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Intereconomics

Suggested Citation: Burton, F. N.; Saelens, F. H. (1983) : Trends in the growth of Japanese international banking in Western Europe, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 18, Iss. 4, pp. 172-176,
<https://doi.org/10.1007/BF02928212>

This Version is available at:

<https://hdl.handle.net/10419/139870>

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Trends in the Growth of Japanese International Banking in Western Europe

by F. N. Burton, F. H. Saelens, Manchester*

Changes in Japan's domestic economy and the emergence of stronger trade and investment links between Japan and the world economy have created substantial pressures for her banks and other financial institutions to expand overseas. The following article examines trends in Japanese international banking since the beginning of the 1970s and, in particular, the growing presence of Japanese banks in Western Europe.

From the mid-1950s until the 1974 oil crisis the Japanese economy expanded at an average rate of close to ten percent per annum in real terms. Since 1975, following some turbulent adjustments, the economy has experienced a relatively moderate growth pattern of about 5 percent. The process of adaption from high to medium growth has profoundly affected Japan's economic structure, not least in the financial sector where an increasingly competitive environment has been enhanced by changes in the composition of the demand for funds. These trends and the emergence of stronger trade and investment links between Japan and the world economy have created substantial pressures for her banks and other financial institutions to expand overseas.

The two dominant and traditional features of Japan's financial sector have been the specialised nature of the institutions and the high degree of governmental control and protection. In sharp contrast to the comprehensive range of financial services provided by commercial banks in Western Europe, Japanese banks can be subdivided according to function into city banks (with nation-wide branch networks), regional banks, trust banks, long-term credit banks and the foreign exchange specialist, the Bank of Tokyo. In addition, there are several government banks including the postal savings system, and a host of other financial institutions such as securities houses and insurance companies. All Japanese banks, at least until recently, have operated in well-defined business spheres among which cross-entries have been prohibited. Moreover, within each group, competition has been subjected to several constraints including a complete ban on new entries, an unwillingness to permit interest rate competition or

advertising of bank services, and strict supervision of banking hours and office location. Effectively, therefore, competition within functional groups has been limited to rivalry in deposit-taking.¹

By 1970 there was a clear realisation that the structure and conduct of the financial sector undermined its efficiency. To facilitate change within this conservative framework the *Committee on Financial System Research* was set up to examine and report on these relationships. Its recommendations, made in May 1981, led to the first amendments to banking law in over fifty years. The essence of the revisions was to retain the basic specialist nature of the institutions but to allow them more freedom to respond to market opportunities by reducing entry barriers.² The most profound revision made provision for banks to handle government bonds, a market of growing importance previously reserved for the securities houses. Other issues of contention between city banks and securities houses (the main protagonists in the financial sector) which the new legislation has also begun to break down have concerned the exclusive handling of gold transactions by the former and the sale of foreign commercial paper by the latter.³

The opening of markets to previously non-competing groups is intended to improve the competitive structure of the financial sector, a development which is only assured if the price mechanism is sufficiently free to allow the supply of funds to respond to changes in the

¹ S. Nishikawa: *The Banking System: Competition and Control*, in: *Japanese Economic Studies*, 1974, Vol. II, No. 3, p. 18.

² Federation of Bankers' Association of Japan: *Banking System in Japan*, 1982, p. 20.

³ "Rivalry Between Banks and Securities Firms", in: *The Oriental Economist*, Oct. 1981, p. 10.

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composition of demand. Here, too, progress has been made, *inter alia*, with the deregulation of interest rates in the call money and commercial bill markets, and the introduction of certificates of deposit with unrestricted rates. Similarly, control of the money supply has begun to rely more on market determined interest rates than on government fiat and quantitative supervision of bank lending.

Market mechanisms have also been improved between domestic and international markets. Up to 1977, Japan closely regulated her trade and capital transactions with the rest of the world. Since then regulations have been gradually relaxed, culminating in a revised Foreign Exchange and Trade Control Law in December 1980 which provides freedom for all external transactions except in emergencies.⁴ This greater latitude now allows banks to lend yen and foreign currencies at home and abroad and corporations to borrow directly in overseas capital markets. One rather important consequence of this development is that foreign banks in Japan do not currently have the freedom which Japanese banks enjoy abroad.⁵

In addition to these competitive adjustments, as a consequence of large and persistent government deficits since 1975, the banking sector has been faced with a dramatically adverse shift (as shown in Table 1) in the demand for funds from the private to the public sector. These government deficits, incurred to sustain economic growth rates and permit greatly enhanced public spending on social welfare programmes, were financed by huge bond issues which reached the yen equivalent of US \$ 60 billion in 1979. Meanwhile, corporate requirements for industrial funds supplied through financial markets declined from a peak of twenty-two trillion yen in 1973 to around sixteen trillion yen in 1979.⁶

Together, these changes in the economic environment have severely squeezed the profits of the banking sector, especially those of the city banks. Thus, while the operating income of the five largest city banks increased by 22 % in the period 1975-80, assets rose by 73 % indicating a substantial decline in returns.⁷ Overall, profit margins for the banking sector have

Table 1
Supply Ratios of Primary Domestic Securities,
1963-1979
(in %)

	1963-70	1971-74	1975-79
Corporate:			
Borrowing	56.5	50.4	27.9
Bonds	2.4	2.1	1.9
Stocks	5.1	3.6	2.6
	64.0	56.1	32.4
Public:			
Borrowing	5.6	9.2	13.9
Bonds	12.3	13.7	33.1
	17.9	22.9	47.0
Personal:			
Borrowing	18.0	21.0	20.7

Source: Adapted from H. Okumura: A New Financial System Takes Shape, in: Economic Eye, June 1981, Vol. 2, No. 2.

steadily declined since 1972, a trend which turned negative in 1980.⁸ The emphatic shift in the demand for funds from the corporate to the public and personal sector has contributed particularly to the pressures on the city banks with their traditional focus on the financial requirements of large corporations.⁹

The Internationalisation of Japanese Banks

In the early 1970s, uncertainty about domestic market growth and the ability to maintain market share persuaded the banking sector in general to promote policies of domestic diversification and the city banks to strengthen also their international operations. Domestic diversification and greater commitment to the consumer market (including the retailing of government bonds) induced an increase from 2 percent in 1970 to 12 percent in 1981 in the share of funds lent to individuals by private sector banks.¹⁰ Nevertheless, the domestic market for personal finance does not appear to be particularly attractive in the long run, given the dominance in this market of post office banking facilities and the existence of considerable consumer apathy towards former "zaibatsu" banks (i. e. traditional pre-war banks linked to large industrial groups).¹¹ Further, although the new banking legislation provides for a larger role for banks in the sale and brokerage of government bonds, their ability to compete in these and

⁴ "Controls Relaxed Under New Legislation", in: Financial Times, Dec. 3, 1980, p. iv.

⁵ James Horne: The Internationalisation of Japanese Finance: A Preliminary Assessment, Australia-Japan Research Centre, Research Paper No. 59, The Australian National University, Canberra, Mar. 1980, p. 28.

⁶ Statistical Handbook of Japan, 1981, Statistics Bureau, Prime Minister's Office, Tokyo, p. 100.

⁷ P. A. Jones: Banking Profit Squeeze, in: The Banker, Aug. 1981, p. 111.

⁸ Federation of Bankers' Association of Japan, op. cit., p. 80.

⁹ "Corporations' Declining Dependence on Banks", in: The Oriental Economist, Aug. 1981, p. 26.

¹⁰ Federation of Bankers' Association of Japan, op. cit., p. 16.

¹¹ Author's interview.

related activities requires them to match the expertise of the well-established securities houses and to overcome their own long-standing neglect of the consumer market.

The relative lack of domestic opportunities since the 1974 oil crisis has increasingly encouraged banks and other financial institutions to expand abroad – a process which began to take off in the late 1960s when the rapid growth of Japan's foreign trade induced the Ministry of Finance to allow the establishment abroad of an increasing number of branches. The close domestic cooperation between banks, trading companies and manufacturers naturally extended to foreign business. Thus, by 1971 there were around 120 foreign branches of Japanese banks (of which half were owned by the Bank of Tokyo) all, primarily, specialising in the finance of Japanese foreign trade.¹² In addition, the city banks enjoyed equity participation in twenty-one foreign financial institutions, sometimes in partnership with Japanese securities houses. The dominance of the Bank of Tokyo – favoured by the Ministry of Finance, at least in the early years of expansion, by virtue of its foreign exchange specialism – allowed it to enjoy economies of scale and to emerge later as a leading institution in the world of international finance.

The second phase in the banks' international expansion ran parallel to the surge in Japanese foreign direct investment from 1971-74. During this period the banks established overseas subsidiaries with the purpose of extending medium and long-term loans to Japanese enterprises operating in foreign countries.

In the third phase, starting in 1973, Japanese banks established merchant banking arms overseas either independently or jointly with foreign multinational banks. During this phase medium and long-term loans were extended to foreign multinational firms, governments and their agencies through participation in consortia and syndicated loan arrangements in the rapidly developing Euro-currency market. These merchant banks also provided the vehicle for Japanese banks to advance into underwriting of securities, a sector from which they were excluded in the domestic market. A fourth phase, commencing in 1974, saw Japanese city banks enter into retail banking abroad, a move which until now has been limited to California.

The momentous bankruptcy of the Herstatt Bank in 1974 led the Japanese Ministry of Finance to suspend the establishment of new banking branches overseas and to critically review the quickly growing international syndicated loan portfolios of Japanese banks. These syndicated arrangements – in themselves a tacit

recognition of the inexperience of international lending by their members – and the excessive imbalance between short-term Eurodollar borrowings to fund medium and long-term loans persuaded the Japanese authorities to impose severe limitations on Euromarket business and, indirectly, to restrict the participation of Japanese banks in international joint ventures.

Shrinking Market

The pre-1974 oil crisis momentum was not regained until mid-1977, when Japanese banks became free once more to lend when and to whom they wished provided a safe match was maintained between the maturity structure of lending and borrowing. This new found freedom and the lack of domestic lending opportunities propelled Japan's banks once again into the international sector, but this time into a shrinking market. By the summer of 1978 their aggression evoked strong criticism in international banking circles, including the accusation of loan dumping.¹³ Meanwhile, the overseas activities of Japanese securities firms had also been expanding rapidly, often into the same market segments as the banks. Hence, whereas these respective institutions were more or less barred from entering the other's traditional markets, they did so abroad with considerable vigour.

During 1978 and 1979 the share of Japanese banks in the non-yen syndicated loan market grew rapidly to twenty percent, causing the Japanese authorities in late 1979 to moderate this growth by the introduction of "guidelines". These effectively limited the Japanese market share to ten percent and served to enhance the quality of participation in the Eurocurrency market by, *inter alia*, requiring the bank to act as lead bank or to co-manage in syndicated loans rather than act as mere providers of funds. Thus, by 1982 Japanese banks had become prominent as lead managers of syndicated Euro-loans and Euro-bonds. Four Japanese banks were ranked among the top twenty lead managers of Euro-currency loans, and Nomura Securities, Japan's leading securities firm, ranked seventh in the bond market.¹⁴

The Japanese banking sector, by 1980, was equally well represented in terms of employees and number of subsidiaries and agencies in New York and London, with 25 units in each centre and around 3000

¹² T. F. M. Adams, I. Hoshii: A Financial History of Japan, Kodanshi International Ltd, 1972, p. 473.

¹³ "The Astonishing Influence of the Bank of Tokyo", in: Euromoney, Jan. 1979, p. 18.

¹⁴ "International Capital Markets", in: Financial Times, Oct. 26, 1981, pp. iv and vii.

employees.¹⁵ Currently, the assets held by overseas branches of the city banks amount to 16 percent of total assets, a ratio which they intend to increase to 30 percent.¹⁶ To achieve this they will be required to rely increasingly on financial services to corporate clients, including host country firms and the increasing number of small and medium sized Japanese firms with overseas operations. In addition they can be expected to expand into securities business overseas, in particular into the lead management of Euro-bond issues for Japanese companies. In turn, the major securities houses have begun to conduct banking activities in the Far East and Europe – a development which, by accelerating the breakdown of traditional and clearly defined lines of demarcation in the Japanese financial sector, is regarded with some trepidation by the traditional banking sector.¹⁷

Japanese Investments in European Financial Institutions

All thirteen city banks and three long-term credit banks have invested in a number of European financial institutions. The earliest investments, in the mid- and late 1960s, were often joint participation by several Japanese banks in international investment banks such as ADELA (Latin America) and SIFIDA (Africa), with each individual investor holding around one percent of the equity and the total Japanese stake usually being less than ten percent. A similar equity participation occurred in 1972 in the Euro-Clear Clearance System Ltd. of London.

A second class of equity participation is represented by the association of two Japanese banks with the Iran Overseas Investment Bank of London and the Central

European International Bank (established in 1979 to finance Hungarian trade with the West). The combined Japanese equity ratio in these two banks is 12.5 percent and 22 percent respectively. A third and larger group consists of a less than 20 percent participation of single Japanese investors in European institutions entered into in the period 1971-75 in association with several other international investors holding similar shares. These are mostly merchant banks dealing in international debt finance and securities. A fourth group consists of three important all-Japanese merchant banks. The first, the Banque Européenne de Tokyo was established in Paris in 1968 with the two largest shareholders, the Bank of Tokyo and the Industrial Bank of Japan, holding 28.5 percent of the equity and the remaining investors being Japanese. The other two merchant banks, established in London in 1970 and including Japanese securities houses as partners, were upgraded from licensed deposit-taker status to that of recognised banks a decade later.

Common to all these groups is the presence of the Japanese investor as but one of several partners, none of whom exercises full managerial control. The 1960s marked the beginning of consortia banking, founded to pursue lucrative international banking business on behalf of shareholders with little experience of such business and preferring, therefore, to provide finance under the umbrella of syndicated arrangements rather than from their own balance sheets. The timing of the Japanese entry into consortia banking in the 1970s identifies Japanese banks as late entries into large scale international banking. To date there are twenty-five European international banking institutions in which Japanese banks have a minor participation.

In 1981 there were three all-Japanese consortia and thirty-three in which one Japanese parent held at least 50 percent of the equity.¹⁸ Strongly encouraged by

¹⁵ The Banker, Feb. and Nov. 1981.

¹⁶ Author's interviews. See also Kenichi Ishigahi, Fujita Masahiro: The Development of International Business by Japanese Banks, Australia-Japan Research Centre, Research Paper No. 86, Australian National University, Canberra, Aug. 1981, p. 12.

¹⁷ "Japan – Banking, Finance and Investment", in: Financial Times, Oct. 26, 1981.

¹⁸ Toyo Keizai Shimposha: Japanese Multinationals – Facts and Figures, Tokyo, 1982.

WELTKONJUNKTUR DIENST

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ISSN 0342-6335

This quarterly report – compiled by the Department on Business Cycles and Statistics of the Hamburg Institute for International Economics – analyses and forecasts the economic development of the most important Western industrial nations and of the international raw materials markets.

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Japan's Ministry of Finance, the number of Japanese lead banks in the first fifty international syndicated loans rose from six in 1980 to eleven in 1981. As a group, Japanese banks now rank second in international banking behind US banks,¹⁹ and have increased their share of UK based international lending from 11.4 percent by the end of 1977 to 23.4 percent by September 1981. Their domination of the London market, gained mainly at the expense of US banks and by the diversification of oil-exporting country deposits, has given them more funds than the London branches of US banks and the London clearing banks.²⁰

Significantly, Japanese banking subsidiaries have also become a force in bond underwriting, surpassing Japanese securities houses in underwriting Euro-bonds by 1980 – an international diversification, supported by the Ministry of Finance, likely to encourage a further reduction in domestic barriers between banks and securities houses.²¹

In Europe the number of Japanese customers is very small relative to the number of Japanese banks,²² and long standing clients such as the large general traders who require mainly trade finance are no longer dependent on the services of Japanese banks. Thus, according to interview evidence the banks intend to extend their role beyond the local capital markets. A recurrent theme is the expansion of corporate financial services to host country firms. This does not imply that Japanese customers will be disregarded. Some banks, for example, actively assist small and medium-sized Japanese firms in moving abroad, sometimes placing finance specialists with the European subsidiaries of Japanese manufacturers.²³ A recent innovation has been the establishment of a joint venture between the Industrial Bank of Japan and the Istituto Mobiliare Italiano to advance investment finance to assist Japanese enterprises in setting up subsidiaries in Italy.

Conclusions

Up to the early 1970s the expansion of Japanese banks abroad was largely a response to Japan's rapidly growing international commerce and the derived demand for trade finance. During the period 1971-74, Japanese foreign direct investment suddenly increased and many banks followed their customers abroad. The slow-down in the Japanese economy following the 1974

oil crisis meant fewer domestic banking opportunities, a situation exacerbated by a distinct trend towards more competitive processes and structures in the domestic financial sector, and adverse developments for the banks in the composition of the domestic demand for funds. In response, the banks (and securities houses) attempted to diversify at home and, as government policy allowed, to expand foreign business aggressively. In particular, there was an extremely successful attempt to penetrate quickly the expanding but increasingly competitive Euro-currency markets. The declining profit potential of these markets and the cautionary controls imposed by the Japanese authorities have more recently caused a further diversification into corporate services. Due to market imperfections in the domestic financial sector, the international activities of Japanese banks are more diversified than their domestic operations, and there is considerably more competitive overlap between Japanese banks and securities houses abroad than at home.

The activities of Japan's financial sector worldwide are controlled and manipulated to achieve domestic objectives by the Ministry of Finance to a rare degree among modern industrialised nations. Competitive conduct is strongly encouraged, but only within strictly defined boundaries which are regularly adjusted as the authorities pursue their stated goals of a more efficient financial sector.

The aggressive expansion of Japanese banks into the highly competitive Euromarkets closely conforms to the behaviour of Japanese manufacturers abroad who have located production facilities in Western Europe despite no apparent advantage over local firms, typically in industries producing standardised products.²⁴ The success of Japanese banks in the Euromarkets is explained by a number of factors including the market imperfections created by the directional influence of the Ministry of Finance, the added motivation derived from deep market penetration of Western markets which has compensated for the lack of specific advantages,²⁵ the aggressive pricing behaviour which market share objectives require, and the uncontrolled free-for-all nature of Euro-currency lending.

¹⁹ "Japanese Banks Increasingly Play Major Role in Loan Syndication", in: *The Japan Economic Journal*, Feb. 16, 1982, p. 5.

²⁰ "Japan Eclipses US in London Markets", in: *Financial Times*, May 4, 1982, p. 21.

²¹ "Japanese Banks, Securities Firms Cut into Each Others' Fields", in: *The Japan Economic Journal*, Aug. 26, 1980, p. 3.

²² One Japanese bank manager in Belgium claimed that: "About ten Japanese banks are chasing fifteen Japanese manufacturers". Only two Japanese banks have significant business with Japanese manufacturing subsidiaries in Brussels.

²³ Author's interview.

²⁴ T. O z a w a: *Multinationalism, Japanese Style*, Princeton University Press, 1979, pp. 71 and 73.

²⁵ *Ibid.*, p. 72.