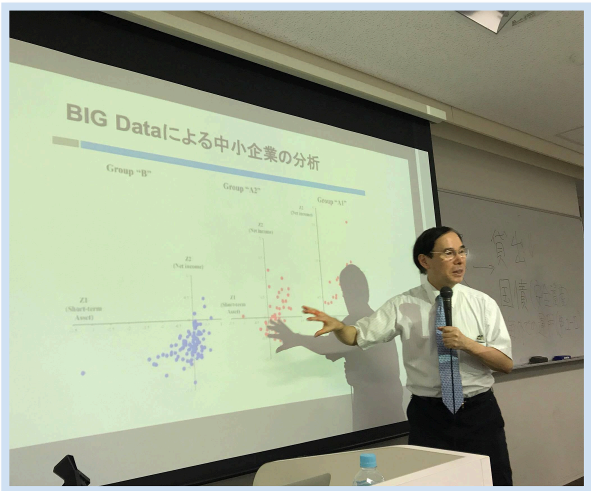
Todai Finance Innovation Program Lecture 8

The second half of the Todai Finance Innovation Program commenced on September 26th with the 8th installment led by Professor Naoyuki Yoshino, who currently serves as Dean of the Asian Development Bank Institute (ADBI) and Professor Emeritus at Keio University among various other roles. The theme of the lecture was “Savings to Asset Formation and the Financial system” which dealt with the recent financial conditions in Japan and the broader Asian region, while taking a closer look into the challenges that stand in the way of increasing the flow of money from savings accounts to investments.




***Professor Naoyuki Yoshino****. Ph.D. Johns Hopkins University, 1979*

*Dean and CEO of the Asian Development Bank Institute (ADBI). Professor Emeritus at Keio University.*

## Economic Conditions in Asia and Japan

Around the 1700s, the Asia region accounted for approximately 60% of the world’s GDP but with developments such as the industrial revolution, this share dropped to as low as 20%. However, in recent years Asia is once again on the rise, led by countries such as China and India, and if growth continues at current rates we can expect Asia to account for approximately 50% of the world’s GDP again by 2050. Against such a backdrop, the economic situation in Japan must address several key issues if it is to keep up with the emerging Asian powerhouses (China, India) and catch up to western powers.

## *Monetary Policy in Japan*

Since the start of Abenomics in 2013, the monetary base has been rapidly growing to a point where it now accounts for approximately 80% of the total GDP (2016) in Japan. This compares to levels of approximately 20% in the United States and various European countries. This growth in the monetary base has arisen from the BOJ purchasing government bonds. Traditionally financial institutions such as banks, insurance firms and pensions funds would also such purchase these government bonds, but as the interest rates on these bonds have fallen into negative territory in recent years, this has left the BOJ as the main buyer (It should be noted that overseas investors account for approximately half of the purchases of short-term government bonds as they aim to get returns on speculation and make use of fluctuations in the exchange rate). Although people ask how the current situation differs from the one observed in Greece, there is a major difference in that there is still someone buying the governments bonds (BOJ) whereas in Greece this was not the case. In case of Greece, 2/3 of their bonds were purchased by foreign investors. On the other hand, Japanese government bonds are purchased by domestic investors and the Central Bank of Japan for more than 90%, which stabilized the government bond market. Having said that there is undoubtedly the need to gradually decrease the issuance of government bonds in the near future or else there is the risk that Japan will face the same fate as Greece.

Usually financial institutions obtain money from depositors and lend this money out to firms or individuals for a certain premium. However, there are now less and less people who they can lend this money out to and a surplus of money they have been entrusted with by depositors. Normally in such a situation financial institutions would then turn their attention to government bonds in order to gain returns, however, at present, as the interest rate on such bonds is negative it is not a suitable option. This has forced financial institutions to invest in overseas products, which exposes them to currency risk (although many do hedge it does not completely remove the risk and the rate of return on investment reduces by the costs of hedging.).

## *How did Japan get to this situation?*

The BOJ has set an inflation target of 2% (in line with other major overseas central banks) and the current monetary policy continues to be implemented as this target is not being achieved. So why is the economic condition not improving despite the extensive monetary easing?

Firstly, the reason that the inflation target is not being met might lie in factors outside monetary policy altogether. Japan is heavily dependent on oil imports and in recent years the oil price has decreased by approximately 3 fold. This means that import prices decrease considerably and hence it functions to work against raising the price level. The same phenomenon could be seen in the late 1980s although the driving factor then was the exchange rate between the dollar / yen dropping to half its value unlike the current drop in oil prices.

Secondly, it can be thought that the IS curve is perpendicular so at present investors are not willing to invest regardless of any changes in the interest rate. This means that even if the interest rate were to drop (hence making it cheaper to borrow) investors will not increase their investments. This can partially be explained by Japan's aging society, which means that companies do not want to make capital investments as they fear that demand for their products will decrease going into the future with a declining population. It is important to note that the benefits of the current monetary policy are being reaped by the working class but not by those that have already retired. Hence with the aging society in Japan, year-by-year the proportion of people that benefit from the current monetary policy is decreasing.

## *What needs to be done to address these issues?*

There is a need to change the pay structure in Japan. At current, people earn a greater salary as they get older. However, as one gets older their output decreases so their earnings do not become representative of their output and hence companies want to get rid of these people as quickly as possible. This is preventing people from working on past the retirement age. However, if we change the pay structure so that the pay is proportional to the level of output produced, these people may be able to stay on and keep working for the company. Although people may point out that this could get in the way of young people obtaining jobs and it cannot be denied that young people will end up working less hours, the overall picture in terms of real disposable income would remain unchanged or increase a bit. This is because the young people would have to pay less tax than at present because the older people will work till an older age so require less financial support from pension. So in essence the young people will still receive of receive higher amount of money after tax. Furthermore, these older people will have more money to spend because they have pension money as well as income revenue, so their increased spending will act to create a virtuous cycle in the economy.

**FinTech in Japan and Asia**

FinTech has become very popular in China, and a big factor behind this is the lack of sensitivity of Chinese citizens surrounding privacy. In particular, the MyNumber equivalent overseas (social security number in the United States) is very useful in the financial sector to manage all the transactions of a customer. China being a socialist country, the government already possesses such information so people do not mind it being known by others. This has made it easy to confirm someone's identity instantly (for example when opening a trading account), a process that poses a big hurdle in the Japanese system. In addition to speediness, the implementation of FinTech has brought about services with lower costs than before. As most Chinese people tend towards services with the lowest costs, despite its novelty FinTech services have been able to establish a large user base. This lack of sensitivity towards privacy, combined with Chinese people's desire to pay the lowest price for any given service has paved the way for a FinTech boom.

One aspect that is threatening the spread of FinTech in Japan is the culture that promotes the mainstream and tries to reject anything new. For example, if some new financial product derived from FinTech caused some losses to investors in Japan (such as a group of elderly people), the media would be onto it right away and accuse the Financial Services Agency of not doing their job. Hence the FSA would be obliged to move to regulate the products at the center of the losses, which would discourage the launch of other new products from FinTech. There exists an expectation in Japan that all financial products should be safe (i.e. should not cause losses), so there is no expectation for investors themselves to assess the risks and possible rewards associated with a particular financial product. An idea suggested by Professor Yoshino to tackle such an issue was to establish two groups of financial products in Japan that people can invest in. One group should comprise of safe products that anyone can invest in and the other should comprise of new financial products, which may have a higher level of risk than the former group. Investors in this latter group should be made to understand that there is a degree of risk involved so it is their own responsibility to assess any risks and to make the decision to invest or not. Generally in Japan there is a lack of respect towards those that try new things or deviate away from the mainstream path, and there exists a strong pressure that attempts to crush such endeavors. Parents in particular are major culprits and many are always pushing their kids to go down the well trodden path and discouraging any new challenges deviating from this path.

**From Savings to Asset Formation**

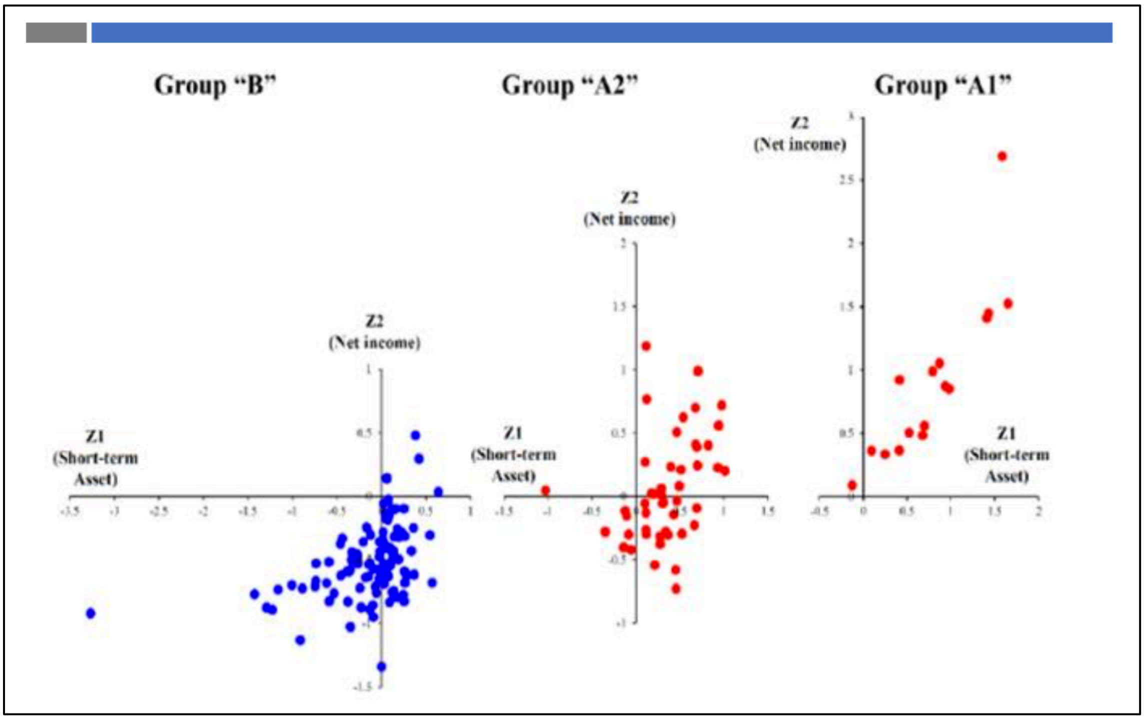
People in Japan and Asian countries in general have a very high proportion of assets stored away in savings accounts compared to their counterparts in the United States and various European countries. For Japan's case, one of the reasons for this may lie in the low returns available from the asset management sector. In particular, there is a need to review the structure of service fees and trust remunerations. The current fee structure in Japan means that financial institutions selling investment trusts make money from transaction fees when a product is sold, so want to get customers to change trust as much as possible. In the long term this goes against the total return of the investor so does not produce a win-win situation. Such an ideal situation may be achieved if the fee structure is altered to be based on the return of the customer on their investment. Under such a system financial institutions would encourage investors to hold onto the same trust for longer periods to maximize the customers returns and consequently their own returns. Another change that could be made to benefit investors is to collect money from investors in specified overseas currencies such as the US Dollar or Great British Pound so that currency risk can be eliminated when investing in overseas financial products. If you use the yen then you must hope that the exchange rate is favorable when your investment is making profit or else all your profits may be lost through the exchange rate. If you collect in the currency you will be investing in to begin with you can just hold any bad positions and convert to the yen when the rate is favorable at a later date.

**Regional Finance Institutions**

Regional Financial Institutions are currently under a large amount of pressure. In response to such pressures there are regional financial institutions that have done little to try to come up with a resolution and those that have come up with innovative means to reduce costs. For example, some have closed their local branches and instead employed a mobile bus to continue to provide their service in various regions. Other methods include mergers while closing any branches that are in close proximity to one another. The situation in these regions is going to call for more innovative solutions like these going into the future. So how are we going to support such entrepreneurs?

Firstly there is the need to identify which small/medium companies have the potential to grow larger and provide the local community with these new solutions. With the availability of new technologies such as Big Data, it is now possible to categorize these small/medium companies into different "groups" from a scientific viewpoint and give them ratings so that comparisons may be made quantitatively. An example of such analysis is shown in the diagram below:

**Analysis of Small – Medium Companies using Big Data**




*Taken from lecture slides Pg. 38. The red dots represent very good small/medium companies whereas the blue dots represent small/medium companies with high risk. This kind of analysis utilizing Big Data will become increasingly important.*

The second step is to provide the small/medium companies identified in the first step with the funding they require. Obviously normal banks cannot lend money to such companies using money collected as deposits because this has far too much risk attached. However, what we can do instead is to utilize crowdfunding or set up Hometown Investment Trust Funds to collect money from people willing to invest in these small/medium companies and the ideas they pose. The funds raised through such schemes can be used by the companies to grow larger and develop a solid base over a period of around two to three years. Once they have developed to this stage, it may now be safe enough for banks to lend them money for them to develop their company and idea further and meet the needs of these regional areas. The money collected as deposits should not be lent to risky sectors. Instead, hometown investment trust funds (or crowd funding) will be used to support startup businesses and provide finance to riskier borrowers.