on this. In addition, liberalization should be progressed separately from such discussion.

Discussions on trade friction and a wide range of demands on Japan reached a peak in the "Japan-U.S. Structural Impediments Initiative Talks" in 1989 to 1990. In these talks, discussions were held on how the Japanese market was closed as a whole, and how Japan's investment/savings balance (over-saving: small fiscal deficits and the over-saving of private sectors, which means a shortage of investment) was one of the causes of the current account surplus towards the United States. However, this logic was still insufficient from the viewpoint of economics. First, the balance of payments is multi-faced, so it is meaningless to talk about only two countries. There is no specific reason why the current account would be affected by how open or closed a market is. For instance, even if Japan's imports were forced to increase for some reason, the exchange rate would be changed by yen depreciation, and set off the effect of current account deficit (reduction of surplus) as if it was intentional. Moreover, the investment/saving balance and the current account are simply in a de facto balance relationship, and it is not a one-way relationship. As the balance can only be made in the two countries, it is hard to say that the domestic situation of one country is the cause of a trade imbalance. Therefore, the current account balance (result) could not be changed only by controlling the domestic factor (cause) of Japan.

However, the request from the United States certainly had a great influence.

The "Yen-Dollar Meeting Report" and "Current Status and Future Prospects". As mentioned above, the "Yen-Dollar Meeting Report" and the MOF's document "Current Status and Future Prospects" were published on May 30, 1984. "Current Status and Future Prospects" stated the comprehensive concept and policies, and the "Yen-Dollar Meeting Report" described specific measures and case studies, mainly referring to interests of both countries.

"Current Status and Future Prospects" stated as follows:

- Financial liberalization is inevitable because it is the basis for stable economic growth. And it is basically desirable to achieve efficiency. Liberalization is steadily progressing and will continue in the future.
- The internationalization of the yen is interrelated with the liberalization of

financial and capital markets, and these policies should be progressed in balance.

- Expansion of the deposit insurance system, and the promotion of merger/partnership and disclosure - these liberalization-related measures should be taken.

The "Yen-Dollar Meeting Report" stated as follows:

- As for the yen-dollar exchange rate, Japan insisted that the major cause of dollar appreciation was the high interest rate of the United States, and that the fiscal deficit is related to this. The United States did not agree with this.
- Japan's financial liberalization has steadily progressed. It will further progress voluntarily, vitally and progressively.
- Specific items will be studied, including Japan's interest rate liberalization, capital trading liberalization, liberalization to allow access to foreign institutions to Japanese money and capital markets, and the promotion of direct investment.

Measures that were subsequently taken related to this are described in Chapter 3.2.

Trends in Macro Monetary Policy. As stated above, Japan's official discount rate decreased to 3.5% in March 1978, as the finance was eased in order to cope with the recession after the first Oil Crisis and the yen appreciation in 1977-1978. However, when the second Oil Crisis occurred at the end of the year, the BOJ raised the official discount rate to 4.25% in April 1979, which was followed by a series of interest rate raises and monetary tightening policy measures.

As shown in Table 2-2-1, the monetary tightening policy continued even into 1980, and the official discount rate was eventually raised to 9% in March 1983, for the first time since 1973. As a result of these agile tightening measures, by May 1980, the economy showed signs of inflation, so that the official discount rate was decreased to 8.25%, and it was gradually reduced after that.

The BOJ, in the meantime, remained cautious about monetary easing. One of the reasons was that the interest rate had surged due to strong monetary tightening measures in the United States for restraining inflation, since around 1980. The difference between the interest levels in Japan and the United States widened and funds flowed into the United States (yen selling/dollar buying), which led to a trend of dollar appreciation/yen depreciation. Under these conditions, the reduction in interest rates had accelerated the yen depreciation, and there were concerns that this would lead to criticism of Japan's expansion of its current account surplus. However, the global recession affected Japan's domestic economy and demands for an easy money policy increased. Measures for increasing Japan's domestic demand were also requested, to prevent trade friction between the two countries from getting worse, but Japan was reluctant to launch a fiscal policy, as they were still in the middle of conducting fiscal reconstruction. Therefore, the government mainly applied monetary policy to stimulate demand. Then, a gradual reduction of interest rates and an easy money policy were executed. The official discount rate reached 5.0% in October 1983. In fact, it did complicate the economic variable (the practical target) that the government was supposed to be watching, and on which they were basing their monetary policy.

Table 2-2-1 Change in the Official Discount Rate (FY1979～1983)

Year/Month/Date	%
1980. 2.19	7.25
3.19	9.00
8.20	8.25
11. 6	7.25
1981. 3.18	6.25
12.11	5.50
1983.10.22	5.00

Source : Bank of Japan, *Nihon Ginko Hyakunenshi* [One-Hundred-Years History of the Bank of Japan] (1987)

2 Measures for Liberalization and the Increased Flexibility of Financial Regulations

The Basic Direction of Financial Administration. In the first half of this period, "On the Working of the Ordinary Banks and Reform of Banking System" studied by the Financial System Research Council, was fulfilled as an amendment of the Banking Law (a comprehensive revision of the 1927 Banking Law, so-called the "New Banking Law") (promulgated in 1981; enforced in 1982). Revisions of various pertinent regulations, such as the Mutual Bank Law and the Shinkin Bank Law, were also conducted. Commencement of handling of government bond public offerings (1983) and dealing of government securities (1984) by financial institutions were also big topics for discussion.

Liberalization and internationalization further progressed. With the start of service for NCDs (Negotiable Certificate of Deposits) in 1979, the liberalization of interest rates was begun. Many new financial commodities and services emerged. In terms of administration, the “Liberalization and Increased Flexibility of Financial Regulation Measures” started in FY 1981, upon amendment of the Banking Law. For internationalization, capital trading, liberalized by the new Foreign Exchange Control Law (promulgated in 1979; enforced in 1980), was booming.

The authorities intended to implement liberalization and the increased flexibility of financial regulations in a progressive and gradual manner. It was thought to be difficult to maintain conventional domestic regulations due to internationalization, and also hard to avoid the liberalization of interest rates in Japan, due to the expansion of the government bond market. In addition, mergers or partnerships of companies should also be progressed, because new products and services across the industries also emerged thanks to the deregulation. However, it should not be drastically progressed, in order to avoid confusion. It was thought that the government should aim at soft-landing for the changes.

The Banking Bureau once tried to take the lead in progressing liberalization against the strong resistance of parties who enjoyed vested rights, but it took a lot of time to make the changes. Liberalization of interest rates was finally completed in 1995. Business field regulations remained unchanged in this period. The administrative guidance included deregulation to restrain the conventional quantitative expansion but strengthen the regulations on the authorization of new commodities and services. Liberalization and the increased flexibility of financial regulation measures had the same effect, as new detailed regulations were added annually. Therefore, the relationship between administrative guidance and the reaction of private sectors remained unchanged and as it was.

Enactment and Enforcement of the New Banking Law. The Financial System Research Council’s report on “How Ordinary Banks Should Be and Reform of the Banking System” report was issued in June 1979, but it required complicated adjustment. Then, the New Banking Law draft was finally submitted to the Diet after 2 years in April 1981, enacted in May, promulgated in June and enforced in April 1982.

The biggest issue was the one related to the city banks: it was argued that 1) the categories of securities-related services for banks should be widened; 2) the strengthening of the banking regulations and orders should be opposed; 3) the legislation of the regulations on large loans should be opposed; and 4) the legislation of disclosure should be opposed. For the authorities, 2) was an unexpected misunderstanding. They intended to eliminate arbitrariness and improve the transparency of the system by legislating, but could not make the private sectors understand this. In the end, facilitation of talks between the authorities and city banks relied upon the Liberal Democratic Party and the Ministry of Finance, and agreement was finally reached in April 1981.

Hence, the Banking Law was finally amended for the first time in 50 years.

Various Amendments Related to the New Banking Law. With the amendment of the 1927 Banking Law, a tremendous number of amendments were made to the pertinent laws. The Banking Law provided the basic legal character of the financial regulations, which had a ripple effect on 26 other related laws which needed to be amended (corresponding revisions).

Regarding securities-related services that had been postponed, handling of long-term interest-bearing government bonds, government-guaranteed bonds and local government bonds by financial institutions (offering newly issued bonds) started on April 1, 1983. In addition, handling of medium-term bonds, purchasing the bonds upon request and handling of discount government bonds by financial institutions were permitted from October 1983. Dealing in government securities by financial institutions (buying and selling of issued bonds) started in June 1984.

New Entries, Exits and Mergers of Financial Institutions. In this period, the number of financial institutions was stable, as shown in Table 2-2-2. There were 12 city banks, 1 foreign exchange bank, 3 long-term credit banks and 7 trust banks, which remained unchanged. The number of regional banks increased by 1, to 64 in total, in 1984, while the number of mutual banks decreased by 2, to 69, because of the conversion of the Nishi-nippon Sogo Bank into an ordinary bank and the merger with the Takachiho Sogo Bank. The number of Shinkin banks decreased every year and reached 456. After that, the number remained unchanged. The number of credit cooperatives decreased every year, and reached 461 in 1984.

Table 2-2-2 Number of Financial Institutions

Year End	1980	1981	1982	1983	1984
City bank	12	12	12	12	12
Foreign exchange bank	1	1	1	1	1
Long-term credit bank	3	3	3	3	3
Trust bank	7	7	7	7	7
Regional bank	63	63	63	63	64
Mutual bank (Sōgo Bank)	71	71	71	71	69
Cooperative bank (Shinkin Bank)	461	456	456	456	456
Credit cooperative	476	473	468	468	461

Source : Research and Statistics Department, Bank of Japan, *Keizai Tōkei Nenpō* [Economic Statistics Annual] 1985.

The following are the major cases of financial trouble of financial institutions and the countermeasures taken. In March 1982, Tokyo Shinkin Bank's financial trouble emerged but the bank recovered with a deficit in settlement of accounts and no dividend upon making arrangements to avert a financial crisis. In September 1982, the Daiichi Kangyo Bank's Singapore Branch faced the loss of its foreign exchange dealing, as a risk related to overseas activities. In 1983, Jitsugyō Shinyō Kumiai (Osaka)'s large bad loans were revealed. The Kinki Finance Bureau of the MOF and parties concerned consulted on this issue and preserved the bank, with rescue funds of ¥20 billion from National Federation of Credit Cooperatives, ¥3 billion from the Osaka Federation of Credit Cooperatives, ¥3 billion from Osaka Prefecture and ¥2.5 billion from Daiwa Bank. Then, the bank was merged with Houtoku Shinyō Kumiai in December 1984 (it became Osaka Shinyō Kumiai in 1985).

Regulations on Branching. In this period, a 2-fiscal year unofficial notification was conducted.

In FY1981 and 1982, the voluntary discretion of financial institutions was emphasized based on the New Banking Law, which: 1) restrained the number of general branches; 2) emphasized small automated branches; 3) promoted the consolidation and integration of branch patterns; 4) introduced the branch transfer system; and 5) encouraged care to be taken for regions with no (or few) financial institutions. 4) meant that, under the system, a bank should divide 1 ordinary branch into 3 small branches, or divide 1 small branch into 3 automated branches, which would widen the voluntary discretion of financial institutions. The regulations regarding locations (distance from existing branches) were eased as well. Relocation was also allowed for four branches in 2 fiscal years.

In FY1983 and 1984, the policy of leaving decisions to the voluntary discretion of each financial institution was continued. Expansion of small automated branches, increased flexibility of CD (cash dispenser) installation out of branches (ATMs were also authorized), and flexibility of relocation (in the same economic bloc; this meant the abolition of regulations on relocation within the jurisdiction of the Local Finance Bureau).

Measures for the Liberalization and Increased Flexibility of Financial Regulations.
Regulations regarding managerial indicators were organized, under the range of notifications related to the amendment of the Banking Law, into the following 4 operational indicators:

1) Loan-deposit ratio: aiming for an average balance for the period of no more than 80%
2) Capital Requirement: aiming for a deposit balance for the period of 10% or more
3) Liquid assets ratio: aiming for 30% or more of total assets
4) Commercial real estate ratio: aiming for no more than 40% and up to 50% in the capital account

Upon the amendment of the Banking Law, the Banking Bureau announced its “Measures for Liberalization and Increased Flexibility of Financial Regulations” in June 1981 and implemented in 6 sets of measures. They mainly included the following: in the first set of measures (FY1981), the deregulation of the dividends of financial institutions, cancellation of guidance and requests by authorities on the self–regulation of advertisements, and the launch of a study on the abolition of the “3 Bureau Agreement” (restrictions on the securities services of Japanese banks in foreign countries). In the second set of measures (FY1982), the expansion of the services of associate companies and the increased flexibility of regulations for large loans. In the third set of measures (FY1983) included the deregulation of using funds from foreign bonds which were issued by overseas affiliates, the diversification and liberalization of housing loans, and the expansion of the NCD issuance limit. The fourth set of measures (FY1984) included the liberalization for the entry of foreign financial institutions to the Japanese market, the expansion of credit card related services, authorization to establish associated companies for the money-lending business, the deregulation of NCD issuance and the start of a swing service (automatic fund transfer between time deposits and ordinary deposits).

In addition to this, the evaluation method for bonds was changed, as a revision of the accounting standards of financial institutions.

For the evaluation of listed securities, the lower market method, under the uniform accounting standards of 1967, was adopted (evaluating the lower value of the acquisition value and the actual cash value). However, due to the price collapse of the so-called 6.1% government bonds, a tremendous amount of appraisal loss occurred. Therefore, the authorities changed the system to the selective option of the lower market method or the cost method. from March 1980. The important thing here is how one thinks about this issue. In this issue, there were two opposite opinions: that it was unsound for financial institutions to hold latent loss and they should disclose the actual conditions as an actual cash value (the opinion supporting the lower market method), and that it was inappropriate for corporate performance or management due to a short term fluctuation of market price (supporting the selectivity method). The authorities then decided to apply the selectivity method, based on the latter opinion, and for the reasons that it would be inappropriate to encourage repetitive selling for benefits only to compensate losses, or to distort the system as unlisted bonds gain popularity because they do not count the appraisal loss. As a result, financial institutions decided whether to select either the cost method or the lower market method.

The Money Lending Control Law. Since the early 1970s, the number of money lending business institutions rapidly increased and the number of such applications reached 200,000 cases by the end of FY1981. Most of them were consumer finance companies, called *Sala-Kin* (Salary Man Kinyū: money lending for businessmen). This became a social issue in the late 1970s, as some of these companies conducted illegal acts, such as excessive money lending, demanding high interest rates, or using violence in the collection of money. The Small Banks Division of the Banking Bureau dealt with these issues, and in April 1983, two so-called money lending control laws, the “Money Lending Business Control Law” and the “Law Concerning the Partial Amendment of the Law Concerning the Regulations for Receiving of Capital Subscription, Deposits and interest on Deposits” (the so-called Laws of Subscription) were enacted (promulgated in May and enforced in November). The points of these laws were as follows: 1) a change from the easy conventional post application system to an advance registration system, with penalties on unregistered businesses; 2) the reduction of penalty interest to an annual rate of 40.004% (the cap interest rate under the conventional Law of Subscription was 109.5%); 3) the prohibition of excessive advertising and excessive lending: compulsory indication of lending conditions, such as interest rates, and compulsory issuance of contract documents, and regulations on collection of money (no violent verbal or physical actions should intimidate people's privacy or business); and 4) regulations on supervision and administrative disposition.

Discussions of the Financial System Research Council. The Financial System Research Council resumed in May 1982, and established the "Subcommittee on the Desirable Form of Financial Liberalization in the Future", to study financial liberalization. Its primary interim report, "Current Status and a Desirable Picture of the Financial Liberalization in the Future" in April 1983, stated that there were various opinions from the experts, and summarized the discussion of the subcommittee as follows.

- ○ Financial liberalization is inevitable and desirable in principle, but it needs to be dealt with progressively. Its scheduling is difficult so that each specific issue should be resolved separately.
- ○ Liberalization of interest rates on deposits should start from large loans for institutional investors and corporations, which should be followed by small loans on a flexible and progressive manner.
- ○ The regulations of the financial business need to be made more flexible, while taking into account of soundness of financial institutions, which should be regarded in terms of specifics.
- ○ Maintaining the financial system is the main premise, therefore the inspection and a deposit insurance system need to be reinforced.
- ○ Quantitative control is being phased out, and monetary policy should be diversified and flexible and utilize interest rate functions.

3 Increased Flexibility of the Securities Market and Administration

Trends of the 4 Major Companies and Acquisition. The following is a review of the trends of industrial structure, as a premise of administration for the securities business.

In terms of stocks trading, the share of the four major securities companies (Nomura, Daiwa, Nikko, and Yamaichi) remained at the 40% level. There was a trend for the increase in shares of the semi-major securities companies. For public and corporate bonds, the share of the four major companies was even higher at around the 60 to 70% level. However, there was an oligopoly by the major and semi-major companies during the bubble economy, as the semi major companies expanded their share. As for underwriting, while the four major companies had 80% initially, semi-major companies expanded their share (gradually increased) as well. The share of the four major companies was high in underwriting, public and corporate bonds, and stock trading, in that order. But the semi-major companies also increased their share in each of those categories. This was because of increase in quality of the semi-major companies, due to the mergers of companies.

Administrative Guidance. As for regulations on branching, policies which prioritized areas with no branch and carefully considered competitiveness between the major (and semi-major) securities companies, and local small and medium securities companies for areas with existing branches, were emphasized.

As for sales attitude, the notification “On Issues to be Considered for the Current Management of Securities Companies” was issued in June 1980. The points were as follows: 1) a reassessment of public and corporate bond exchange (e.g. there were companies incapable of adjusting to the rapid expansion of the bond market); 2) the establishment of a sound corporate management system (e.g. an increase of net worth; efforts to restrain the debt ratio and to restrain excessive services related to credit transactions in trading stocks); and 3) the reinforcement of in-house management systems to self-impose the restrictions made by laws, the administration and securities trade groups.

Inspections of Securities Companies. The operating procedure for the inspection of securities companies was amended in 1980, to include not only pointing out incorrectness (point-out inspection) but also to take the viewpoint of guidance, as part of the supervisory administration, by fully assessing sales attitudes, corporate management and finance, and actively and effectively conducting inspections by the minimizing necessary documents and providing a copy of the inspection report to the companies which were inspected when administrative division guides them.

In this period, there was a trend of a widening difference in profitability between companies, so that some local securities companies were in corporate management crises. Some could not adapt to the expansion of the market, led by companies in Tokyo, and some faced conflicts within the company, under a family-business type corporate management. In the case of Takagitei Securities (June 1980), which was the first case of the revocation of license after the introduction of the license system (the Securities and Exchange Law Article 35), it had a large capital deficit due to reckless management.

4 The Mature Insurance Market

The 1979 and 1981 Insurance Council Reports. The survey conducted by the Japan Institute of Life Insurance in July 1982 showed that the ratio of households who had life insurance contracts was more than 90%. As it showed, the life insurance market in Japan had entered into a mature phase.

Under these circumstances, the Insurance Council submitted its 1979 report "On the Desirable Form of the Insurance Business in a Structurally Changing Economy and Society". This report mainly made proposals regarding life insurance, including three major proposals, such as the promotion of efficiency, bringing out the public and social nature of insurance, and the improvement of asset management. Of these, the promotion of efficiency, it was suggested, needed to alter the postwar insurance business and insurance administration. The 1979 report was based on the recognition of the following: the government had needed a system of protection and uniform regulation in order to reconstruct and foster the insurance business, which was weakened after the war, but the insurance business was now fully developed. The insurance business had to cope with its new environment of a mature society. Therefore, it needed to seek a way to achieve self-responsibility and competitiveness, moving away from the policies of protection and uniform regulation.

Next, the Council summarized a 1981 Report ("On the Desirable Form of the Non-Life Insurance Business in the Future") for non-life insurance. This report focused on the issues relating to the nature of non-life insurance, which are quite unique as they need cooperation, "an extreme and uniform approach to business operations", as well as the promotion of efficiency (in terms of premium rates, products and sales), bringing out the public and social nature of insurance, and the improvement of asset management.

The insurance administration of this period proceeded based on the proposals in these reports.

The Efficiency of Management. First, in terms of life insurance sales, it was necessary to improve the agency system. Although the "Three Year Improvement Plan" had been implemented since FY1976, the MOF further issued a notification to guide the implementation of a three year plan, for the establishment and improvement of the second offer system from FY1979, and a third three year plan from FY1982. For the non-life insurance agency system, it was pointed out that the knowledge and business capability of agencies were not sufficient to cope with the popularization of non-life insurance and the incentive system for agencies that specialized in mass insurance. Then, according to the notification "On a Basic Outline of a Non-insurance Offering System" in June 1980, a new non-marine agency system was established, including rules for raising the rank of agencies specializing in mass insurance.

Secondly, it suggested the development and improvement of new products in order to meet consumer needs to improve and diversify the product descriptions.

Thirdly, it suggested using the rating system of the Insurance Rating Association for non-life insurance, to use the mechanism of flexibility of the rating (e.g. range premium rate, standard premium rate system, etc). This required a strict rating review and there were also reduction of some ratings based on this review.

Bringing out the Public and Social Nature of Insurance. Insurance is based on the laws of large numbers and is required to maintain reliability and soundness, because as a business it has a wide range of customers and a deep relationship with national welfare, and providing assets for the future. In this regard, the authorities classify the insurance business as having a public and social nature.

From this viewpoint, firstly, the need to improve the policies of disclosure and the provision of information were pointed out in particular. Specifically, it was seen as necessary to grasp important information through questionnaires and the collection of complaints.

Secondly, so-called "moral risk" (fraudulent or excessive acquisition of insurance amount) measures were requested by the authorities in order to secure reliability of people. The authorities proposed to providing a system to execute an appropriate survey of the actual conditions, while paying full attention to personal privacy and use opportunities to exchange information.

Efficiency and the Increased Flexibility of Asset Management. The authorities proposed to expand the categories of asset management and make them more flexible, while restraining loans for "*Sala-Kin*". In addition, a voluntary agreement within the industry was reached to deal carefully with foreign securities investments carrying a high exchange risk.