Trends in International Banking in the United States and Japan

Good afternoon, ladies and gentlemen. I am pleased to be able to participate in this most important and timely discussion of Japanese direct investment in the United States with emphasis on developments in the financial sector Allow me to say at the outset that the views I will express today are my own and should not be construed as necessarily reflecting the official point of view of the Federal Reserve as a whole Before turning to the particulars of developments in the financial sector, allow me to begin with several more general observations which I believe can provide some perspective on the discussion that will follow

- First, patterns of direct foreign investment and international capital flows more generally must be viewed in the context of bilateral and global patterns of national savings and investment rates as well as patterns of current account positions. That is, for a country like the United States, which is running large internal and external deficits, the external deficit must be financed by some combination of direct and/or portfolio investment flows from abroad Thus, so long as there are large imbalances in these macroeconomic relationships, there will have to be — as a matter of simple arithmetic — corresponding capital flows and swings in net foreign investment positions among countries The bilateral relationship between Japan and the United States is no exception to the inevitability of this arithmetic It follows, therefore, that the only way the rise in net foreign investment in the United States can be ameliorated is in a context in which underlying economic imbalances are reduced over time As in most things, at the end of the day, the economic fundamentals are what really count

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- Second, as a general matter, the free flow of capital and investment across international boundaries is a clear plus for national economies and for the global economy as a whole Free and efficient flows of capital on an international scale (1) help to promote more open, competitive, and efficient national economies, (2) better allocate savings and investment on a global basis, and (3) may even help to promote greater harmony among nations Looked at in this light, Japan is in a unique position and has unique responsibilities to assist in the optimal deployment of savings, not just here in Japan, but more generally
- Third, direct investment, particularly de novo investment in productive plant and equipment, can play a particularly important role in stimulating competition, growth, and improvements in stan-

Remarks by E Gerald Corrigan, President of the Federal Reserve Bank of New York, before the A F I I and C B I U S Conference on Japanese Direct Investment in the United States, in Tokyo, Japan, October 12, 1989 dards of living. Indeed, economic history—especially in the postwar period—provides unambiguous evidence that foreign direct investment works to the benefit of all.

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- Fourth, all countries have some limits on the amount or nature of foreign investment they will accept within their national boundaries. Among the industrialized countries, such limits often take the form of restrictions on the extent—if any—of foreign ownership or control of firms or industries that are associated with the production of goods or services that are seen to have national strategic importance. Often, but not always, these restrictions grow out of national security considerations. However, while all governments respect the right of other governments to limit or restrict foreign investment on such grounds, there can be significant differences of opinion as to what constitutes legitimate grounds for such restrictions. For example, over the years we have seen evidence in some countries that suggests that banking—or at least certain core components of banking—can be viewed as falling within the range of commercial activities having special status for these purposes. In short, there can be an exceedingly fine line distinguishing between practices and policies that are motivated, on the one hand, by legitimate national strategic considerations and by protectionist-like attitudes on the other.

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- Finally, in order to provide a workable framework within which individual countries and countries at large can better manage both the politics and the economics of foreign investment, many countries—the United States and Japan included—have come to rely on the principle of national treatment. That principle, in its simplest form, states that, subject to limitations growing out of national strategic considerations, foreign firms should have the same rights, privileges, and responsibilities as domestic firms. In practice, however, the principle of national treatment is subject to many ambiguities since it is not always easy to determine whether such equality of treatment prevails even in de jure terms much less in de facto terms.

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Partly for this reason, the principle of national treatment is increasingly accompanied by an implicit or explicit policy of reciprocity, which in effect says that one country will be willing to provide national treatment to another only so long as the second country provides national treatment to the first. This is the philosophy which was associated with the so-called primary dealer amendment to the omnibus trade bill enacted in the United States in 1987. I personally, and the Federal Reserve generally, resisted that approach, partly on the grounds that a policy of "reciprocal national treatment" can all too easily put us all on the very slippery slope of protectionism. Indeed, this episode should serve as a forceful reminder that we all have an ongoing responsibility to see to it that policies and practices are fully consistent with national treatment and that markets for goods and services alike are open and free to all competitors, foreign and domestic.

With those general observations in mind, allow me to turn now to the financial sector in particular. What I would like to do in this regard is to provide an overview of the extent of Japanese presence in U.S. banking and securities markets and contrast that with the extent of U.S. presence in Japanese markets. That discussion must clearly take place in the context of the explosive growth of Japanese banks over the decade of the 1980s. We all know very well that any list of the largest banks in the world is now dominated by Japanese banks. We also know that the enormous growth of Japanese banks in this decade, and especially in more recent years, has to a very considerable extent been driven by macroeconomic considerations, including the high savings rate in Japan, the country's massive cumulative current account surpluses, and net changes in dollar exchange rates

What may not be as widely recognized is the extent to which the growth of Japanese banks has occurred in international banking markets For example, over the seven years ending in December 1988, assets booked at the foreign branches (and agencies) of Japanese banks have increased almost fivefold. Looked at somewhat differently, there are now almost 100 branches and agencies of Japanese banks in the United States as well as a number of relatively large U S subsidiaries of Japanese banks. From still another vantage point, in the few short years between 1984 and 1988, B I.S statistics suggest that the share of international banking assets held by Japanese banks grew from about 23 percent to almost 40 percent

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Turning more directly to comparisons of relative bilateral U S and Japanese presence in banking and securities markets, the following picture emerges

- Judging by the limited data available, it appears that the scope — as measured by employment and capital deployed — of Japanese securities firms' presence in U.S securities markets is not wildly out of line with the scope of U.S. securities firms' presence in Japan However, even this qualitative and broad-brushed judgment must be further qualified in that it may not fully and fairly reflect conditions after taking account of Japanese firms' acquisitions of, or minority investments in, U.S. securities firms which have taken place over the last few years
- The presence of Japanese banks in U S markets far exceeds the presence of U S. banks in Japanese markets To be specific, there are about twenty U S. banks with a presence in Japan In the aggregate, these banks have about $30 billion in assets — a very small market share by any measure By contrast, there are about three dozen Japanese banks in the United States, and their aggregate banking assets amount to about $370 billion. More generally, and reflecting the openness of U S banking markets, foreign banking institutions in the United States now control about one-quarter of the banking assets booked in the United States, with slightly more than half of that total in Japanese banks. Indeed, by this measure of market share, Japanese banks now have about a 14 percent share of the banking market in the United States And for selected geographic and product markets, the market share of Japanese banks is still larger. Further, if the total banking activities in the United States of major Japanese banks were fully consolidated (that is, to include on one pro forma balance sheet the assets and liabilities of the family of subsidiary banks, branches, and agencies), six such Japanese banks would now appear on the list of the thirty largest U S bank holding companies and a couple would be within striking distance of the tenth largest banking organization in the United States. While those comparisons may — as much as anything else — reflect the segmented structure of U S banking markets, they are striking none the less

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Having said earlier that macroeconomic forces such as savings rates, current account positions, and changes in dollar exchange rates can go a long way in explaining the overall growth of Japanese banks over the past decade, the question that naturally arises is can these same macroeconomic forces fully explain the very sizable relative presence of Japanese banks in U S markets? The answer to that question is, in my

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For example, one can reasonably point to a number of historical or institutional factors that help explain this situation. As an illustration, Japanese banks probably developed a major strategic interest in U.S. banking markets before U.S. banks developed similar interests in Japanese markets. Similarly, elements of innovation, liquidity, and diversity of financial instruments in U.S. banking markets probably provided Japanese banks with more opportunities and earlier opportunities to do more things in the United States than they or U.S banks could do in Japan, notwithstanding the similarities between Glass Steagall and Article 65 Finally, it is clear that for a number of years U.S. markets were more open than were Japanese markets. Indeed, the process of significant liberalization and deregulation of Japanese financial and banking markets is only a few years old

But even these historical and institutional considerations, when added to the macroeconomic factors cited earlier, do not tell the whole story regarding the comparative scope of Japanese and U.S. banking presence in the respective marketplaces.

A further factor that must be considered is the market valuation of the shares of major Japanese and U S. banks, respectively Specifically, based on recent experience, the shares of major Japanese banks on the Tokyo Stock Exchange sell at price earnings multiples that are often in the range of fifty or more. By contrast, none of the major U.S money center banks have P/E ratios of more than ten This pattern raises two closely related questions. first, what accounts for the dramatically higher market valuation of the shares of Japanese banks, and second, what implications, if any, does this have for the bilateral patterns of banking presence in the two countries?

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I am not well positioned to answer the first question since stock market valuation matters are not an area in which I claim any expertise, even in the United States much less in Japan. I suspect, however, that some of these differences can be traced to tax, accounting, and regulatory considerations. The high internal savings rate in Japan may also be relevant in that the pool of funds available for investment in equities is so large. It is also widely stipulated that Japanese equity market valuations provide a significant premium for unrealized capital gains on real estate and equity holdings. In the case of the Japanese banks, these unrealized capital gains on equity investments are large in part because some of the investments they represent were seed money for industrial companies in the immediate post-war period that have since grown to become industrial giants on a national and global scale. (It should be noted that equity investment limitations governing investments by Japanese banks in industrial companies are technically now quite similar to those prevailing in the United States.)

Whatever the precise factors accounting for the very high P/E ratios for Japanese banks relative to U.S. banks, the more important question in this context is does it matter in terms of the competitiveness between Japanese and U.S. banks? The answer to that question is yes, it does matter, and it *may* matter a lot There are at least three reasons for this. First, even in the face of broadly similar international bank capital standards, it is obviously cheaper — and presumably easier — for the class of banks with high P/E multiples to raise fresh equity in the marketplace. Second, it is also likely that this condition may provide room within which Japanese banks may have opportunities to price individual transactions at spreads that are lower than U.S. banks can justify — a pattern that would not be inconsistent with the low rates of return on assets generally observed at Japanese banks relative to U.S. banks. Finally, these differences in market valuation of shares also result in a situation in which it is easier for Japanese banks to expand in the United States by acquisition while it is virtually impossible for U.S. banks to expand in Japan by acquisition The economics of the price tag may therefore represent a significant barrier to U.S. banking expansion in Japan. For this reason, it is all the more important that no stone is left unturned in the effort to ensure that all barriers — visible and invisible — to expansion and openness in Japanese banking and financial markets are eliminated

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All of this raises still another very difficult question namely, is there a point where the extent of foreign banking presence in U S markets could give rise to public policy concerns about such presence? In my judgment, the candid answer to that question is yes, such concerns could arise, particularly in the context of any pattern of future behavior that might be viewed by some as an aggressive strategy of expansion through acquisition I refuse to speculate whether—or under what circumstances—such future concerns might arise, since the initial point of friction—if it ever comes about—is likely to be more political than economic However, leaving aside any such political considerations, there are other public policy issues which could arise in this context

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For example, in the United States, concerns about concentration of economic and financial power—particularly in the credit origination process—have been at the heart of the national debate about banking structure for 200 years While much of the doctrine about concentration has centered on market shares of individual institutions, it is not a major leap in intellectual terms for some to suggest that concerns about concentration should be extended to foreign banks or to foreign banks from a single country There are also a number of supervisory and "safety net" issues that arise in this context, not the least of which are those relating to the responsibilities of the home country's central bank as lender of last resort should a sizable liquidity problem arise in a foreign country Finally, there are also the continuing questions whether the second country is really doing all it can in law, in regulation, and in practice to provide the same degree of openness as prevails in the first country—again, the whole question of national treatment or reciprocal national treatment

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Fortunately, the last several years have seen some major progress in containing these points of concern. The B I S capital standards surely are working in the right direction even though they cannot and do not solve all the problems, the very significant deregulation and liberalization of Japanese banking and financial markets in recent years have clearly helped, even though here too, more needs to be done, the very close and cooperative efforts between official institutions in the United States and Japan are also a clear plus even if progress does not always come as quickly and as smoothly as both sides would hope, finally, the recognition that both countries have a major stake in finding mutually acceptable ways to blunt points of tension has grown, but here too, that recognition is not as widespread as it could be

In closing, allow me to return to the point where I started namely, to stress the mutual benefits arising from the free flow of capital internationally and to stress the importance of the economic fundamentals The most constructive thing we can both do to check points of tension in the bilateral economic and financial relations between our two countries is to pursue policies aggressively that will wind down in an orderly way the macroeconomic imbalances I referred to earlier We all lost a good friend recently with the passing of Governor Mayekawa, a man greatly respected throughout the world for his vision and his contributions to international harmony. Not the least of his accomplishments was the report bearing his name that was aimed at encouraging basic structural changes in the Japanese economy

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Looking ahead, I know others will take up this important work just as I know we will continue to make progress in our efforts to better harmonize competitive conditions in our respective countries I am also acutely mindful of the pressing need for substantial reform in economic policy in the United States, just as I am sensitive to the need to achieve a still higher level of cooperation and coordination in policies and practices that relate to the structure, operation, and supervision of our banking and financial markets None of this will be easy, but the stakes for us and for the world economy are so very large that we have no choice but to find the will and the way that ensure success.