LIBERALIZATION OF DEPOSIT RATES IN THE JAPANESE FINANCIAL MARKETS WITH PARTICULAR EMPHASIS ON ITS EFFECT ON CITY BANKS

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I. INTRODUCTION -Objective and Methodology-

The specific objective of this paper is look into the effect of liberalization of deposit rates on banks, particularly, city banks, by comparing the changing trend of several key factors like interest margin, deposit structure, growth of deposit-bearing instruments, profitability, liquidity and interest rate risks, as well as changes in operating profits and costs.

City banks was chosen as the object of study because of its relatively faster rate of liberalization due to the fact that depositors are mainly corporate businesses and that most of their funds are raised through deposits. The impact that liberalization of rates had made could be seen from the changing trend of interest margin, which in the past were assured by interest controls and their monopolistic role as the main financial intermediaries. Five out of the twelve city banks were selected based on ranking of efficiency performance for 1990, according to the April issues of the Kinyu Journal for each of the years 1985-1990 consecutively. For data consistency purposes second-ranking newly merged Taiyo-Kobe Mitsui Bank was omitted.

Statistical data was obtained for the following banks: The Daiichi Kangyo, Sumitomo, Mitsubishi, Sanwa and Fuji Banks. These years were chosen because liberalization of deposit rates were actively initiated only after 1985. In determining the margin of interest, interest rate on deposit was cosidered instead of that on lending since the essential feature of competition amongst banks is the payment of interest on deposits.

II. LITERATURE

a. Overview of the Japanese financial system

The post-war Japanese financial system was highly regulated interms of func-

tional segmentation restricting competition and regulation of rates, notably the deposit rates. Direct control by The Bank of Japan (BOJ) was made effective by the distinctive peculiarities of the financial system like excessive indebtedness of banks to the BOJ, and the equally heavy dependence of business on banks.[1] Due to lack of suitable substitute for bank deposits, regulations helped mobilised household savings to corporations which mainly comprised individual bank's own 'keiretsu' groups. This indirect manner of financing strengthened by controlled interest rate structure was effective until the early 1970s.

The high inflation and slow economic growth period following the first oil shock induced financial innovations on the part of financial institutions and changing customer demands eager to benefit from higher returns. The free link from the US$ in 1971-73 generated competition between domestic and international markets, reinforced further by progress in telecommunications, facilitating linking of these markets. Financial reforms in Japan was said to have been carried out less enthusiastically unlike those of other developed countries[2]. This was deliberately done to prepare each segment for the anticipated competetive environment.

b. Contributory factors for deregulation

Interest deregulation began in 1975 when goverment-issue bonds were floated to finance increase in government expenditure initiated during the high growth period and public sector deficit caused by the subsequent slackening of business investment. Sale of these bonds by banks in the open markets, promoted further by successively relaxed rules, induced the shifting of funds from the relatively lower-yielding regulated bank deposits into these markets. To curb this fund outflow, eventually, in 1979, banks were allowed to issue Negotiable Certificate of Deposits (NCDs), which marks the beginning of free deposit rates formation. Constraints on size of issue and maturity term had since been eased successively.

Availability of new and less restricted funding and investment vehicles through corporations' own overseas subsidiaries, foreign capital market and the Euromarket, reduced reliance on bank loans. The resulting intense competition for a relatively narrower customer base forced banks to reduce loan rates to below fixed prime levels in their attempt to compete for prime borrowers, antiquating the traditional prime rate system.

Pressures to liberalize controls were further intensified by presistent overseas demands particularly from the United States and the European Community countries following perceived threat from Japanese banks' competition in their own financial markets, whereas monopoly practices of the domestic 'keiretsu' groups was felt to be hindering foreign competition. There are controversial views with respect to US-Japan trade frictions amongst American economists themselves, even to this date. Channon[3], for example, are amongst those who are defensive of America's position while many others like Cargill[4], El-Agraa[5], were critical of US protectionism. Krugman[6] too was sceptical about the Japanese 'keiretsu' practice but at the same time admitted America's own shortcomings. A series of bilateral talks held since 1983 such as the US-Japan Dollar/Yen Committee, 'the UK-Japan Finance Consultations' and the 'US-Japan Working Group on Financial Markets'[7] indicates Japan's efforts in liberalizing its domestic market.

c. Liberalization measures

Japan started deregulating its financial markets much later than other developed countries. For instance, by the end of 1988, 78% of America's commercial banks' deposits were already liberalized and that regulation on time deposits had been completely lifted since 1983[8], when at this time Japan was only on the verge of promoting further liberalization of her financial markets. New financial instruments with successively better terms were developed.[9] Liberalization pace has advanced markedly recently[10] and plans for further

liberalization of rates have been observed[11].

Some regulations still prevail which hinders banks from competing with not only the open markets but also from the higher rates of the 'Maruyu' system, peculiar only to Postal Savings holders whereby the tax-free earnings benefit had managed to attract about a third of all household deposits in Japan[12].Interest rates controls was felt to be constraining bank's competitiveness. Changes in the official rate, the BOJ's monetary tool, directly affects deposit rates since liquidity prudence allow banks little scope for manipulating their lending rates. To quote Glasner's (1989) words, "Increase in lending at reduced rates would simply cause a drain on the bank's reserves as depositors demand redemption withdrawal"[13]. It is the deposit rates which is the true marginal cost of funds to banks[14]. However has liberalization of rates actually helped improved bank's margin and profitability? This study proves otherwise as dealt with in the following sections.

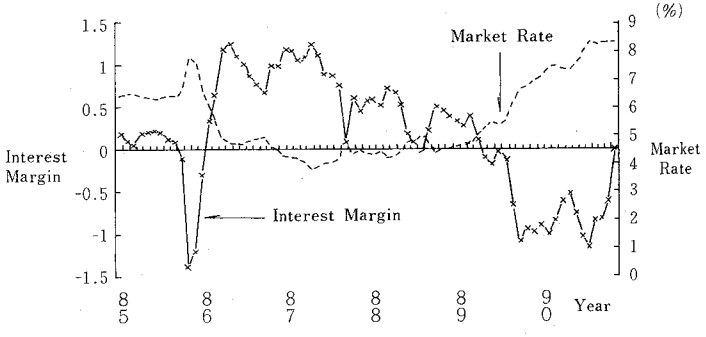
III. ANALYSIS

a. Effect on margins of commercial banks in general.

Figure 1 shows the monthly movement of interest margin in relation to changes in market rate from 1985-1990 consecutively. Generally, as market rate rose, margin declined particularly in the latter years as more and more regulations on interest, deposit maturity and ceiling controls were freed.

In 1985 when the official rate was at the 5% equilibrium, market rate moved steadily between 6.31% and 6.51% except for the year-end periods when the rates exceeded 7.6%. This corresponds to the period when ceiling on interest rates of large time deposits (10 million yen and above) and ceiling on issues of Certificate of Deposits (CD) were raised in October 1985. Interest charged on loans throughout the year was at a gradually reducing range of between 6.5%

Fig. I : Interest Trend by Month (1985—1990)



Source : Trends of Savings and Economy, April 1989, Ministry of Post and Telecommunication, Japan

and 6.4%. With the increase in rate of interest that banks had to pay for deposits while interest income from lending decreased, margin spread gradually thinned, reaching its lowest at −1.21% by December.

In 1986, following the fall in official rate from 4.5% to 3%, interests on deposits too fell, steadily improving interest margins for the first half of the year. Then, following a drive to attract deposits on CDs and large MMCs, market rate again increased resulting in a re-fall in margin spread. The official rate was then maintained at 2.5% for the subsequent two-year period. Various financial reforms were introduced then, including the extension of maximum maturity period of MMCs and CDs to two years and one year respectively. Interest margin began to decline steadily while market rates continue to rise. The introduction of small MMCs in mid-1989 with minimum issuance unit of only 3 million yen have sharply pushed up market rates, resulting in negative margins. From mid-1989 onwards, with the increasing availabilty of deposit instruments bearing market rates, interest margins have plunged to and remained at negative levels.

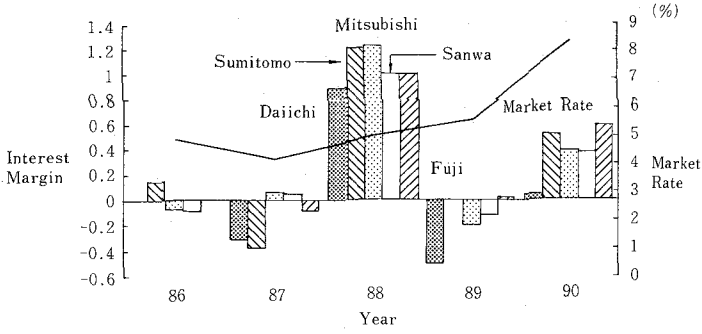
Thus as more and more refoms were introduced and financial instruments di-

versified, market rates were pushed up by the competitive drive for share of deposits. Liberalization has resulted in the squeezing of interest margin by raising cost of obtaining funds.

b. Effect on margins of City banks.

Likewise, movement of market rates of city banks showed a rising trend whilst interest margin curves, a declining trend, with slight variations in slope between the five different banks (**see Figure 2**). Since all showed similar and undeviated curve patterns, it can be generalized that these banks have responded similarly to the competitive pressures accompanying interest deregulation.

Fig.2 : City Banks-Market Rate and Interest Margin



Source : Kinyu Journal, April 1985—1990 issues

There is a relationship between reforms in issues of financial instruments and banks' interest margins. When the MMC was introduced in 1985 and the minimum requirement for large time deposits to be eligible for free-interest treatment was reduced to 500 million yen in 1986, interest margin fell except for Mitsubishi and Sanwa which showed a slight increase. More reforms were introduced in 1987 such as the lowering of threshold limits of large time deposits and MMCs, and variations in maturity periods, causing market rates to rise as

demand for these instruments increased. However rises in interest margin too followed. This can be explained by the fact that as at 1987 there were still 64.2% of deposits that were being regulated and that the official discount rate cut to 2.5% in that year had entailed reduction in these regulated deposits. Low interest paid on deposits had improved interest margins for the period. Market rates continue to rise gradually until 1989 and even more sharply thenafter (See Figure 2). As market rates rose and more deposits liberalized, interest margin continue to drop from 1988 onwards reaching negative levels the following year. This coincided with the period when restrictions on size and maturity of time deposits were relaxed, CD limits reduced and small MMCs introduced.

The active drive for deposits by banks have undermined each other's margin following the introduction of these reforms. Cost of obtaining funds had increased relative to income from lending activities.

From 1989 onwards market rates rose abruptly in response to several hikes in the official rate which had reached 6% by August 1990. Since rises in the official rate also entails rises in lending rates, interest differentials widened and margins improved considerably.

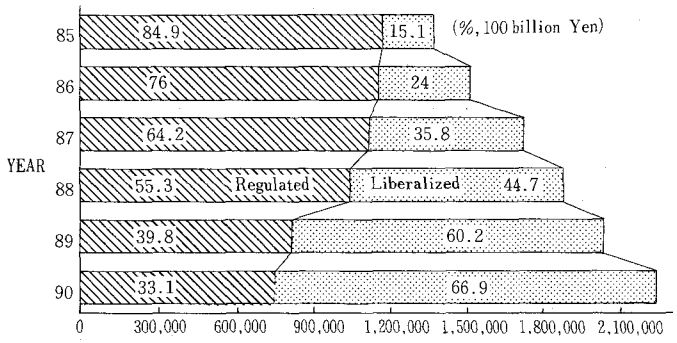
Thus it can be inferred that in the absence of rate controls, expansion of liberalized deposit instrument market results in the narrowing of interest margin of city banks.

c. Effect on deposit structure of banks.

Share of regulated deposit continue to decrease from 84.9% in 1985 to 33.1% by 1990 whilst that of liberalized deposits showed a marked increase from 15.1% to 66.9%. In terms of volume, the fall in regulated deposits over the five years period was relatively small compared to the sharp increase in the share of bank deposits with deregulated interests. **Figure 3** shows the changing trend of liberalized deposits against regulated deposits.

The increase in share of deregulated bank deposits was obviously for its re-

Fig.3 : Trend of Deposit



Source : Bank of Japan, Monthly Economic Statistics

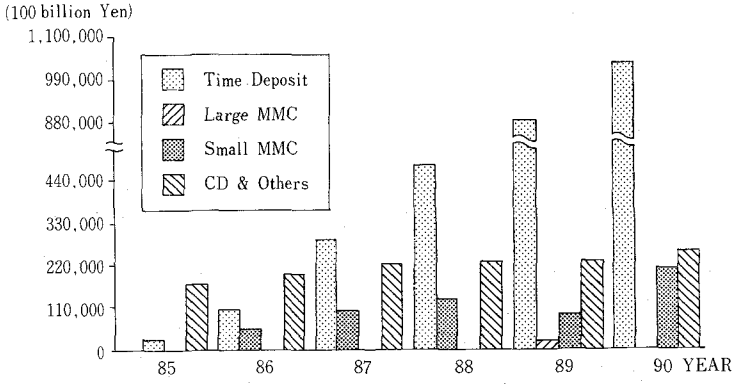
latively higher yield, but the comparatively lower fall in volume of regulated deposits suggests that this increase did not fully occur at the expense of regulated deposits but may probably be due to the additional share obtained from the overall financial market in response to the reforms introduced. Despite the fact that as at 1990, more than 30% of bank deposits were still regulated, the substantial volume that banks managed to attract implies that competitive interests had been paid to expand deposit base, even at the expense of interest margins.

Liberalization has resulted in a favourable response towards bank deposits whose rates were market-determined, and to a certain extent, is responsible for the outflow of funds from regulated deposits.

d. Effect on deposit instruments of City banks.

Figure 4 shows the growth of various forms of deposit instruments as liberalization phase progressed. 3 main groups of deposit instruments were compared: the large time deposits, the large and small MMCs, and CDs and others such as non-resident deposits in yen and foreign currency deposits. Of these deposit forms, that of the large time deposits show a sharp increase. The minimum requirement for these deposits had been successively reduced from 1000 mil-

Fig.4 : Liberalized Deposit Instrument



Source : Bank of Japan, Monthly Economic Statistics

lion yen from its inception amount to 10 million by October 1989, and maturity periods reduced from 3-24 months to 1-24 months. As threshold limits were lowered potential for obtaining funds too expanded. The minimum amount required for large MMCs when it was first introduced in 1985 was 50 million yen afterwhich this amount was progressively reduced to 10 million yen by October 1987. The large MMCs rate of increase over the years was gradual until 1988, afterwhich they were absorbed by large time deposits when both forms had the same maturity periods and minimum issuance amount. The large MMC rates were restricted by the fixing of standard on the maximum and minimum limit. Due to this imposition of limits, the MMCs lack the benefits of market interest linkage and its growth was therefore slow. Small MMCs (Super MMCs) of 3 million yen issuance was then introduced in mid-1989. The small MMCs which had a lower threshold limit than large time deposits and CDs but at the same time possess market-related interest rates, rose sharply. By 1990 its deposits jumped by 130.9% following a further reduction in issuance limit to 1 million yen in April 1990. Regulations on the capping and flooring rules were removed in Nov. 1990, so that the rates now reflect market rates more directly.

Compared to the above two forms of deposit instruments, CDs and others in the form of non-resident deposits in yen and foreign currency deposits proceeded more moderately. The minimum requirement for a CD issue had been progressively lowered from its 500 million yen inception amount to 100 million yen by 1985. Maturity periods too were varied from 3-6 months to 1-12 months. These changes were made to boost up market share of deposit banks. Although interest rates on CDs were higher than that of large time deposits and MMCs, the minimum issuance limit is at least ten times larger, thus limiting eligible depositors to only bigger corporations. This explains the moderate but steady growth of the CD market.

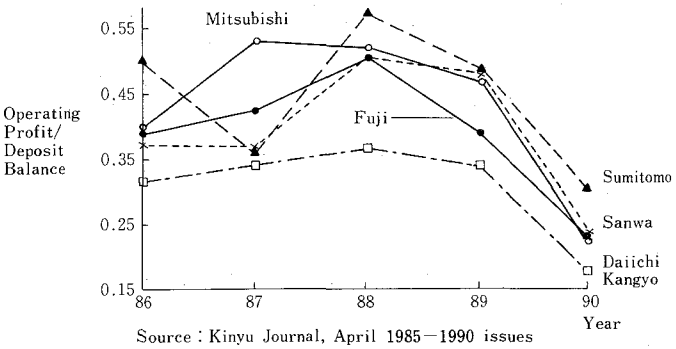
Liberalization of interest rates on deposits have brought about diversification and growth of new deposit-bearing financial instruments. Amongst the classes of deposits it can be inferred that deposits that reflect market rates more directly,that possess lower issuance limit and longer maturity periods are more favourable.

e. Effect on deposit balance and operating profit.

With continued liberalization and on-going innovations, deposit base of each individual bank consequently increased. Interest rate is said to be the factor that lures deposits which banks depend on to carry out lending and other activities. The ratio of operating profit to total deposits outstanding reflects the degree to which a fall in operating profit has been justified by an increase in deposit volume.

Operating profit is operating revenue less operating cost, the major components of which are interest receipts from loans and interest payment on deposits respectively. A declining value indicates an increase in total deposits or a fall in operating profits. Conversely an inclining value indicates a decline in total deposits or an increase in operating profit. **Figure 5** shows the trend of turnover of operating profit/deposit balance over the five-years period. All the five banks

Fig.5 : Operating Profits ahd Deposit Balance Rate



Source : Kinyu Journal, April 1985—1990 issues

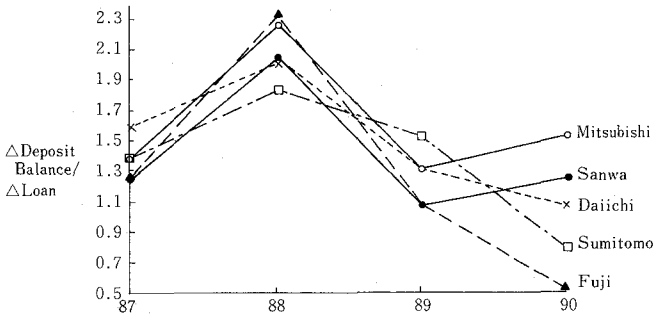
showed a declining trend from 1988 onwards at different rates of fall. The difference in pace reflects the management skill and internal matters of each individual bank. Generally the rate of fall had been more abrupt since 1989 as more and more deposits were liberalized and interest liability increased. Since deposit balance had increased significantly since 1986, the declining curve suggests that deposit base had increased faster than operating profit. This suggests that interest expenses had increased considerably relative to interest receipts. Thus it can be assumed that as deposit volums increases, operating profit tend to fall as cost of procurement for the deposits too increased. However the loss in operating profit had been justified by the increase in deposit base.

f. Effect on deposit balance and volume of loan financed.

There is a direct relationship between deposit balance and volume of loan financed. Deposit is the crucial base upon which lending and other activities depend on. With large deposit base, more volume of loan could be financed. A faster rate of increase in loan financed relative to increase in deposit volume would tend to expose a bank to liquidity risk which may in turn affect deposit repayment, lending and other services.

Figure 6 shows the rate of increase in deposits over the rate of increase in

Fig.6 : Change in Deposit Balance & Volume of Loan



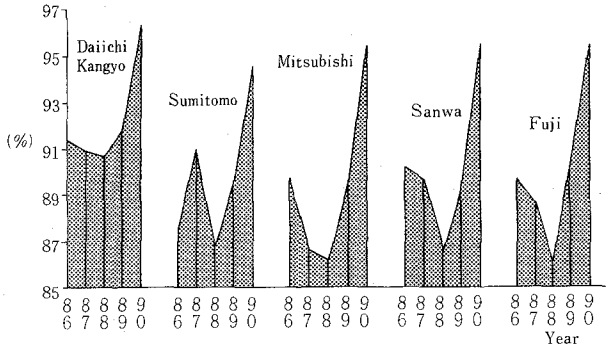
Source : Kinyu Journal, April 1985—1990 issues

loans financed over the five-years period. Between 1987 and 1988 all the 5 banks showed inclining curves implying that growth in lending had been slower than growth in deposit base. From 1988 onwards these curves continued to decline. Although Mitsubishi and Sanwa showed some signs of recovery after 1989, they have still not reached even the minimum levels of 1987. The declining trend suggests either an over-loan position of banks or a weakening of deposit base. Low deposit base may expose a bank to liquidity risk. The rate of increase in volume of loans financed had been greater than the rate of increase in deposits for all the five banks. This suggests that liquidity risk increases following increasing liberalization.

g. Effect on cost/revenue rate

Reflecting rising interest rates, both the operating cost as well as operating revenue had been on the increase since 1986. However the operating cost/operating revenue rate shows a fluctuating trend for all the five banks (**Figure 7**). Daiichi Kangyo's rate was 91.4% in 1986, fell slightly for the following two years, then rose slightly before it shot up to 96.4% in 1990. Sumitomo's rate was 87.5% in 1985, went up to 91% the following year, fell the next two years

Fig.7 : Cost-Revenue Rate



Source : Kinyu Journal, April 1985—1990 issues

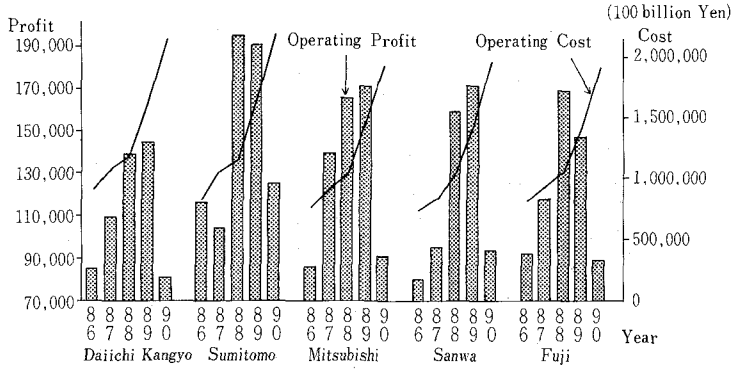
and re-increased to reach its peak in 1990 at 94.6%. Mitsubishi's rate fell in 1986 and 1987 , recovered its initial level in 1988, then jumped to 95.5% in 1990. Sanwa's lowest was at 86% in 1988, afterwhich, this rate rose markedly to 90.6% and 95.5% in 1989 and 1990 respectively. All the five banks showed their peak levels in 1990, that is, when interest on majority of their deposits (66.9%) were market-determined.

Since the main component of operating cost is interest payment, it can be generalised that the fluctuation in rate of operating cost/operating revenue suggests that there have been fluctuations in interest amount paid on deposits. Thus increasing liberalization have caused banks' liability on their free-rate deposits to fluctuate more in line with market rates and that cost had risen faster than revenue.

h. Effect on operating profit and operating cost.

Figure 8 shows the trend in operating profits and operating costs of the five banks since 1986. Operating cost curves showed rising trends with marked increases in the latter years while operating profit curves at first showed generally sharp inclinations in the earlier years but then fell towards '90, reflecting

Fig.8 : Trend in Operating Profit and Cost



Source : Kinyu Journal, April 1985—1990 issues

rising market rates of the period. Daiichi and Fuji Banks highest profits was in 1988, whilst Sumitomo, Mitsubishi and Sanwa Banks peaked in 1989. Operating profits fell sharply for all the five banks in 1990 as a result of rising operating cost from larger interest commitments, adversely affecting operating profit margins.

Since loans were at more or less fixed rates, profit margins were reduced when interest rates began to rise in the latter years as the short-term deposits would have to be renewed at higher market-rate costs. The volatile rates of the open market causes banks' liabilities on such deposits to be affected by its fluctuations, thereby exposing banks more to interest rate risk and resulting in unstability of profit margins. Thus increasing liberalization of rates causes operating cost to rise and operating profit to become instable depending on the influence of market rates. The fluctuating interest in the open market may entail the problem of interest rate risk.

IV. RESULTS

Liberalization has brought about innovations to existing financial instruments and widening choice of available financial assets like CDs, MMCs and large time deposit instruments whose conditions of issuance, threshold limits and maturity periods have been eased over time. From corporation's point of view, the increasing availability of these liquid instruments have widened the scope of financial investments. Because of the low market risk as well as the high flexibility in terms of maturity, these deposit-bearing instruments can function as payment reserves and temporary investments as well as for effective use of excess liquidity. Banks in turn depend on deposits from corporations to carry out lending and other activities.

1. An important consequence of rates liberalization is the narrowing of banks' interest margins. The cost of fund procurement have risen for all banks as a result of intense competition. The following comment by Jenny Corbett illustrates the extent liberalization of interest had made on Japanese banks' margins. "The shift away from controlled interest rates structure has apparently squeezed margins considerably so that the gap between the average cost of funds and the average yield on assets is lower in Japan than in the large competitor countries".[15]

2. Similarly, city banks' interest margin too had been adversely affected. Since deposits form the main source of funds for city banks, the increased cost of obtaining funds have squeezed margins as terms had to be adjusted to market conditions.

3. Liberalization has also resulted in an increased tendency to favour financial instruments with market rates of returns. Interest differentials between those of the higher but more volatile market-related deposits and that of regulated banks deposits have resulted in the outflow of funds from the latter into

free deposits.

4. Financial reforms brought about by liberalization has induced portfolio substitution between bank deposits. By lowering denominations, reforms have effectively expanded an otherwise fixed investment base. For instance, a reduction in the minimum unit of large time deposits and MMCs at market-related rates had increased incentive to shift fund from other types of financial instruments. Thus within the class of deregulated deposits itself, switching of deposits from one interest-bearing account to another occurs in response to interest rate differentials, lowering of threshold limits and extension of maturity periods.

5. Tendency to enlarge deposit base increases as cost of procurement for the deposits increases. The cost of procurement of funds had risen following the increasing share of liberalized deposits over the years.

6. Increasing liberalization has caused a relatively faster rate of increase in volume of loans financed as compared to the rate of growth in deposits. This implies that deposit base of banks have weakened following intense competition and that liquidity risk have risen following increased liberalization. Pressures on margins have forced banks' liquidity to be substantially reduced.

7. Following liberalization of rates, the ratio of operating cost and operating revenue tend to move parallel to market rates, causing unstable fluctuations in operating profits' margins.

8. Fluctuations in rate in the open market in turn tend to expose banks to interest rate risk as seen by the rise in operating cost and inconsistency in profit margins.

V. CONCLUSION

In the latter half of the 1980s, as financial liberalization expand rapidly, banking became more competitive and innovative. With the deregulation of in-

terest rates and financial innovation continuing and interacting, competition for deposits became severe. Liberalization has severely affected profitability in the domestic market as a result of increasing cost of fund procurement and thin margins. In the last six months of fiscal year 1990 the profits of Japan's biggest banks plummeted an average of 4%.[16] The occurrence of retrenchment, consolidation and merges among major banks is a reflection of the margin contractions resulting from liberalization. For example, the merge between Mitsui Bank and Taiyo Kobe Bank, Saitama and Kyowa Bank was a recourse to boost margins in light of competition faced.

Although continued competition would eventually result in the survival of only the best managed banks, to the advantage of savers, it may also eliminate those that are less efficient. A failure of one bank may trigger loss of confidence in the banking system and instability in the whole financial system. Therefore it is inevitable that the monetary authorities still retain some kind of transmission mechanism to maintain monetary control and financial order and that banks on their part should reshape their strategies in response to the new banking environment.

In response to the increased cost of raising funds, banks could enhance their ability to attract funds by taking advantage of their liberalized deposit rates. As it is, retail banking in Japan is already overcrowded. There is one bank for every 2700 of its population[17], resulting in over-capacity and lower profitability. Potential measures that could be taken to defend profitability include: reconsidering organization and market approach, productivity and international diversification and expansion.

Since increased liberalization allows rate to be market-determined, fluctuations in the rates tend to increase bank's potential exposure to interest rate risks and liquidity risks more than under the regulated rates system. This risk would be further aggravated if banks were to rely solely on unstable marketable

funds that are sensitive to interest rate changes. Thus it is advisable for banks to diversify business opportunities like enhancing fee-based business through subsidiaries and securities, foreign exchange business, appropriating commission for non-interest rate related services, and tailoring products more to the needs of different customer segments.

The short-term borrowing and long-term lending interest rate structure directly affect costs as it may cause mismatch in bank's funding. To reduce risk, the practice of offering rates to one that reflects market rates could be adopted so that lending rates would move parallel to deposit rates and thereby ensuring a stable profit margin. As fixed rate lending is vulnerable to interest rate changes, Reid[18] and Kinoshita[19] recommended increase in loans with variable interest. In this way, banks could reduce their interest rate mismatch in their asset-liability position. To minimise liquidity risk, maturity periods of loans and other investments could be considered.

On the deposit side, banks could overcome interest rate risk by flexibly setting the maturities of its deposit instruments. Elimination of maximum-minimum maturity restriction was proposed by Kinoshita[20] so that banks could adjust independently their degree of maturity mismatch to maintain adequate liquidity.

Although continued liberalization of rates would eventually result in bank deposits earning market rates of return and weaken the link of deposit rates to the BOJ's official rate, monetary policy's mechanism could still be transmitted through interest rate effect instead of through credit availability effect.[21] Interest rates in the open markets would instead be used as index of oppotunity cost of spending, portfolio investment and capital expenditure for businesses.[22] For example, rising interest in the open market tend to depress private spending and demand for bank loans by raising the oppotunity cost. From bank's point of view, as interest rates in the open markets rise, it is more profitable to lend in the open market than to customers and as a result less funds would be available

for lending. However the volatility of rates in the open market provides oppotunity for speculative activities which can be destabilising as it may generate sharp deviations from market fundamentals.

Ever since the BOJ began liberalizing rates, almost every aspect of deposit taking and lending have been made competitive. Costs have been substantialty pushed up. Presently, city banks are already paying market-based rates for nearly 70% of their local funding needs[23]. Against this background of greater competition and thinned margins on financial operations, certain banks unscrupulously indulged themselves into speculative development activities and imprudent lending practices, in their desperation to boost margins and to maintain relative market positions.

The fierce unprofitable competition, coupled with recent requirement to meet proper capital adequacy ratios had put city banks in tight positions. To make matters worse, the city banks face serious debt repayment problem in real-estate and industry when stock and property market slumped following uncontrolled lending boom in the 1980s, when costs of funds were very much cheaper. Before 1987, non-realized gains on stock portfolio was high, drawing banks to rush to expand their assets. About 20% to 25% of total city banks' loans were reportedly made to speculative markets[24]. Stock and property prices inflated, often far above their actual earning values. The boom bubble burst following rise in rates because of the resulting negative cash flow from higher costs of funds. With more and more of the development and securities companies suspending interest payments, city banks are now saddled with the problem of bad debt.

Lately, Japanese banks' image has been severely tarnished by a series of scandals due to their involvment in helping to forge certificate of deposits for favoured corporate clients, their commitment to save closely-associated collapsed companies, and by the impact of mounting real-estate-related bad debts.

City banks, in particular, suffer huge losses due to their nature of business in dealing with big corporations.

Administrative regulations, as opposed to full liberalization is therefore essential so as to avoid the destabilizing potential caused by strenous competition. To ensure soundness and stability of the financial markets, importance of capital strength should be stressed and the normal standards of prudential banking strictly adhered to . The aim is to promote a conducive competitive environment so that the financial market function in a way that accurately reflects participants' expectations of interest rates. This is where the BOJ's role come into play to ensure that this aim is materialized.

To facilitate its supervisory function, The BOJ has, since 1988 progressively automize its clearing network system to allow swifter and more direct handling of fund transfers between financial institutions.[25] This new, extensive and interconnected clearing house facility eliminates the past intermediary role of the Bank of Tokyo and the highly automated system makes possible spot settlement and reconciliation of inter-bank transactions. Starting with the clearing of inter-bank current acount transactions, the clearing house has extended its services to include on-line clearing of bond transactions, foreign exchange transfers, sale and purchase of short-term bonds, and most recently, spot settlement of treasury bill transactions. Besides upgrading efficiency of financial survices and reducing voluminous paper-work involved, what is more important to the BOJ is that, this clearing house function provides if a unique oppotunity to oversee movement of funds within the institutions. Financial control becomes more efficient as large and abnormal fluctuations in fund mobility could instantly be detected and probable malpractices be checked. Regulating the banking institutions alone without regulating the speculative markets may defeat the purpose of control as banks may pass on their loans to these markets through securitization of assets.

Thus despite liberalizing certain areas, it is imperative that the BOJ maintains control of the overall financial market as the task of managing and stabilising the financial system lies with the BOJ.

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