

Japan's Overseas Investment - the New Waves

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Japan's financial sector: investment and reinvestment

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In order to understand what Japanese banks and Japanese financial firms are doing overseas it is first of all important to understand what is happening in the financial sector back in Japan.

There are a lot of worries about the Japanese financial sector. Some are justified but many are misplaced and it is important to stress that, even if the Japanese economy was doing incredibly well at this moment, there would have been a need for a shake-out in the financial sector. The fact that the economy is not doing well means that the shake-out is inevitably going to be much larger and much more painful. The whole focus of the financial sector has had to change and the ability to change is complicated by the bad loan problem in Japan. The scale is immense.

That said, as in most other things in Japan in manufacturing as well as banking, it is important to say that big is best. As deregulation takes place, it is the small and medium sized firms who are exposed and this is as true in the financial and banking sector as it is in manufacturing. The banks in Japan, and the big banks in particular are in very good shape. The big banks in the first half of fiscal year 1995 reported operating profits on average 66 per cent above the average profits seen in the five previous years. Banks are making immense profits from essentially borrowing at very cheap rates and just investing in the bond markets. So the big banks will probably take two to three years to address fully their bad loan problem.

However, there is valid concern that there will be problems further down the scale, particularly for the non-banks financial sector, construction-related lending areas and the credit cooperatives. Some of these will inevitably fail.

The financial sector in Japan is going through dramatic structural change. The big banks are easily past the worst and that is very important when you look at what is happening internationally because it is the big banks who will take, as they have in the past, the key international role for the Japanese financial sector.

The Japanese financial sector has already

established a major presence in international markets. Back in 1960 there were only 27 international branches of Japanese banks; by 1970 that number had almost doubled to 52. In 1980 the number of overseas branches had gone up to 135 but by 1990 (and in particular in the mid to late 1980s) had soared to 315. The latest mid 1995 figures from the Ministry of Finance put the number of overseas branches of Japanese banks then at 395. Add in local companies and representative offices, and the number actually rises to 1,118.

The scale of expansion has not been all at the same speed. In the mid to late 80s, when the Japanese economy was booming, and the banks were making incredible profits at home - and the global economy generally was going through a bubble period - Japanese banks expanded dramatically. But as they moved into the 1990s they were hit by three problems, their pace of overseas expansion slowed and the focus changed slightly. Those three problems were, firstly, developments at home - bad loans and profit margins being squeezed. Second, introduction of the BIS ratios which meant that Japanese banks had to meet minimum capital adequacy requirements, and which essentially hit the Japanese banks very hard at a time when the bubble had already burst. The regulators should have seen that the Japanese banks were to face difficult times in the early 90s because of the changing economic circumstance. Japanese banks at the moment cannot write off their bad loans as quickly as they would like, partly as a lag effect of these capital adequacy requirements.

The third problem that really affected the banks was the collapse in the real estate market in Europe. There are many instances of Japanese banks buying at the peak of the market in London but they were affected generally by the collapse in the property market across Europe and this caused them to reappraise their activities. They cut lending to small firms in Japan which are now not being nurtured through recession as they were in the past. This is a reflection of what Japanese banks are doing internationally: having to become more competitive, their relationships with small firms

are changing.

Furthermore, there was a focus on the quality of assets as opposed to the expansion of loan books - again, reflecting what other non-Japanese western banks had been doing in the past. There was still a lot of lending to Japanese firms that remained the focus of attention but also there was a shift in focus into some other areas, such as project finance - including some glorious failures such as the lending to the Eurotunnel - not just general lending.

So, the Japanese banks had a very big presence in the mid to late 80s, and they still have a big presence. The pace of expansion did slow in the 1990s but it was still an expansion and within that expansion the focus of activities has changed. London has done incredibly well so far in this process. In the number of banks alone, London is the third biggest location for them after New York and Hong Kong - far in the lead of anywhere else in Europe. Japanese banks have 80 branches in the UK, against 52 in Germany. The same is true of securities companies. Located in 27 countries around the world, their biggest presence is jointly in London and Hong Kong. The concentration in the UK far outstrips that elsewhere on the continent. As far as the Japanese are concerned, despite any worries about monetary union, London is clearly Europe's financial centre and is expected to remain so.

From now on there will be further expansion overseas by Japanese banks and financial firms, and that expansion in my view will be concentrated more in Asia. But Europe is not going to perform that badly and within Europe the UK will still be the main focus of investment.

On the macro-economic side, the Japanese economy, even though it is going to be growing more slowly in the future and even though its trade surplus is going to be falling, is still going to have large current account surpluses. Thus Japan is still going to be the world's net saver.

The Japanese will still have to recycle their savings overseas and Japanese banks, financial institutions and insurance companies will have to increase their international profile to reflect that. Secondly, the hollowing-out of the Japanese economy will continue, at quite a significant pace. This February's quarterly report from the Bank of Japan showed that, this coming fiscal year, the largest Japanese manufacturers planned to put 30

per cent of their overall investment outside Japan. Japanese banks will follow in their footsteps in order to lend to them.

Meanwhile, Asian financial markets are being liberated and fully developed. As they mature, that will mean a very important role for the Japanese financial sector to play within Asia. And reflecting all of this, is the yen.

One of the most interesting global developments of recent years is the growth of intra-regional trade. Trade within Asia has picked up, as has trade within Europe, and trade between the Americas. One consequence is that the dollar has seen its role diminish. In the last 15 years the dollar has gone from 80 per cent of world reserves to 60 per cent. The deutschmark has gone up to about 16 per cent of global reserves but more importantly, the yen has gone from accounting for only 2.5 per cent of global reserves 15 years ago to just under 10 per cent now. It has become more important because of that rising intra-regional trade. Back in 1992/93 the OECD region accounted for 55 per cent of world GDP, Asia only 20 per cent. Even on conservative forecasts, by the year 2015 or 2020 Asia will have become the dominant region of the global economy accounting for 35 per cent to 40 per cent of world GDP. If higher intra-Asian trade has already boosted the yen, the Japanese currency inevitably will continue to benefit from what is happening in Asia.

That is the macro-economic background which is going to put the Japanese financial sector in good shape to continue to expand overseas. At the micro level, the biggest banks intend to become global universal banks. Consequently they will not only indirectly expand overseas operations for service companies overseas, they will continue to directly expand to boost their own profile. For instance, in DKB in London we have got 440 people. We have just leased the adjacent building which increases our space by about another 70 per cent. We have three dealing rooms, all of which are going to double in size in the next year.

The securities houses will essentially go through the same process and I would not rule out Japan's big securities houses having to merge with the big banks there.

There is also a change in the whole pension system in Japan. Japanese portfolio investors

tend to keep their money at home and to keep their money in bonds. Institutional investors, in the UK and the US tend to focus more on equities and to be more diversified internationally. Japanese institutional investors, who hold and control Japan's pensions, need to invest more overseas to get higher returns. Following a recent change to the "5332 rule", the authorities are hoping that Japanese institutions will move more than 30 per cent of their assets overseas. At the moment the trust banks, who control 60 per cent of Japan's pensions, have only 7 per cent of their assets overseas; given the future ageing of the Japanese population, they will be desperate in the next few years to get higher returns. Eventually, not just yet, you will see not only direct investments from the financial sector out of

Japan, but also increased portfolio investment out of Japan. That is why many international firms - UK and US pension funds - are already trying to improve their position in Japan, in order to grab a slice of the action.

So there are macro-economic and individual reasons why Japanese firms will continue to invest overseas. Most observers believe that the bulk of that focus will be on Asia reflecting what the Japanese corporate sector is going to do. But given that many of the Japanese banks and financial institutions have to be global players they will have to keep a big presence within Europe. And within Europe it is going to be the UK which is easily going to remain the financial leader, whether we go into a single currency or not.
