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Abstract

Japan has various advantages over many other countries in terms of the capacity to further develop the capital, financial, and foreign exchange markets as a more internationally-competitive financial center. The advantages include the 2nd largest economic size (large market size), ample financial assets (large investor base), presence of many internationally-competitive knowledge-intensive manufacturing firms (large issuer base), good infrastructure, the 2nd largest stock market (large market access), role of the Japanese yen as one of key international currencies, etc. Despite these advantages and a series of reforms implemented since 1997 under the slogan of Japanese version of "Financial Big Bang", Japan has not been able to foster an internationally-competitive international financial center until today. The gaps with the United States and United Kingdom have expanded further over the past decade. This paper gives a detailed analysis over the present state of Japan's capital, financial, and foreign exchange markets to highlight where Japanese advantages and challenges lie, as compared with the United Kingdom and the United States. It also provides a clear picture of Japan's position in Asia (Korea, Singapore, Hong Kong, and mainland China). It also reviews recent Government's vision and actions.

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[1] The original draft of this paper was presented at the 4th APEC International Finance Conference to Commemorate the 13th Summit Meeting in Busan, Korea in November 2008.

1. INTRODUCTION

Japan has various advantages over many other countries in terms of the capacity to further develop the capital, financial, and foreign exchange markets as a more internationally-competitive financial center. The advantages include the 2nd largest economic size (large market size), ample financial assets (large investor base), presence of many internationally-competitive knowledge-intensive manufacturing firms (large issuer base), good infrastructure, the 2nd largest stock market (market access), role of the Japanese yen as one of key international currencies, etc.

Despite these advantages and a series of reforms implemented since 1997 under the slogan of Japanese version of "Financial Big Bang", Japan has not been able to foster an internationally-competitive international financial center until today. Factors—such as continuation of regulatory restrictions, high living and utility costs, high corporate taxation, and limited variety of financial product—have deterred Japan from making use of all the afore-mentioned advantages. Even though the capital market is large, the market mainly serves domestic firms and institutional investors. There is also a sense of resistance to accept a large number of asset management firms, hedge funds, and other investors from abroad. As a result, many foreign institutions have established their regional offices in Singapore and Hong Kong to engage in financial businesses targeting the Asian region. The gaps with the United States and United Kingdom, thus, have expanded further over the past decade.

This paper analyzes the present state of Japan's capital, financial and foreign exchange markets to examine whether Japan functions as a vibrant international financial center. It also reviews recent government's vision and actions. The paper consists of three sections. Section II briefly reviews Japan's advantages and ranking of its financial center, based on the *Global Financial Center Index* compiled by City of London. Section III provides a detailed analysis of Japan's stock markets, bond markets, banking sector, and foreign exchange markets, as compared with major financially-active countries. Some comparisons between *Tokyo Stock Exchange* and *Osaka Securities Exchange* are also conducted. Section IV takes an overview of Japan's advantages with respect to the capital, financial, and foreign exchange markets in the Asian region (Korea, Singapore, Hong Kong, and mainland China). Also, it focuses on the Government vision and recent actions regarding the measures to achieve an internationally-competitive financial center.

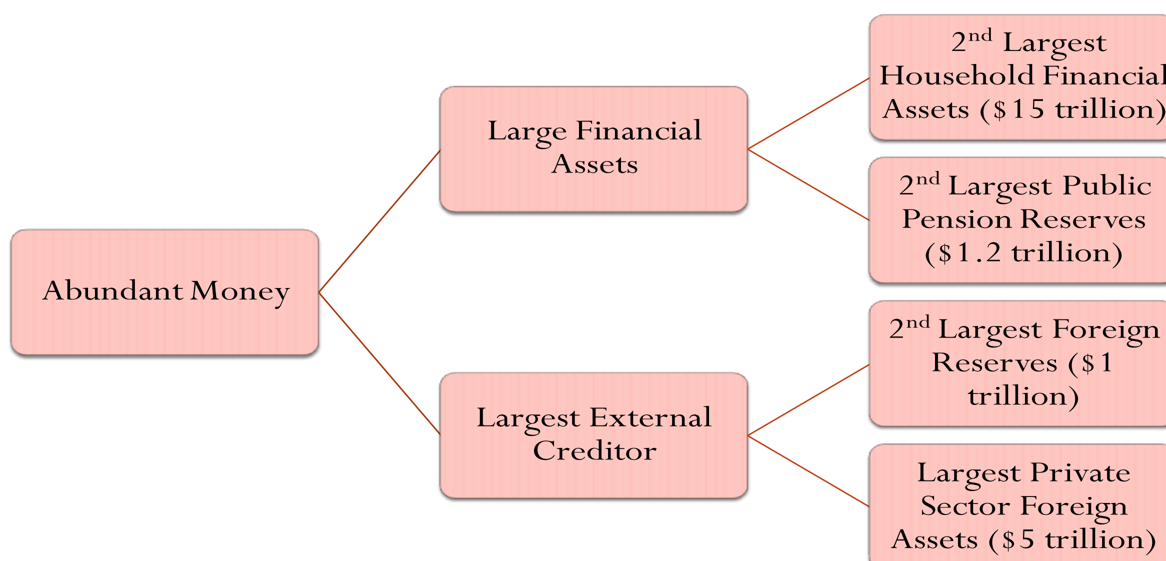
II. JAPAN'S ADVANTAGES AND GLOBAL FINANCIAL CENTER INDEX RANKING

The Japanese economy has several advantages of becoming an internationally-competitive international financial center in the world. The Japanese economic size has been US$4.4 trillion equivalent GDP in 2007, the 2nd largest in the world. Reflecting the large economic size, the amount of total assets held by resident financial intermediaries has been large, amounting to US$25 trillion at end-2007 (of which, US$13 trillion was held by deposit taking institutions, US$4 trillion by pension funds and insurance firms, and US$7 trillion by other financial institutions). The sheer size of financial assets reflects (1) the large household financial assets of $15 trillion (2nd largest after US household financial assets of $41 trillion)

and (2) the large national pension reserve funds of $1.2 trillion (2nd largest after US Social Security Trust Fund of $2 trillion), as seen in Chart 1.

Moreover, Japan has been the largest external creditor in the world, while US has been the largest external debtor. Its net asset—the difference between foreign assets of about $6.1 trillion and foreign liabilities of $3.6 trillion—recorded about $2.5 trillion at end-2007. Foreign assets included foreign reserves of about $1 trillion, the second largest after mainland China. However, the amount of foreign reserves accounted for only 18% of Japan's total external assets, suggesting that the private sector remains the main source of foreign investment activities. The amount of foreign assets held by the private sector recorded $5 trillion (see Chart 1). This is contrasted with mainland China, whose foreign reserves accounted for 67% of total foreign assets; and thus, the public sector is the main source of foreign investment activities (see Chart 2). Korea's position lies between Japan and China. Nearly a half of Korean foreign assets are accumulated in the form of foreign reserves, but outward FDI and equity investment are also active. Compared with other Asian countries, Hong Kong has been an active investor of outward FDI, accounting for 38% of total foreign assets. About 47% and 40% of outward FDI are invested in British Virgin Islands (tax heaven regions) and mainland China, respectively. About 75% of outward FDI takes the form of establishing investment holding companies overseas. Singapore's foreign assets are concentrated on loans and deposits, reflecting active cross-border banking activities.

Chart 1. Financial-Side Advantages of Japan (2007)



Source: Prepared by the author based on Flow of Funds data.

Chart 2. The Composition of Foreign Assets by Japan and Major Countries (2007)

	US	Japan	China	Hong Kong	Korea	Singapore
FDI	**19%**	**10%**	**5%**	**38%**	**11%**	**19%**
Equity	**29%**	**11%**	**1%**	**19%**	**18%**	**14%**
Financial Derivatives	**13%**	**1%**	**--**	**2%**	**--**	**--**
Debt Securities	**11%**	**36%**	**10%**	**10%**	**9%**	**9%**
Loan&Deposits	**24%**	**24%**	**18%**	**26%**	**17%**	**40%**
Foreign Reserves	**2%**	**18%**	**67%**	**6%**	**45%**	**18%**
Total	100%	100%	100%	100%	100%	100%

Source: Prepared by the author based on Balance of Payments Statistics, IMF.

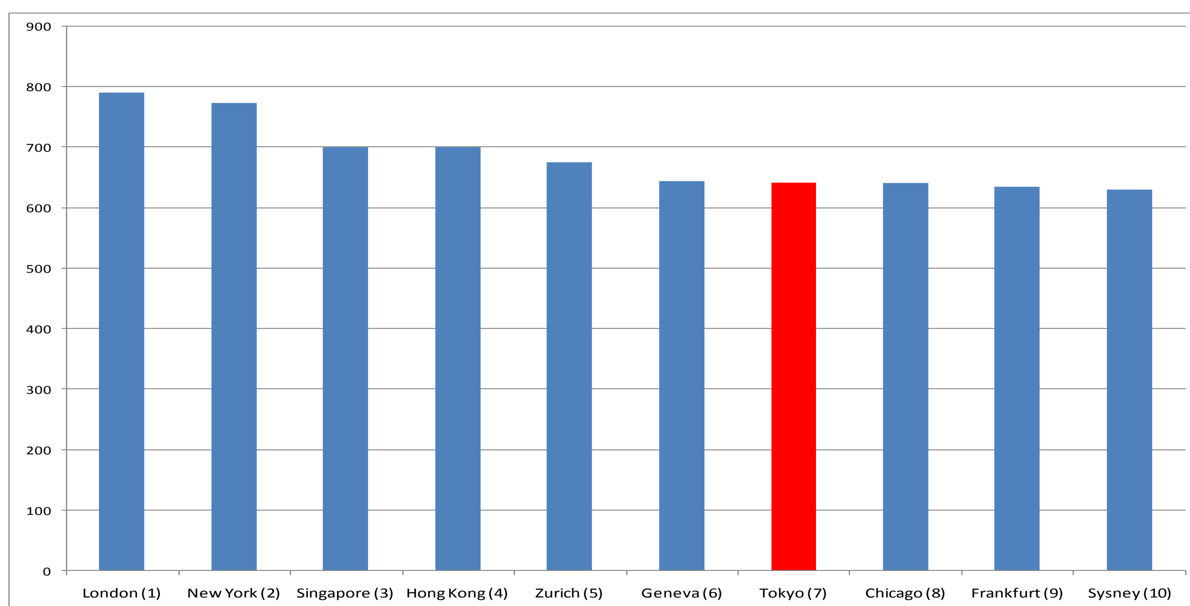
In spite to the afore-mentioned advantages, however, Japan's financial and capital markets have not realized their full potential until today. This is so in terms of providing diverse, innovative financial products and services at reasonable cost, giving domestic and foreign entities greater access to diverse sources of finance, and creating an active and self-disciplinary environment for the wholesale market. By contrast, the Hong Kong and Singapore financial and capital markets have increased their presence as regional international financial centers in Asia, notwithstanding their small economic and financial asset sizes.

This trend is confirmed by the rankings based on the *Global Financial Center Index*, developed by City of London. In September 2008, London and New York were rated the 1st and 2nd international financial centers in the world, based on a number of existing indicators and regular surveys of senor professional working in relevant financial sectors. Tokyo was rated only the 7th, getting far behind Singapore (3rd) and Hong Kong (4th). London continues to take the lead in the areas of banking, asset management, insurances, and professional services, notwithstanding that the Northern Rock crisis has undermined its reputation over the regulatory oversight capacity of Financial Services Authority (FSA) and its principle-based supervisory approach. London also remains in a top place in terms of people (quality and availability of professionals), business environment (lax regulations and low taxes), market access (cluster of professional advisors and good access to international markets), infrastructure (good transportation link and airport access), and general competitiveness (reputation and efficient marketing). New York has expanded its gap over London since the subprime loan crisis resulted in the failure of *Bear Stearns* in March 2008. Nonetheless, its financial center remains nearly comparable to that of London (see Chart 3).

The report published by City of London (2008) evaluates that the Japanese economy continued to perform well, and Tokyo has the second highest stock market capitalization in the world (indicating a high degree of market access), as Japan's main strengths. It also indicates that these two features offset long-term regulatory difficulties and poor access to international financial personnel (shortage of English-speaking financial professionals). To improve the rankings, nonetheless, Japan needs to increase the quality and variety of professional services and availability of people, for example, by re-examining the quality of

business schools, promoting the use of globally-acknowledged examinations such as CPA (Charted Financial Analyst, an international professional certificate for financial analysts), and attracting foreign skilled-workers and financial institutions. It also needs to transform business environment more market-friendly (further deregulation over firewalls among commercial banking, securities firms and insurance firms, a cut in high corporate taxes, etc.). For example, Japan's effective (central and local government) corporate tax currently reaches 40.7%. This rate is comparable to that of California in the United States (40.7%), but much higher than France (33.33%), Germany (29.83%), the United Kingdom (28%), Singapore (18%), Hong Kong (16.5%), mainland China (25%), and Seoul in Korea (27.5%). There is a growing global trend towards cutting corporate taxes (and partially offsetting by increases in the value added taxes or consumption taxes) in the face of fierce competition among firms. Accordingly the Government announced a medium-term tax reform plan on December 16, 2008, which included a possible cut in the effective corporate tax in the foreseeable future (together with an increase in the consumption tax starting in 2011 under the condition of realizing favorable economic growth performance, followed by step-by-step increases by 2015).

Chart 3. Global Financial Center Index (September 2008)



Note: The theoretical maximum index ranking is 1000.

Source: City of London (2008).

III. FEATURES OF JAPAN'S CAPITAL, FINANCIAL AND FOREIGN EXCHANGE MARKETS

3.1. Stock Market Performance

Existence of Multiple Stock Exchanges

There are 6 stock exchanges in Japan: *Tokyo, Osaka, Nagoya, Fukuoka, Sapporo* and *JASDAQ* (by the order of the size of market capitalization). In particular, Tokyo and Osaka stock exchanges stand out as the largest and most active exchanges in Japan. Tokyo Stock Exchange is the largest stock exchange. Its

operating revenues and current profits amounted to ¥75.5 billion and ¥33 billion, respectively in FY2007 (ending March 2008). Osaka Securities Exchange is the 2nd largest stock exchange with its operating revenues and current profits recording ¥18.7 billion and ¥10 billion, respectively.

The history of Tokyo Stock Exchange is traced back to 1878. The Osaka Securities Exchange has even a longer history, whose origin stems from *Edo Period*, when the exchange for rice and crops was established in Osaka as a center of the economy. In those days, each prefecture set up its own warehouses in Osaka for shipping and preservation of their rice and sold them to merchants. In 1716, a market similar to futures transactions was introduced in Osaka. During the WWII, the *Securities Exchange Law* was enacted to reorganize all the stock exchanges as a war-time controlled institution in 1943; subsequently, the then existing 11 stock exchanges were unified into the Japan Securities Exchange as a semi-public corporation (and dissolved in 1947). While the exchanges were difficult to re-open officially during the period of occupation under the Supreme Commander of Allied Powers (SCAP), a trading began as unofficial group transactions at end-1945. Following the *Securities and Exchange Law* of 1947 and a subsequent revision of 1948, stock exchanges in Tokyo, Osaka and Nagoya were introduced in 1949. Five additional stock exchanges were established later in Kyoto, Kobe (dissolved in 1967), Hiroshima, Fukuoka, and Niigata. The Sapporo Securities Exchange was established in 1950. Thus, a large number of stock exchanges operated in Japan before 2000. In 2000, this trend turned and Hiroshima and Niigata Stock Exchanges were merged into Tokyo Stock Exchange. In 2001, Kyoto Stock Exchange was absorbed into Osaka Securities Exchange.

JASDAQ Securities Exchange joined as the 6th stock exchange, as the largest market for venture capital firms and small- and medium-enterprises in 2004. JASDAQ market was established in 1963 and was reborn as a stock trading market for small and medium venture firms in 1983. Since then, the number of issues and trading volume grew rapidly. JASDAQ market was reorganized as JASDAQ Securities Exchange in 2004, after transforming from an over-the-counter market to a securities exchange. Top-listed companies include *Yahoo Japan Corporation*, *Rakuten* (portal, media, internet company), *Jupiter Telecommunications* (J:COM), and *McDonald's Holdings Japan*.

In April 2008, the *Japan Securities Dealers Association*, which holds a large stake in JASDAQ (73% of outstanding stocks), announced its intention to sell its majority stake to Osaka Securities Exchange in order to revamp the struggling *Hercules* market, market for venture capital firms operating in Osaka Securities Exchange. The start-up markets in Osaka and other stock exchanges have been suffering from a decline in investment by investors after experiencing a series of scandals involving listed firms. In particular, the stock prices in both Hercules and *Mothers* markets (Mothers is the market for venture capital firms operating in Tokyo Stock Exchange) plunged sharply since January 2006, when prosecutors raided *Livedoor*, a famous internet firm, in a fraud investigation. The decision of the Japan Securities Dealers Association to sell the JASDAQ stocks also reflects the recognition that the merger or realignment

of stock markets is a growing world trend in face of fierce competitions among stock exchanges. Moreover, the Association decided to sell its stake because of a potential conflict of interest as an industry regulator. The rest of JASDAQ stocks are held by about 130 Japanese brokerages individually. Osaka Securities Exchange resolved that it would purchase common shares of JASDAQ by Tender Offer Bid (TOB) at the Board of directors' meeting on November 18, 2008 (tender period from November 19 to December 17) with the purchase price of ¥7,000 per share and the minimum number of shares planned to be purchased of 500,001 (thus, aggregate purchase price of ¥3.5 billion). In December 18, Osaka Securities Exchange announced that its TOB to purchase stocks of JASDAQ was successfully concluded with the total purchase value of ¥5.3 billion and acquisition of 76% of outstanding stocks. The stocks sold by Japan Securities Dealers Association reached 50.1% of total outstanding stocks (22.5% remains to be held by the Association). Osaka Securities Exchange purchased 26% of stocks from various securities firms. Accordingly, JASDAQ became its subsidiary on December 25, and will become a whole subsidiary by around September 2009 (after the agreed sales of 22.5% of stocks by the Japan Securities Dealers Association). Osaka Securities Exchange also expressed an intension to merge JASDAQ with Hercules market after 2010, as well as a plan to examine the possibility to cut fees charged on securities firms sometime in 2009.

Listing Requirement and Cost

Tokyo Stock Exchange and Osaka Securities Exchange became joint-stock companies in 2001. Nagoya Stock Exchange became a joint stock company in 2002. Osaka Securities Exchange lists its own stocks on its venture capital market, *Hercules*. Tokyo Stock Exchange consists of three separate sections (1st Section, 2nd Section, and *Mothers*). The 1st Section serves large "blue chips"-type (large and successful) firms, while the 2nd Section is open for smaller firms with lower trading volumes. Mothers was established in November 1999 as a venture capital market for high-growth and emerging venture firms in order to provide them with funds at an early stage of development and simultaneously provide investors with diversified products.

The listing requirement for the 1st Section is tougher than that for the 2nd Section. For example, firms applying for listing at Tokyo Stock Exchange are generally required to (1) have shareholders of more than 800 people (2,200 in the case of the 1st Section) at the time of listing, (2) achieve the number of floating stock units exceeding 4,000 units (20,000 units) and market capitalization exceeding ¥2 billion (¥50 billion) expected at the time of listing, (3) record the net consolidated assets of over ¥ 1 billion at the end of accounting year just before listing, (4) meet the profit requirement, etc. The profit requirement can be chosen from the following three options: (a) positive profits over the recent 2 years with over ¥100 million in the first year and over ¥400 million in the second year, (b) positive profits over the recent 3 years with over ¥100 million in the first year, ¥400 million in the recent year, and ¥600 million as a total, and (c) market capitalization of over ¥100 billion. The requirement for Mothers is lighter than those of the 1st and 2nd Sections. The numbers of shareholders and floating stock units should be more than 300 and 2,000,

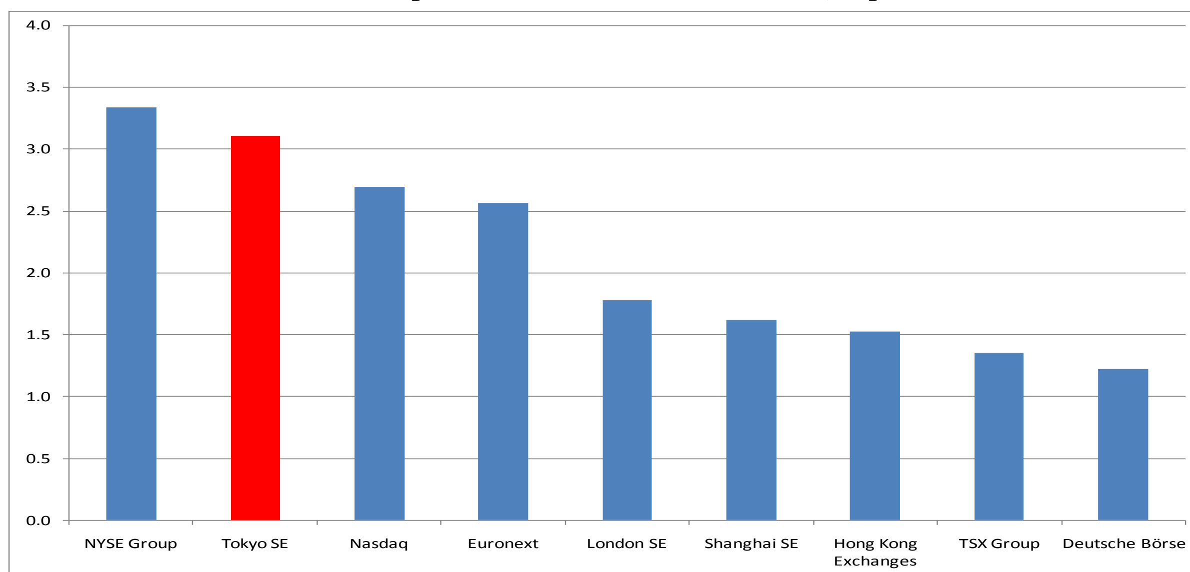
respectively; market capitalization should exceed ¥1 billion; and no requirements are imposed on net consolidated assets and profits. The cost of examination required at the time of application is ¥4 million in the 1st and 2nd Sections, but ¥2 million in Mothers. Osaka Securities Exchange also consists of similar three separate sections (1st Section, 2nd Section, and Hercules). The listing requirement for the 1st Section of Osaka Securities Exchanges is the same as that of Tokyo Stock Exchange. The listing requirement for the 2nd Section of the Osaka Securities Exchange is less stringent than that of Tokyo Stock Exchange.

Following the *Act Concerning Book-Entry Transfer of Corporate Bonds, Stocks and Other Securities* enacted in 2004, Japan implemented a paperless share trading system in January 2009. Accordingly, brokerages began to accept deposits of the stock certificates and converting them into paperless stocks from 2008. The stock certificates will not longer be printed or usable after June 2009.

Sizes of Stock Market Capitalization

Prior to the current global financial crisis, the stock market capitalization of Tokyo Stock Exchange amounted to $4.7 trillion in June 2007. It accounted for 7.5% of world stock market capitalization and the 2nd largest after New York Stock Exchange Group of $16.6 trillion (29% of world stock market capitalization). Since the crisis, Tokyo Stock Exchange reduced its market capitalization sharply from $4.7 trillion in June 2007 to $3.3 trillion in September 2008, while that of the New York Stock Exchange Group also dropped from $16.6 trillion to $13 trillion over the same period (Chart 4). Since almost all stock exchanges in the world have faced similar dramatic plunges in stock prices, the shares of Tokyo and New York Stock Exchange Group actually rose from 7.5% to 7.8% and from 29% to 30.5%, respectively, over the same period. Osaka Securities Exchange is the second largest exchange in Japan, but its size of market capitalization amounted to only $192 billion in June 2007 (only 0.37% of global market capitalization) after removing firms that are dually listed at Tokyo Stock Exchange. The stock market capitalization declined to $154 billion in September 2008 (0.36%).

Chart 4. Market Capitalization (Trillions of US dollars, September 2008)



Source: Prepared by the author based on World Federation of Exchanges.

There are 2,391 listed firms on the Tokyo Stock Exchange (1,714 firms on the 1st Section, 462 on the 2nd Section, 195 firms on Mothers, and 20 foreign firms) as of September 2008. There are 1,039 listed firms on Osaka Securities Exchange (625 firms on the 1st Section, 243 firms on the 2nd Section, and 171 on Hercules). But many firms are also listed on Tokyo Stock Exchange. Excluding those dual-listed firms, there are only 474 firms on Osaka Securities Exchange (473 domestic firms and 1 foreign firm). Accordingly, the size of market capitalization becomes much smaller once dual listed firms are excluded. Market capitalization including dual listed firms amounted to over ¥3 trillion in 2007, but resulted in only ¥192 billion after excluding them. For those dual-listed firms, Tokyo Stock Exchange generally functions as the main exchange, where most of transactions of stocks take place. Some firms choose to dual-list their shares in order to raise reputation and maintain close relationships with business partners in local areas.

Tokyo Stock Exchange dominates the Japanese stock market in terms of the number of listed firms and stock trading. The value of stock trading amounted to $546 billion in June 2007, far beyond the value of $16.9 billion at Osaka Securities Exchange. The values of stock trading in Tokyo and Osaka stock exchanges dropped to $450 billion and to $16.7 billion, respectively, in September 2008.

Limited Presence of Foreign Issuers

The paucity of foreign firms as listed firms in Tokyo Stock Exchange (foreign firms accounting for less than 1% of total listed firms) is contrasted with New York Stock Exchange Group and London Stock Exchange, where the numbers of foreign listed firms are 416 firms (17%) and 701 firms (22%), respectively. Tokyo Stock Exchange introduced the section for foreign stocks in 1973. The number of foreign listed firms reached its peak of 127 in 1991, but has shown a declining tendency during the lost decade (1991-2002). Over the recent year, the number of foreign listed firms dropped further from 25 in

January 2008 to 21 in September 2008, due to the delisting of Barclays (UK), Boeing (US), M-Asia (Bermuda), and British Petroleum (UK).

In December 2008, moreover, Bayer (Germany), Societe General (France), Alcatel-Lucent (France), Toronto-Dominion (Canada), and Merrill Lynch (US as part of steps to merge with Bank of America) delisted their stocks from Tokyo Stock Exchange. As a result, the number of foreign listed firms dropped to 16—the lowest number since 1985—notwithstanding the efforts of Tokyo Stock Exchange to attract foreign firms. The high cost of listing (e.g., requirement of information disclosure in Japanese and different accounting standards adopted in Japan) and the greater access to foreign stocks listed in foreign exchanges through internet channels reduced an incentive for foreign firms to list their stocks on Tokyo Stock Exchange.

Large Stock Holdings by Foreign Investors

While there are a limited number of foreign listed firms, what is remarkable is that foreign (non-resident) investors have increasingly played an important role in activating stock transactions in Japan. The share of stocks listed on the five stock exchanges (excluding JASDAQ) and held by foreign investors rose from 4.7% in 1990 to 18.8% in 2000, and to 27.6% in 2007. While non-bank firms and Japanese banks reduced their mutual share holdings in the process of improving their balance sheets during the lost decade, foreign investors took this opportunity to increase investment in Japanese stocks. Foreign investors also play a key role as active participants in the daily market transactions. Foreign investors accounted for 65% of annual stock transaction value in 2007, rising rapidly from 25% in 1991. Between 2000 and 2006, the monthly average volume of shares traded in the Tokyo Stock Exchange increased 2.6 times for domestic investors, but that of foreign investors expanded even further by a scale of 3.85 times. Over the same period, the monthly average turnover value (valued in yen) grew 3.4 times for foreign investors, while that for domestic investors expanded 2.4 times (IMF 2007).

The investment in Japanese stocks from abroad—difference between newly purchased Japanese stocks and sales of already-held Japanese stocks—amounted to a surplus of ¥14 trillion in 2005 and ¥10 trillion in 2006. The net inflows of inward stock investment contributed to raising the stock prices in Japan. Since the crisis, it dropped to ¥5 trillion in 2007 but still managed to maintain a surplus in 2007. However, it turned into a deficit of ¥5.4 trillion during January-October 2008 as a result of large-scale sales of already-held Japanese stocks (mainly by investors from the United States, United Kingdom, France, and Hong Kong).

Increasing the Variety of Listed Products

The types of financial assets listed on the Tokyo Stock Exchange are limited, as compared with main foreign exchanges. Regarding ETFs, for example, as of September 2008, there were only 56 ETFs (exchange-traded funds) listed on the Tokyo Stock Exchange. The number is much smaller than those of

New York Stock Exchange Group (399) and London Stock Exchange (391). ETFs are investment vehicles or investment trusts listed on exchanges. ETFs hold assets (such as stocks) and trade at approximately the same price as the net asset values of these underlying assets. ETFs are popular because of their low costs and stock-like features. Since the ETF market was introduced in 2001 in Japan, all ETFs were related only to stock indices (such as *TOPIX* and *NIKKEI*). TOPIX (Tokyo Stock Price Index) is a widely-known key benchmark index, which is calculated and published by Tokyo Stock Exchange, based on 1,725 Japanese common stocks listed on its 1st Section. NIKKEI is the most important benchmark index representing the Japanese stock market and calculated based on 225 top-rated Japanese firms listed on the 1st Section of Tokyo Stock Exchange. NIKKEI used to be compiled and announced by Tokyo Stock Exchange, but this service was taken over by Nikkei Inc. (NIKKEI News Paper publisher) in 1970.

Thanks to the efforts to diversify ETFs, however, Tokyo Stock Exchange now covers a wider range of ETFs, including gold (listed in June 2008), Korean KOSPI 200 (November 2007), Chinese CSI 300 (April 2008), Brazilian BOVESPA index (July 2008), Tokyo Stock Exchange REIT Index (September 2008), and Goldman Sachs Commodity Index (October 2008). Tokyo Stock Exchange plans to increase the number of ETFs to 100 by 2010—three times as large as that of 2007. Similarly, Osaka Securities Exchange increased the number of ETFs from 2 in 2007 to 10 in September 2008. The types of ETFs are diverse, including NIKKEI, Shanghai Stock Exchange Index 50, African Top 40, Brazilian Real, Indian Rupee, Russian Rouble, and Russian RTS. Osaka Securities Exchange was the first mover in terms of introducing a gold-related ETF in August 2007.

The REITs (real estate investment trusts) were introduced to Japan in 2001. Since then the Tokyo Stock Exchange listed 41 REITs, while JASDAQ listed one REIT. REITs are pools of investors' money collected by investment corporations or fund managers for the purpose of investing in real estate property, whose rents and proceeds from sales are returned to the investors in the form of dividends. REITs enabled small investors to invest in real estate with a relatively small amount of capital. The market capitalization of REITs (including one listed on JASDAQ) amounted to over $40 billion in June 2007. The REITs market has been developed more deeply in US due to its long history begun since 1960. The number of REITs in the United States is more than 200 and the amount of equity market capitalization exceeded $300 billion. Both corporate-style REITs (where investment corporations issue investment certificates) and contract-style REITs (where issues take the form of beneficiary certificates) can be listed on Tokyo Stock Exchange. Since the current crisis deepened, the REIT market became sluggish in Japan. Between June 2007 and October 2008, Tokyo Stock Exchange REIT index and market capitalization have plunged sharply from 2,400 to about 700 and from over $40 billion to $23 billion, respectively. This reflects investors' growing concern over an increasing number of bankruptcy by real estate firms and a shut down of the fist listed REIT by *New City Residence Investment Corp.*, a real estate investment trust fund (which filed for protection from creditors under the *Civil Rehabilitation Law*, as a result of the inability to repay its debts) in October 2008, followed by its subsequent delisting by Tokyo Stock Exchange in the following

month.

Derivatives Trading

Although Tokyo Stock Exchange dominates stock trading (accounting for nearly 90% of turnover) in Japan, Osaka Securities Exchange has comparative advantages over derivatives trading, including trade in NIKKEI 225 futures. The number of options and futures contracts traded in 2007 recorded 109 million contracts in Osaka Securities Exchange, far exceeding that of Tokyo Stock Exchange (33 million). According to the Financial Results reported by Osaka Securities Exchange for FY 2007 (ending March 2008), it achieved 93.5 million contracts with the value of ¥597 trillion in its futures market, while there were only 17 million contracts with the value of ¥266 trillion at Tokyo Stock Exchange. Also, Osaka Securities Exchange recorded 30 million options contracts traded, while Tokyo Stock Exchange resulted in only 140,000 contracts.

Osaka Securities Exchange's listing covers futures products (NIKKEI 225 futures, NIKKEI 225 mini, NIKKEI 300 futures, and Russell Nomura prime index futures), options products (NIKKEI 225 options and NIKKEI 300 options), and securities options products. Particularly, NIKKEI 225 mini futures are most actively transacted. NIKKEI 225 mini was introduced in 2006 for individual investors by cutting the trading value by 1/10 of the NIKKEI 225 futures. Meanwhile, Tokyo Stock Exchange lists futures (TOPIX futures, mini-TOPIX futures, TOPIX Core30 futures, Tokyo Stock Exchange REIT futures, TOPIX Electric Appliances Index futures, TOPIX banks index futures, TOPIX transportation equipment index futures, JGB futures) and options (TOPIX options, individual options, and options on JGB futures). The mini TOPIX futures, TOPIX Core30 futures, and Tokyo Stock Exchange REIT futures were introduced in June 2008. JGBs stand for treasury bonds issued by the Central Government (see more details in Section 3.2).

Osaka Securities Exchange takes various initiatives to further develop the markets for futures and options. From January 2008, for example, NIKKEI 225 futures, NIKKEI 225 mini contracts, and all equity options became available to be traded in single units in non-auction J-net trading of Osaka Securities Exchange. While previous non-auction trading permitted trade sizes of 100 or more contracts only, the new move improved the usability for market participants. In September 2008, it also modified the rules for listing of strike prices for NIKKEI 225 Options by allowing (1) an introduction of long-term contracts with maximum duration of 5 years (from the current maximum duration of 15 months), (2) a listing of all strike prices for the nearest 3 contract months at ¥250 intervals, (3) a narrowing of minimum price fluctuation (when a price is ¥20 or less, the minimum price fluctuation was narrowed to ¥1), from the current rule of minimum price fluctuation (for a contract priced from ¥10 to less than ¥20, being ¥5).

Osaka Securities Exchange also launched at listing and trading covered warrants, as a fist stock exchange in Japan. A covered warrant is an option issued by a third party. The warrants can be issued on any number

of underlying securities, including single equities, a basket of shares, or even a market index. The issuer of the warrant hedges their position using derivatives (e.g., traded options) and underlying shares. Listed covered warrants are widely traded on major European and Asian exchanges Underlying is expected to cover Japanese listed stocks, ETFs, REITs and major Japanese/foreign financial indexes. First nominated issuers, Deutsche Bank, Goldman Sachs and Societe Generale, placed first 48 issues successfully in September 2008.

In 2009, Tokyo Stock Exchange will introduced Tdex+, a new trading system based on LIFFE CONNECT and AEMS (Atos Euronext Market Solutions) technology and services for its options trading market. LIFFE Connect is the advanced electronic trading system adopted by LIFFE (New York Stock Exchange Euronext subsidiary and largest derivatives exchange in terms of trading value). Meanwhile, Tokyo Stock Exchange undermined its reputation over derivatives trading system as a result of a series of system failure in 2008. In February 2008, the derivatives trading system failed to correctly process order executions, making further processing of the contracts impossible (the system problems occurred in March was related to the failure to properly process the registration of basket orders from the stocks of Alps Electric and Nagoya Railroad). In July 2008, the system of derivatives trading system failed again.

Nonetheless, the volume of futures and options at both exchanges remain small, once compared with world exchanges. According to the annual report on global trading volume of futures and options published by *Futures Industry Association*, *CME Group* (that holds Chicago Mercantile Exchange and Chicago Board of Trade as subsidiaries) recorded the largest 2,804 million contracts in 2007, based on the number of contracts traded on derivatives exchanges worldwide. Thanks to the merger performed in July 2007, the volume of CME Group rose by 27% in 2007, leaving *Korea Exchange* behind as the 2nd largest marketplace (2,709 million contracts). The report describes this phenomenon as remarkable since it seemed like no exchange would ever be able to catch up Korea Exchange that had a huge lead over other exchanges up until a few years ago. CME Group manages popular derivatives, such as Eurodollar futures, E-mini S&P 500 futures, and 10-year Treasury Note futures. While the size of stock market capitalization mounts to only 20% of that of Tokyo Stock Exchange, nonetheless, Korea Exchange became the leading options trading place in the world. This happened after opening its futures market in 1996 by introducing KOSPI 200 futures—followed by an establishment of KOSPI 200 Options Market in 1997 and government bond futures and US dollar futures markets in 1999. KOSPI 200 options remain the largest exchange-traded derivatives in the world, recording 2,643 million contracts traded and exceeding the volume of the 2nd largest Eurodollar futures managed by CME Group (621 million contracts) in 2007. Osaka Securities Exchange is ranked only the 22nd (109 million contracts), although it had a lead over other Japanese exchanges—such as Tokyo Commodity Exchange (30th with 47 million contracts), Tokyo Financial Exchange (33th with 42 million contracts), and Tokyo Stock Exchange (36th with 33 million contracts).

New Market for Professional Investors

In early 2009, Tokyo Stock Exchange plans to establish a new market for Japanese and Asian smaller, growing companies with the main focus on Japanese and foreign professional investors, in close collaboration with London Stock Exchange. The new market envisages a market similar to successful *Alternative Investment Market (AIM)* in London Stock Exchange. The new market will be a joint venture in which the London Stock Exchange functions as an equal partner. In July 2008, these two stock exchanges published an outline framework for their new Tokyo-based market for growing companies. The new market plan is in line with the revised *Financial Instruments and Exchange Act* passed in June 2008, which enables the establishment of Exchange-regulated markets. Like AIM, the new proposed market is expected to be managed under a regulatory framework specifically designed to suit the needs of smaller, growing companies, where Nominated Advisers (Nomads) play an important role in assisting issuers with meeting their obligations as public companies. In July 2008, Tokyo Stock Exchange announced that it would accept listed firms to adopt international accounting standards and conduct information disclosure in English.

Growing Cooperation with Foreign Stock Exchanges and Domestic Commodity Exchanges

There are growing mergers and linkages among foreign stock exchanges, as exemplified by a merger between New York Stock Exchange and Euronext, as well as a purchase of the New York-based International Securities Exchange by Deutsche Boerse (operator of the Frankfurt stock exchange) in 2007. In response, Tokyo Stock Exchange Group has begun to make efforts to enhance cooperation with foreign stock exchanges. It signed a Memorandum of Understanding (MOU) with the Abu Dhabi Securities Market (the largest exchange in UAE in terms of listed firms and established in 2000) in January 2008. Under the MOU, both exchanged agreed to increase collaboration on cross-border investment in areas of development and listing of financial products. In April 2008, in addition, the first ETF based on TOPIX was listed in the United States on New York Stock Exchange ARCA, the largest ETF market in the world. This new ETF was developed and managed by Northern Trust Global Investment (a large investment subsidiary of Chicago-based Northern Trust Corp.). It is now traded in US dollars under the name NETS™ TOPIX Index Fund (Japan).

Moreover, Tokyo Stock Exchange Group and Mongolian Stock Exchange (100% owned by the Government) signed a MOU in May 2008. Another MOU was signed in July 2008 between Tokyo Stock Exchange Group and Wiener Borse AG (the company founded in 1771, operating the Vienna Stock Exchange) in order to promote collaboration in the areas of ETFs. In October 2008, a MOU was also signed between Tokyo Stock Exchange Group and Markit Group in order to improve innovation solutions for the market place in Tokyo and examine the feasibilities of potential business alliances. Markit Group is a financial information services company, which was founded in 2001 as the first independent source of credit derivative pricing. Markit data, valuations and trade-processing services are now regarded as the market standard in the world financial markets. It also has access to a valuable dataset covering credit,

stocks, OTC derivative universe, etc..

Stimulated by the successful merger by Chicago Board of Trade and Chicago Mercantile Exchange in 2007, Tokyo Stock Exchange is in view of the need to expand collaboration with commodity exchanges as well (see also Section IV for further discussions). Accordingly, Tokyo Stock Exchange Group and Tokyo Commodity Exchange signed a MOU in January 2008 on comprehensive cooperation. Based on the MOU, they have been discussing the possibility of cooperation over listing ETFs related to commodities and commodity indices on Tokyo Stock Exchange, while listing underlying commodities and commodity indices on the Tokyo Commodity Exchange.

3.2. Bond Market Performance

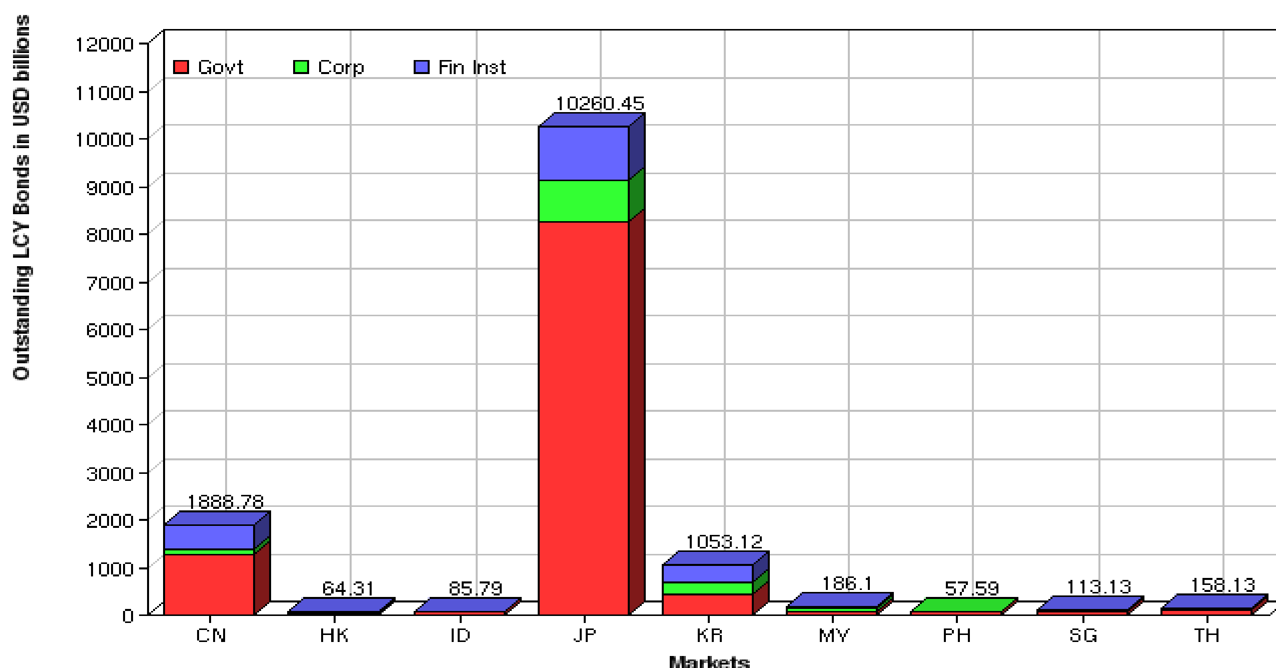
Dominant Government Bond Markets

Japanese General Government Bonds amounted to about $8.2 trillion, largest in Asia, as of March 2008 (Chart 5). They comprise of *Central Government Bonds (Japanese Government Bonds [JGBs]*) of about $6.8 trillion and *Local Governments Bonds* of about $1.4 trillion. JGBs are further decomposed into *General Bonds* of $4.5 trillion, *Fiscal Loan Fund Special Account Bonds (FILP Bonds)* of $1.4 trillion, and others. FILP bonds are regarded as JGBs since they have the same merchantability as General Bonds; and, both General Bonds and FILP bonds are issued together. There is no difference between them from the standpoint of financial products. The maximum issuance of General Bonds and FILP Bonds is determined by Diet resolution in each fiscal year. The difference lies in the sources to finance debt services. As for General Bonds, the proceeds from the issuance are used for general account disbursements (together with taxes and other revenue sources) and their debt services are financed by the general account budget. On the other hand, the proceeds of FILP bonds are allocated as FILP loans; and, debt services are covered through the recovery of existing FILP loans. Because of this difference, FILP Bonds are not classified as debts of the Central Government in the System of National Accounts [SNA] (the global standard of economic indicators set by the United Nations). According to the SNA, FILP Bonds are classified as debt of public corporation.

In 2007, about $1.44 trillion JGBs were issued. The issuance consists of *New Financial Resource Bonds* of $0.25 trillion, *Refunding Bonds* of $1 trillion, and FILP bonds of $0.19 trillion. New Financial Resource Bonds serve as a revenue source for the 2007 general account budget of the Central Government. Refunding Bonds constitute the largest issuing item and are issued to finance the JBGs that are due to mature and cannot be paid by the budgetary revenue and other sources (for example, proceeds generated and accumulated in the Fiscal Loan Fund Special Account). Since Refunding Bonds are issued to rollover the debt that is owed to be paid in the year, it doest not add to the existing debt outstanding. Thanks to this mechanism, one may say that the principal payment burden of the Central Government is mitigated each year. FILP bonds issuance is determined by the scale of new lending under the Fiscal Loan Program as well as the financial position of the overall Fiscal Loan Fund.

JGBs' credit rating is given AA according to Standard & Poor's, as of December 2008. The rating is below the ratings of the United States, France, Germany, the United Kingdom, and Singapore, which were given the best AAA. However, it exceeds the ratings of China (A+), Korea (A+), Malaysia (A+), and Thailand (A). JGBs are available with various maturity periods. There are *coupon-bearing bonds* (which bear semiannual interest payment and principal payment at maturity) and *discount bonds* (principal payment at maturity with no interest). Coupon-bearing bonds have maturities of 2, 4, 5, 6, 10, 15(floating-rate), 20, 30, and 40 years. Discount bonds are offered with the maturities of 3 and 5 years. TBs (Treasury Bills), which are included in JGBs, are discount bonds. In addition to JGBs, the Central Government also issue FBs (Financing Bills), which are also discount bonds, with the maturity of generally 3-month (2-month and 6-month as well). The outstanding FBs amounted to $107 trillion, largely held in the form of "Foreign Exchange Fund FBs" which are issued when there are interventions by the Government in the foreign exchange market (as was the case in 2003-04) as well as insufficient foreign reserves in the Fund.

Chart 5. The Size of Bond Markets in Japan and Other Asian Countries (March 2008)



Note: CN refers to China, HK Hong Kong, ID Indonesia, JP Japan, KR Korea, MY Malaysia, PH Philippines, SG Singapore, and TH Thailand.
Source: ADB.

The size of JGBs of $6.8 trillion is larger that that of US Treasury Securities of $5.2 trillion (as of March 2008). Despites its huge debt, the Central Government has so far found it relatively easy to find investors—mainly from domestic sources thanks to the conservative investment attitude of domestic investors. As of June 2008, the largest holders of JGBs are banks including *Japan Post Bank* (40.7%),

followed by life and nonlife insurance including *Japan Post Insurance* (18.8%) and public pensions (11.5%).[2] Bank of Japan (BOJ) holds 8.8% as a result of monetary operations through the market. Foreign investors hold only 7%, while households account for only 4.2%. The General Government excluding public pensions hold 1.8%. Thus, JGBs are held largely by relatively stable domestic institutional investors (such as Japan Post Bank, Japan Life Insurance, Public Pensions, Bank of Japan, and General Government), together accounting for over 50% of the outstanding JGBs.

The small ownership of JGBs by foreign investors is in sharp contrast with other advanced countries—the United States (43%), France (29%), Germany (47%), and United Kingdom (27%) (IMF, 2007). It suggests that JGBs are less prone to changes in foreign investors' sentiments. At the same time, it indicates that JGBs are not actively used as foreign reserve assets by foreign monetary authorities, as compared with other advanced countries. One may say that the degree of internationalization of the Japanese yen has been limited on this standpoint.

The size of Local Government Bonds of $1.4 trillion is somewhat smaller than US municipal securities of $2.2 trillion. The Central Government (such as FILP loans) and Japan Post (Japan Postal Bank and Japan Post Insurance) hold 42% of total outstanding Local Government Bonds. *Japan Finance Corporation for Municipal Enterprises* holds 5.4%. Those held by the private financial sector (such as banks and other financial institutions) amount to 30.7%. In addition, publicly-offered Local Government Bonds account for 20%. Local Government is authorized to levy its own local taxes; thus, this authority serves as collateral for the principal and interest payments of Local Government Bonds. The bonds sold to the Central Government, Japan Post, and Japan Finance Corporation for Municipal Enterprises are issued in the form of deeds (obligations are not traded in the market until the principal is repaid). The entire amount of publicly-offered bonds is issued in the form of securities and can be traded in the bond market. Bonds underwritten by banks and other financial institutions can be in securities form for trading or in deed form (not traded).

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[2] Based on the privatization road map developed under Koizumi administration in 2005, Japan Post was divided into four private entities under Japan Post Holdings Co. in 2007. Those four companies comprise of Japan Post Service Co. (managing mail delivery service), Japan Post Network Co. (controlling post offices and managing their real estate), Japan Post Bank Co., and Japan Post Insurance Co. Currently, the Government owns all the stocks of Japan Post Holdings with Japan Post Holdings owing all the stocks of these four companies. As early as 2010, Japan Post Bank and Japan Post Insurance are expected to go public, and all the stocks of these firms will be traded on the stock exchange by October 2017. Meanwhile, the Government will reduce its stake in Japan Post Holdings to about 33%. Japan Post Network and Japan Post Service will not be listed because their services entail public nature.

Relatively Inactive Corporate Bond Market

Chart 5 shows that Japan's bond market is dominated by Government Bonds, especially JGBs. By contrast, the corporate bond market has hardly been developed. This is mainly because firms tend to raise funds by issuing stocks, as well as the traditional way of borrowing from banks. Also, the financing position of the corporate sector has shifted from a net deficit to a net surplus since the late 1990s, reflecting the efforts to reduce leverage and the low demand for credit. The presence of too many banks and intense competition, together with low interest rates, has eased firms' borrowing costs from banks and thus reduced the need to issue corporate bonds. The outstanding corporate bonds issued is recorded as US$853 billions in March 2008—far below the size in the United States where US$5.8 trillion was recorded as of March 2008.

Regarding credit ratings, Toyota is the only company whose corporate bond is rated AAA, exceeding that of JGBs. Companies that are given the rating of AA include Canon, NTT Docomo, Takeda Pharmaceutical Company, J-Power, and a large number of electric power companies (such as Tokyo, Osaka, Kyusyu, Shikoku, Okinawa, etc.). The majority of issuers have been firms with investment grade or above BBB (90% of total bonds). Namely, the market for bonds with below-investment grade or junk-bond market, commonplace in the United States (accounting for more than 50% of total bonds), has hardly emerged in Japan.

There are several reasons for the absence of the junk-bond market in Japan. First, the *Government Pension Investment Fund (GPIF)*, which manages $1.2 trillion public pension reserves, requires that the credit ratings of the bond issuers they invest in should be equal or above BBB. Such a management policy has adversely affected the behavior of private institutional investors as well. Second, there is growing demand for financial products that have features of stocks and bonds, such as *preferred stocks* (debt instrument where preferred shareholders are paid ahead of common stock holders in the event the liquidation of a firm) and *subordinate bonds* (debt that would have lower priority than other debt in the event of liquidation of a firm). This has contributed to the lack of diversity in the corporate bond market and also hindered skill development in the market regarding the evaluation of risks and returns. These factors partly explain why corporate bond market liquidity has been low. The low liquidity makes it difficult for investors to transact bonds without affecting prices. It has also been pointed out that low interest rates have narrowed the spreads on corporate bonds, which makes it difficult for investors to acquire returns that could be justified by the risks they are undertaking.

Markets for Securitization

The markets for securitized bonds, such as mortgage-backed or asset-backed securities (ABSs), and collateralized debt obligations (CDOs) grew rapidly from the late 1990s. This reflects the enactment of the following laws in the 1990s: (1) *Law Regarding Regulation of Business concerning Specified Claims* ("Special Claims Law" that became effective in 1993), which permitted securitization of lease and credit claims, (2) *Law Concerning Liquidation of Specified Assets through a Special Purpose Company* ("SPC

Law" that became effective in 1998), which removed several difficulties in establishing SPCs, and (3) *Law Concerning Exemptions to Civil Code Requirements for Claims Transfers* (effective in 1998), which simplified the requirements imposed on claims transfers, and (4) *Law Concerning Special Measures for Servicing Business* ("Servicer Law" that became effective in 1999).

In particular, mortgage-backed securities expanded rapidly after *Government Housing Loan Corporation* (HLC) began to issue Residential Mortgage Backed Securities (MBSs). HLC issued Residential MBSs in 2001 (with the amount of ¥50 billion) and 2002 (¥200 billion). In 2003, HLC shifted its business model away from the provision of traditional direct housing loan by revising the existing Government HLC Law. Instead, it began to focus on securitization businesses for new housing loan products, called *Flat 35* (loans with fixed interest rates and maturity up to 35 years) in order to encourage private financial institutions to provide housing loans more actively. The securitization businesses consist of (a) purchasing housing loans from private financial institutions and issuing its own MBSs and (b) guaranteeing MBSs backed by mortgages with long-term fixed interest rates and provided by private financial institutions. In 2003, private financial institutions commenced selling the Flat 35, which became possible as a result of risk sharing with HLC. Prior to 2003, private financial institutions had to bear credit and interest risks with respect to their housing loan products, thereby making it difficult to provide long-term fixed rate loans. The interest rate of the Flat 35 reflects the coupon rate of MBSs issued by HLC, operation cost of HLC, and fees charged freely by private financial institutions. In 2007, HLC was transformed to *Japan Housing Finance Agency* as an incorporated administrative agency, which is wholly-owned by the Government. Japan Housing Finance Agency remains the sole government-owned financial institution specialized in securitizing mortgage loan products. It also began to provide direct loans for sufferers of natural disasters, loans to rehabilitate urban areas with densely build-up buildings, multi-family loans for child-nurturing family, etc. (which are difficult to be provided by private financial institutions).

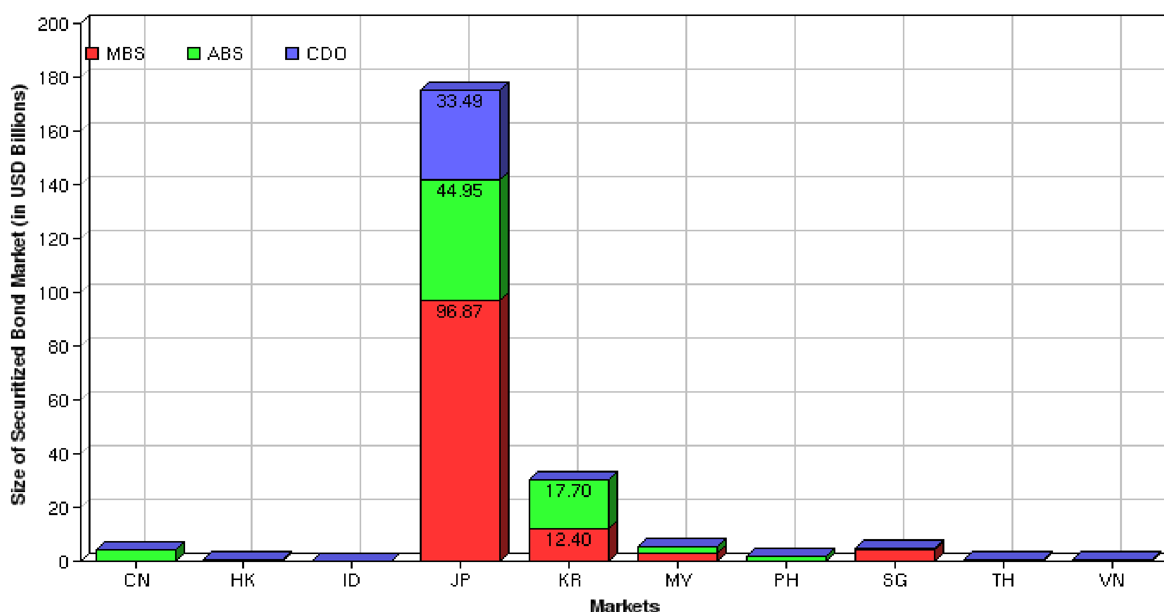
Residential MBSs issued by private financial institutions were small and sluggish during the zero-interest period. They began to issue more actively from 2004 after the abolition of a zero-interest policy by BOJ in 2003 in anticipation of rising interest rate trends. The total newly issued residential MBSs reached $50 billion in 2005-06, of which private banks (city banks, local banks, and trust banks) accounted for 37% in 2005 and 44% in 2006. HLC accounted for 41% and 43% over the same period. The rest of Residential MBS were issued by nonbank financial institutions. The issuance by Residential MBSs dropped sharply to $30 billion in 2007, due to the decline in issuance by private financial institutions. Commercial MBSs have been actively issued by securities firms and nonbank financial institutions. Domestic and foreign banks also participated in the Commercial MBSs market as issuers.

The size of the mortgage-related securities recorded about US$100 billion in 2007 (see Chart 6), which was largest in Asia, but much smaller than the United States of US$7 trillion in March 2008. In the United States, foreign investors actively invested in MBSs and accounted for 18% of outstanding MBSs. The size

of ABSs in Japan reached $45 billion, while that of ABSs in US amounted to $2.4 trillion in March 2008. ABSs consist largely of MBSs based on consumer loans, shopping credit and lease in Japan. The size of the securitized bond market as a whole also accounts for just 3% of GDP. Over 80% of securitized assets are rated AAA. Also, liquidity in the secondary market is relatively low. It has been indicated that the lack of information for third parties about the products available makes it difficult to properly analyze risks.

According to the regular Securitization Survey conducted by Japan Securities Dealers Association and Japanese Bankers Association, the amount of newly issued securitized assets dropped sharply from ¥3.4 trillion each in the first and second half of 2007 to ¥2.3 trillion in the second half of 2008. Residential MBSs accounted for 52% of newly issued structured assets. About 80% of Residential MBSs were issued by Japan Housing Finance Agency in the first half of 2008. Regarding Commercial MBSs, mere ¥0.2 trillion were issued in 2008; and, a half was issued by foreign banks. About 74% of total newly issued securitized assets were rated AAA.

Chart 6. The Size of Securitized Bond Market in Japan and Other Asian Countries (2007)



Source: ADB.

3.3 Banking Sector Performance

There are about 122 banks (6 City Banks, 64 Regional Banks, 45 Member Banks of the Second Association of Regional Banks, and 7 Trust Banks) in Japan. Their total assets reached ¥781 trillion as of March 2008. Loans and bills discounted accounted for 57% of the total assets. Securities accounted for 24% (of which, 41% of total securities were held is in the form of government bonds, 17% in the form of corporate bonds, and 14% in the form of stocks). Bank loans remain the most important source of financing for firms reflecting abundant deposits, low interest rate policy adopted by BOJ, and limited

demand for credit by firms (caused by accumulation of profits and own funds in the process of cleaning up the balance sheets, followed by relatively high economic growth in 2003-07).

Meanwhile, Banks' deposits amounted to ¥567 trillion, accounting for 72% of total liabilities. Banks' reliance on market-based or wholesale funding instruments has been limited. Namely, debentures, bonds, call money, and borrowed money from other banks accounted for mere 0.8%, 1.6%, 2.5%, and 2.5% of total liabilities, respectively. Thanks to ample deposits, the ratio of banks' loans and bills discounted to deposits was 78%. This ratio was much smaller than Australia (180%), New Zealand (140%), Korea (130%), and India (110%). In the case of Korea, both domestic banks and foreign bank branches borrowed actively from abroad in the form of short-term loans. Although the amount of short-term external debt (i.e. $176 billion as of March 2008) exceeded the amount of foreign reserves (i.e. $264 billion), Korea faced a sharp depreciation of its currency in the midst of the current financial crisis. This reflects the growing concerns over Korea's deterioration of the current account balance and the capacity to repay external debt (total external debt including long-term debt recorded $412 billion as of March 2008). As a result of limited foreign borrowing, on the contrary, Japanese banks faced limited direct damages caused by the shrinkage of the international interbank markets, which suddenly emerged after the failure of Lehman Brothers in September 15, 2008.[3]

Reflecting the conservative attitude, on the other hand, the performance of the Japanese banking sector was not as good as that of other advanced countries prior to the current financial crisis. For example, major Japanese banks' ROA (return on average assets) was 0.36% in 2006, as compared with 1.1% in the United States, 0.49% in the United Kingdom, and 1.5% in France. Their ROE (return on average equity) was 2.78%, much smaller than 10.4% in the United States, 9.97% in the United Kingdom, and 13% in France (IMF, 2008). This may reflect that about 68% of ordinary income comes from interest income and only 13.8% from fees and commissions. Impaired loans as a share of gross loans recorded 4.46%, exceeding that of United States (0.6%) and United Kingdom (3.3%) but below that of France (5.7%).

Japanese banks' cross-border activities have been largest in Asia, but the scale of activities is not as large as that of the United Kingdom, Germany, the United States, and France. Japanese banks' external assets amounted to $3,015 billion in June 2008. The amount is comparable to the United States ($3,015 billion) and France ($3,043 billion), but much smaller than the United Kingdom ($6,681 billion) and Germany ($3,887 billion). On the other hand, Japanese banks' foreign liabilities reached only $758 billion, in part owing to the availability of ample deposits domestically and cautious behavior regarding foreign borrowing. The amount of external liabilities was even smaller than Singapore ($856 billion). The banking

[3] Japanese banks were affected severely once a decline in Japanese stock prices began to reduce their own capital. The decline in the stock prices reflected a slow down in exports (due to a sudden decline in foreign demand) and a sharp appreciation of the Japanese yen (triggered by the rewinding of the yen carry trade).

crisis experienced in the mid-1990s and prolonged recession until 2002 reduced Japanese banks' foreign activities over the past decade.

By contrast, banks in the United Kingdom are the most active player with respect to cross-border banking businesses. Their amounts of external assets and liabilities are both largest in the world. Loans and deposits accounted for 61% of total external assets and 64% of total external liabilities as of March 2008. In particular, deposits were the largest item in both external assets and liabilities, recording 46% of total external assets and 48% of total external liabilities. This indicates that many foreign banks made deposits in (domestic and foreign capital) banks operating in the United Kingdom, while many (domestic and foreign capital) banks operating in the United Kingdom also made large deposits in foreign banks. As bank deposits are used for various sources of financial investment, this indicates that the United Kingdom functions as an intermediary or a hub in the global financial investment. Over 50% of banks are comprised of foreign bank branches and subsidiaries. Similarly, banks in Singapore also actively participate in cross-border banking businesses, although their scales are much smaller than those of the United Kingdom. Loans and deposits accounted for 40% of external assets (see also Chart 2) and 44% of external liabilities, respectively, in 2007.

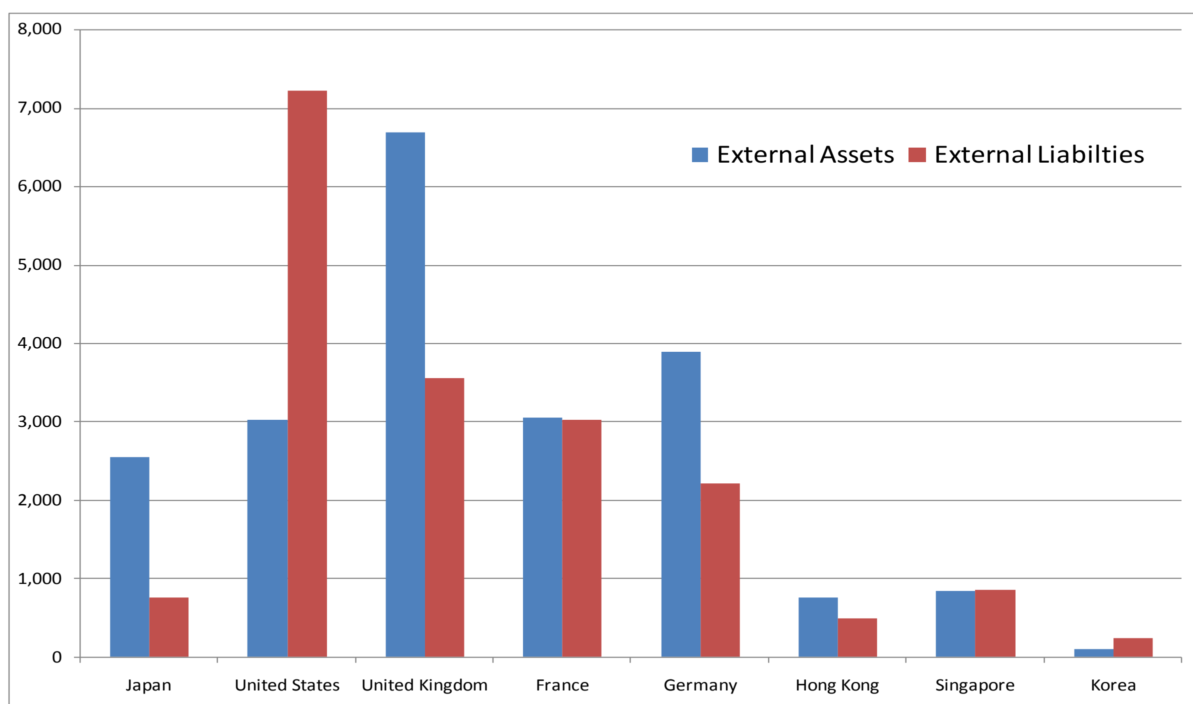
After the East Asian crisis of 1997-98, cross-border banking businesses dropped substantially in Asia. This is because one of the main causes of the crisis stemmed from short-term (less than one year) borrowing by Asian financial institutions and firms from banks in the United States, Japan, and Europe. While the East Asian crisis severely damaged the balance sheets of domestic banks, it also negatively affected the businesses of foreign banks. Foreign banks stopped lending for a few years in the midst of the crisis. But, banks in the United States and Europe (especially, United Kingdom and Germany) began to activate their cross-border banking businesses with Asia afterwards. Those banks included Citibank, HSBC, Standard Chartered, Deutsche Bank, and ABN Amro (Hohl et al. 2006). Meanwhile, Japanese banks remained cautious until the mid-2000s due to the continuous restructuring and de-leveraging efforts. As a result, foreign banks in the United States and Europe became the most active player in Asia, particularly through their subsidiary banks operating in Singapore and Hong Kong. Foreign banks' lending from Singapore and Hong Kong to the region accounted for over 80% of their total cross border claims (Hohl et al., 2006). This ratio grew from about 50% that prevailed prior to the East Asian crisis. Deregulation over inward FDI in the services sector in Asia after the East Asian crisis contributed to this move as well. For these reasons, Singapore and Hong Kong now stand out as international financial centers in Asia.

Based on the nationality of ownership of banks, Germany, United Kingdom, France and the United States have produced most active banks with respect to cross-border banking activities in the world (BIS, 2008). Banks headquartered in the United States actively invested in banks in the United Kingdom, Germany, and France. Those in the United Kingdom were prominent claimers vis-à-vis banks in the United States, France, and Germany. Banks headquartered in Germany were active lenders to banks in the United

Kingdom. Those in France stood out as active creditors to banks in the United States and Kingdom. These US and European banks also increased credit and investment in debt securities issued by nonbanks located in the United States, the United Kingdom, and Cayman Islands (BIS 2008). About 25% of the overall increase in banks' total external assets since end-1999 was performed by banks in the United Kingdom. Many of their external claims as well as liabilities were made toward US non-banks in US dollars. By contrast, banks headquartered in Japan increased lending largely to US banks, but the size of loans was limited as compared with banks headquartered in the United Kingdom, France, and the United States. Japan's banking sector has not yet been internationalized. Indeed, they reversed course towards internationalization and now have become more or less "local" because of their limited cross-boarder activities. There are also less than 100 foreign banks, while there are over 200 foreign banks in New York and London.

Since the current financial crisis deepened, banks located in the United Kingdom (such as foreign bank offices from Switzerland, Netherlands, Belgium) reduced their net long position on nonbanks in the United States. Also banks in the United States reduced cross-border banking activities, which are mostly denominated in US dollars. As a result, the shortage of US dollars promoted some central banks to use their foreign reserves to increase liquidity in the international banking system dominated by US and European banks. These growing linkages among banks intensified the degree of contagion triggered by the US subprime loan crisis and damaged the banking sector severely in Europe. While Japanese banks' direct damages were small thanks to relatively a limited cross-border activities, their presence needs to be increased greatly in the near future (especially in Asia) in order to maintain and raise their profitability.

Chart 6. External Positions of Banks in Japan and Major Countries (June 2008, Billions of US$)



Source: Prepared by the author based on BIS data.

3.4. Foreign Exchange Market Performance and Internationalization of the Japanese Yen

According to banks' cross-boarder positions reported by BIS, the US dollar and euro have been standing out as major currencies, as they are used actively in both external assets and liabilities. The euro is the most frequently-used currency as a domestic currency in both banks' external assets and liabilities, accounting for 65% and 57% each in June 2008. This is attributed to the cross-border banking activities growing within the euro region. However, when we look at the usage of currencies as foreign currencies, it is clear that the US dollar remains the most important international currency. The US dollar accounted for 54% of external assets and 56% of external liabilities, respectively. The US dollar is more frequently used on the side of liabilities, while the euro is used more often on the side of assets. The pound sterling is the third popular currency used for cross-border banking activities. The use of the Japanese yen is limited, as a result of relatively inactive businesses performed by Japanese banks.

Chart 7. Banks' Cross-Border Positions with Currency Breakdown (June 2008)

	External Assets						External Liabilities					
	Domestic Currency		Foreign Currency		Total Currency		Domestic Currency		Foreign Currency		Total Currency	
	Billions $	% Total	Billions $	% Total	Billions $	% Total	Billions $	% Total	Billions $	% Total	Billions $	% Total
US dollar	2,855	19	9,769	54	12,624	38	3,322	25	9,841	56	13,163	42
Euro	9,845	65	4,184	23	14,029	42	7,691	57	3,577	20	11,267	36
Yen	677	4	653	4	1,330	4	273	2	853	5	1,125	4
Pound Sterling	1,139	8	1,208	7	2,347	7	1,436	11	1,231	7	2,666	9
Swiss franc	169	1	429	2	598	2	112	1	437	2	549	2
Others	434	3	1,721	10	2,155	7	587	4	1,625	9	2,212	7
Total	15,120	100	17,964	100	33,084	100	13,421	100	17,562	100	30,983	100

Source: Prepared by the author based on BIS data.

For traditional foreign exchange markets (including spot transactions, outright forwards, and foreign exchange swaps), the United Kingdom is the world's most frequently-traded market place (see Chart 8). The ratio of the turnover in the United Kingdom to world turnover expanded from 27% in 1992 to 34% in 2007. This contributes to the emergence of London as the most competitive international financial center in the world. The United States is the second most active market place with its share growing from 16% in 1995 to 19% in 2004, but declining somewhat to 16.6% in 2007. By contrast, Japan has reduced its share rapidly from 11% in 1998 to 6% in 2007, losing its ratio in the foreign exchange market vis-à-vis the United Kingdom and the United States. In recent years, Singapore and Switzerland emerged as active foreign exchange markets.

Chart 8. Geographic Distribution of Foreign Exchange Market Turnover (Daily Average in April; US$ billions and %, 1992-2007)

	1992		1995		1998		2001		2004		2007	
	Amout	% Share	Amout	% Share	Amout	% Share	Amout	% Share	Amout	% Share	Amout	% Share
Japan	120	11	161	10	136	7	147	9	199	8	238	6
United States	167	16	244	16	361	18	254	17	461	19	664	17
United Kingdom	291	27	363	30	637	33	504	31	743	31	1,359	34
Singapore	74	7	105	7	139	7	101	6	125	5	231	6
Swizerland	66	6	87	6	82	4	71	4	79	3	242	6
Germany	55	5	76	5	94	6	88	6	118	5	99	3
Hong Kong	60	6	90	6	79	4	57	4	102	4	175	4
Australia	29	3	40	3	47	2	52	3	81	3	170	4
Total	1,076	100	1,572	100	1,968	100	1,612	100	2,406	100	3,989	100

Source: Prepared by the author based on BIS (2007).

Among the foreign currencies used in foreign exchange markets, the US dollar has remained the most-actively traded currency, being on one side of 86% of the transactions that sum to 200% for two-way transactions in 2007 (Chart 9). The ratio increased somewhat from 82% in 1992 to 89% in 2004, and declined somewhat to 86% in 2007. The euro is the second most traded currency, taking over the position of the Deutsche mark and accounting for 37% in 2007. The yen is the third most frequently-used currency (17%), followed by the pound sterling (15%). The ratio of the yen declined from 23% in 1992 to 17% in 2007, while that of the pound sterling rose moderately from 14% to 15% over the same period. Among foreign currency pairs, the US dollar/euro pair has remained the most-actively traded pair and accounts for 27% of global foreign currency turnover (summing to 100%), followed by the US dollar/yen pair (13%) and the US dollar/sterling pair (12%). The share of the US dollar/yen pair has declined during 1995-2007, while that of the US dollar/sterling has rapidly expanded.

Chart 9. Currency Distribution of Foreign Exchange Market Turnover (% of Average Daily Turnover in April, 1992-2007)

	1992	1995	1998	2001	2004	2007
US dollar	82	83	87	90	89	86
Euro	--	--	--	38	37	37
Deutsche mark	40	36	30	--	--	--
French franc	4	8	5	--	--	--
ECU and other EMS currencies	12	16	17	--	--	--
Yen	23	24	20	23	20	17
Pound Sterling	14	9	11	13	17	15
All Currencies	200	200	200	200	200	200

Source: Prepared by the author based on BIS (2007).

A similar pattern is also observed for the case of the foreign exchange OTC market as well as OTC interest rate derivatives. The United Kingdom was the world's most-actively traded market place for exchange OTC and OTC interest rate derivatives during 1998-2007, expanding the average April turnover from US$171 billion to US$1.1 trillion and its share in global turnover from 36% to 43%. The United States was the second most active market place with turnover growing from US$90 to US$607 billion and its share from 19% to 24% over the period of 1998-2007. By contrast, Japan's market has not grown much despite its position as the third most active market; the turnover grew only from US$42 to US$88 billion while its share dropped from 9% to 4%.

IV. JAPAN'S CHALLENGES AND POLICIES FOR ACTIVATING ITS FINANCIALCENTER

4.1. Japan's Advantages for Fostering an International Financial Center in Asia

This paper has shown that Japan has various advantages over many other countries in terms of the capacity to further develop the capital, financial, and foreign exchange markets as a more internationally-competitive financial center. The advantages included the 2nd largest economic size (large market size), ample financial assets (large investor base), presence of many internationally-competitive knowledge-intensive manufacturing firms (large issuer base), good infrastructure, the 2nd largest stock market (market access), role of the Japanese yen as one of key international currencies, etc. Despite these advantages and a series of reforms implemented from 1997 under the slogan of Japanese version of "Financial Big Bang", Japan has not been able to foster an internationally-competitive international financial center (see Shirai [2009] for detailed information). The gaps with the United States and United Kingdom have expanded further over the past decade.

Continuation of regulatory restrictions, high living and utility costs, high corporate taxation, and limited variety of financial product has deterred Japan from making use of all the afore-mentioned advantages. Even though the sizes of capital markets are large, the markets are mainly serving domestic firms and investors. There is also a sense of resistance to accept a large number of asset management firms, hedge funds and other large-scale investors from abroad. As a result, many foreign institutions have established their regional offices in Singapore and Hong Kong to engage in financial businesses targeting the Asian region.

Given that Japan is closely linked to rapidly-growing Asian economies through production and trade networks and that Japan is in close proximity to Asia, it is important for Japan to increasingly focus on this region through greater financial activities. Chart 10 shows that Japan still has various comparative advantages over Korea, Hong Kong, Singapore, and mainland China. For example, Japan maintains the top position in terms of the size of stock market capitalization, the value of share trading, the number of listed firms, the number of ETFs, as well as the size of securitized assets. Although the size of foreign exchange turnover is about the same as that of Singapore, the Japanese yen remains one of the most important international currencies in the world and Asia. While Korea has a significantly large number of

contracts traded with respect to options and futures, Japan has the potential to increase the volume of transactions by merging various existing commodity exchanges. Currently, in addition to Osaka Securities Exchange and Tokyo Stock Exchange, there are Tokyo Commodity Exchange, Tokyo Financial Exchange, Tokyo Grain Exchange, Central Japan Commodity, and Kansai Commodities Exchange that deal with various futures and/or options (see Section 4.4 for further discussions).

Chart 10. Advantages of Japan's Capital, Financial, and Foreign Exchange Markets in Asia

Item	Data
Stock Market Size (% of world market capitalization, Sep. 08)	•Tokyo (8.2%) •Korea (1.5%), Hong Kong (3.7%), Singapore (0.8%), Shanghai (4.2%), Shenzen (0.9%)
Stock Trading Value (% of world Trading Value, Sep. 08)	•Tokyo (5.3%) •Korea (1.4%), Hong Kong (1.6%), Siganpore (0.26%), Shanghai (1.4%), Shenzen (0.6%)
Number of Listed Firms and % of Domestic Firms (Sep. 08)	•Tokyo (2,393 firms, 99%) •Korea (1790, 99%), Hong Kong (1,259 firms 99%), Singapore (775 firms, 60%), Shanghai (864 firms, 100%), Shenzhen (740 firms, 100%)
Number of ETFs (Sep. 08)	•Tokyo (56) •Korea (35), Hong Kong (24), Singapore (19), Shanghai (3), Shenzen (2)
Exchange-Traded Futures and Options (Millions of Contracts, 07)	•Japan (257), Korea (2,709), Hong Kong (88), Singapore (44), China (364)
Securitized Asset Market Size ($ billions, 07)	•Japan ($174) •Korea ($30), Hong Kong ($0.63), Singapore ($4.86), China ($4.4)
Cross-Border Banking Activities ($ billions, June 08)	•Foreign Assets: Japan (2541), Korea (102), Hong Kong (754), Singapore (838) •Foreign Liabilities: Japan (758), Korea (234), Hong Kong (495), Singapore (856)
Foreign Exhcnage Market Turnover (% of world turnover, 07)	•Marketplace: Japan (6%) , Korea (0.8%), Hong Kong (4%), Singapore (6%), China (0.2%) •Currency: Yen (6.5%), Won (1.1%) , Hong Kong Dollar (2.8%). Singapore dollar (1.2%), Renminbi (0.5%)

Source: Prepared by the author based on various data indicated above.

4.2. The Risk-Averse Behavior of Investors

Section 2 has shown that there are relatively a limited number of risky assets (such as ETFs, REITs, options, futures, corporate bonds, junk bonds, structured assets) in Japan, as compared with the United States and the United Kingdom. This is closely associated with the conservative investment attitude of Japanese investors. Japanese households as well as institutional investors (pension funds, insurance firms,

and investment trusts) continue to prioritize the guarantee of principal over high returns—thus preferring bonds to stocks. Their low risk appetite also contributes to the underdevelopment of the wholesale market, where diverse professional market players compete with each other to create new and innovative financial products and services to institutional investors.

As of June 2007, for example, households' total financial assets amounted to $15 trillion, the 2nd largest after the United States ($41 trillion). Of which, holdings of stocks accounted for 8% of their total financial assets—much lower than those of the United States (15%). Bonds and investment trusts accounted for 7% while those of the United States were 22%. Japanese households continue to hold over a half of their financial assets in the form of deposits and cash, even after the Financial Big Bang had been implemented. By contrast, US households held only 16.5% in the form of deposits & cash. This phenomenon appears puzzling, since their behavior has not changed much despite the nearly zero interest rates in place since the second half of the 1990s. This feature is also unique from the standpoint of global experiences, as households' holdings of deposits & cash account for only 16% in the United States, 25% in the United Kingdom, 31% in France, and 36% in Germany. Thus, it is clear that households were not the major contributors to the increase in the market capitalization that had occurred prior to the current financial crisis. Even after the occurrence of the current crisis, US households hold 12% of their assets in the form of stocks and 22% in the form of bonds and investment trusts (although there was a slight increase of holdings of deposits & cash to 17.6%)..

The conservative investment attitude seen in Japan is affected partly by regulations on investment portfolios. For example, the *Government Pension Investment Fund* (GPIF)—which was established in 2006 as an independent administrative institution with the mission of managing and investing the *Public Pension Reserve Funds* by taking over the old *Government Pension Investment Funds*—possesses investment assets of $913 billion in 2007. As of March 2008, GIPF held these market instruments in the form of domestic bonds (62%), domestic stocks (15%), foreign bonds (10.6%), and foreign stocks (12%). Fee-included total returns on market investments during April 2008-March 2008 recorded a loss of $58 billion. This portfolio reflects the policy target that 67% would be invested in domestic bonds, 11% in domestic stocks, 8% in foreign ones, and 9% in foreign stocks by the end of March 2009, with some permissible ranges. In addition to these market instruments, GPIF holds FILP bonds of about $285 billion. These were underwritten in accordance with instructions from the Ministry of Health, Labor and Welfare. Adding FILP bonds, GPIF's total assets amount to $1,198 billion, the 2nd largest after the Social Security Trust Fund ($2,048 billion) in the United States. US Social Securities Trust Fund allocates all its assets in the form of non-tradable treasury securities. However, Government Pension Fund-Global in Norway, whose assets amount to $27.8 billion, allocates 48% to stocks and 51% to bonds. Similarly, National Pension Funds (AP1-4 and 6) in Sweden holds assets of $11.7, allocating 53% to stocks and 39% to bonds.

In May 2008, the *Expert Committee on Reforms Addressing Globalization (of the Council on Economic*

and Fiscal Policy) published the second report entitled "Toward Reform of Public Pension Fund Management". The report stressed a need to maximize returns within the people's risk tolerance under solid governance on the condition that a sufficient amount of financial resources would be secured for the payout of pension benefits over the long term. To meet this goal, the report recommended a split of the pension fund assets into several independent investment funds in order to enhance competition among them in management (after the transitional period). In order to enhance governance, moreover, the report proposed a transformation of GPIF by establishing an authorized corporation with independence (like central banks), an improvement of asset management by staff with high degree of expertise, and a maintenance of a higher level of transparency/accountability. A better clarification of responsibility between the government and GPIF is also suggested. Specifically, the government's responsibilities are suggested to include a determination of the targeted returns and risk tolerance and an appointment of the board of directors; those of the board of directors of GPIF include a decision on important matters common to all funds; and, those of management committees of each fund (proposed under the report) focus on management by expert staff based on each own decision.

Moreover, investment trusts allocated 44% of their assets to foreign securities, but they largely consisted of bonds, not stocks. Also, their holdings of domestic stocks & investments account for only 26% and domestic bonds for 12%. US investments trusts, on the other, hand, allocate more than 50% of their assets to stocks & investments, while only 36% to bonds. Thus, Japanese domestic investors on the whole have been very conservative.

It has been pointed out that domestic investors' unwillingness to hold a large amount of stocks reflects the sluggish returns experienced from the 1990s to early 2000s, which have been lower than those from bond investments. The average return on domestic bonds achieved 6.3% in the 1990s, while that on stocks was -4.2%. It is also attributable to the policy of Japanese firms to pay smaller amounts of dividends from their profits as compared to firms in the United States and Europe. A series of corporate scandals and false accounting practices added to the low risk appetite of households. It is likely to take a while for households to feel more comfortable with the idea that in the long run stocks' returns are on overage higher than other financial assets (such as bonds, deposits) and thus investors would be better off taking greater risks in their investments. It is also likely to take time to obtain public support for the idea of energizing GPIF in order to raise the returns and activate the capital market. Therefore, it is important to attract foreign investors and foreign market players in order to invigorate the Japanese market, where a greater number of innovative financial products and services are offered.

4.3. Government Plan and Policy for Further Activating the Japanese Market

Action by the Government and Its Impact

In response to the instruction provided by the *Economic and Fiscal Reform 2007* (so-called "Basic Policies" determined by the cabinet in June 2007), the Financial Services Agency (FSA) published the

Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets in December 2007. The Plan stresses that a strengthening of the competitiveness of Japan' financial and capital markets is a pressing policy issue in order to sustain the economic growth in the face of aging population. Attractive financial and capital markets are expected to provide good investment opportunities to Japanese investors (such as households) with large financial assets, and to supply domestic/foreign companies with adequate amount of capital for growth. If the more attractive markets are fostered, Japan's financial services industry is likely to generate high value added, thereby contributing to sustainable economic growth.

The Plan incorporated specific measures to strengthen the competitiveness in the following four policy areas: (1) creation of vibrant markets in which investors can have confidence, (2) business environment (that vitalizes the financial services industry and promotes competition), (3) improvement of the regulatory environment, and (4) improvement of the broader environment surrounding the markets. As for policy area (1), a market infrastructure needs to be put in place that enhances diversity in financial services and raises customer benefits, while ensuring market fairness and transparency. The measures to be taken to achieve this objective include introducing a bill to the Diet that would enable diversification of ETFs and establishment of markets for professional investors. With respect to policy area (2), the FSA intends to introduce a bill to the Diet that would reduce the firewall regulation among banking, securities, and insurances and broaden the scope of businesses permitted to banking and insurance groups. Under policy area (3), the FSA aims to improve its supervisory method in order to enhance the effectiveness, efficiency, and transparency of financial regulation. This includes intensive dialogue with the industry, close monitoring of market developments, and effective supervisory response. Policy area (4) covers measures to develop internationally-competitive professionals specializing in finance, law, accounting, etc., and improve the urban infrastructure suitable for an international financial center.

Based on the Plan, the *Bill for Amendment of the Financial Instruments and Exchange Act* was submitted to the Diet in March 2008 and subsequently passed in June 2008. The Bill permitted a creation of exchange markets for professional investors, where certain deregulations and simplification would be introduced, as compared with conventional exchange markets serving both general (retail) and professional investors. Those deregulations cover (a) exemption of securities for professional investors from current disclosure regulations, (b) establishment of a simple framework for providing information to professional investors (e.g. providing information at least once a year), and (c) permission of delegating a part of self-regulating businesses (pertaining markets for professional investors) to persons other than self-regulating juridical persons. These deregulations become possible under the condition that resale to general investors would be restricted and various penalty systems would be introduced in case of the provision of false information (such as civil damage compensation provisions, administrative money penalty system, criminal penalty provisions). In line with this Bill, Tokyo Stock Exchange and London Stock Exchange are planning to establish an Alternative Investment Market for emerging and growth firms with the focus on professional investors in 2009, as already pointed out in Section III.

Moreover, the Bill allowed a further diversification of ETFs (such as investment trusts that are transferable to commodities in kind) by adding investment trusts that invest in commodities or related derivatives, as well as an addition of emission trading to the businesses of financial instruments exchanges. Under this new legal framework, Tokyo Stock Exchange listed gold-related ETFs, SPDR® Gold Shares, managed by World Gold Trust Services (a subsidiary of the World Gold Council, a non-profit organization established in 1987 by major gold mining companies with the objective to increase the demand for gold) in June 2008. This product is the first physically-backed commodity ETF listed in Japan. The gold-related ETF tracks the prevailing international gold price and provides all investors with simple, secure, cost-effective and transparent access to the gold market. Each security is backed by physical allocated gold bullion held at custodians for the benefit of shareholders. This EFT differs from the gold-related ETF listed on Osaka Securities Exchange in July 2007. The gold ETF listed on the Osaka Securities Exchange simply tracks a gold price index rather than owning actual commodity and is managed by Nomura Asset Management.

One of the most important elements of the Bill is to relax the firewall regulations among securities firms, banks and insurance firms. First, the ban would be abolished on concurrent posts among securities firms, banks and insurance firms. Each firm or group will be required to establish systems for managing conflicts of interest by securities firms, banks, and insurance firms, for example, by implementing proper information management and developing an appropriate internal control framework aimed at preventing customers' interests from being unfairly harmed. Second, the scope of businesses permitted to banking and/or insurance groups would be broadened. It would introduce a framework that allows banks' related companies in the same banking groups with adequate risk management to engage in spot commodity transactions. It would also allow banks and insurance firms to engage in investment advisory businesses, as well as emission trading. Third, the Bill would broaden the scope of exemption to the restrictions on holding shareholder voting rights (applied to banking and/or insurance groups) in order to promote corporate restructuring. Fourth, banks would be allowed to provide agency/intermediary service for businesses of foreign banks within the same banking group. The Government has already announced that the firewall regulations would be revised by June 12, 2009.

The Bill would also strengthen the administrative monetary penalty system. The amount of administrative monetary penalties would be raised. In case of insider trading, the penalty determination is to be shifted from the current practice (based on the closing price on the day following the day of publication of insider information) to the new practice (based on the highest price during the two-week period after the publication). Regarding market manipulation as well as dissemination of unfounded rumors (and trading by fraudulent means), the amount of penalty would be based on the highest price during the one-month period—from the current profits and losses realized by sales and purchases during the one-month period after the violation. As for false statements in offering disclosure documents, the penalty would be raised from 1% of the total offering amount (2% in the case of shares) to 2.25% (4.5% in the case of shares).

Regarding false statements in ongoing disclosure documents, the penalty would be expanded from 3/100,000 of the total market value or ¥3 million to 6/100,000 of the total market value or ¥6 million.

In addition to the Bill, furthermore, the Financial Services Agency (FSA) has introduced various measures that do not require legislation, based on the *Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets* announced in December 2007. For example, FSA increased disclosure in the English language to all types of securities issued by foreign issuers (with the effective date from June 2008). Regarding the vision to set a business environment that vitalizes the financial services industry and promotes competition, FSA has been making efforts to minimize the "permanent establishment risk" in order to attract foreign fund managers to the Japanese markets. The relevant Cabinet Order was amended on April 2008, and intensive works have been ongoing with tax authorities to clarify the details. With the purpose of improving the regulatory environment (so-called "better regulation"), FSA agreed with financial service providers to share the "Principles in the Financial Industry" in April 2008, and released the first progress report on the efforts toward better regulation in May 2008. A proposal was released with respect to the ways to develop human resources specialized in finance in April 2008. Furthermore, the Government's *Joint Headquarters for Revitalization of Local Areas* released a "Plan to Enhance Japan's Role as an International Financial Center" in April 2008. The Plan includes a vision to establish three *international financial special districts* that would be provided with special deregulations and faborable treatments (such as deregulation on a floor area ratio restriction, a fixed asset tax cut), in Tokyo Metropolitan Area (*Shinbashi, Akasaka, and Roppongi*), in order to promote a cluster of (domestic and foreign) financial institutions and professionals.

4.4. Strengthening and Rationalizing Existing Exchanges

There are four major commodities exchanges in Japan: *Tokyo Commodity Exchange* (largest exchange, dealing with energy, precious metals, industrial metals, and agricultural products), *Tokyo Grain Exchange* (dealing with agricultural products), *Kansai Commodities Exchange* (located in Osaka, mainly dealing with agricultural products), and *Central Japan Commodity Exchange* (located in Nagoya with main products covering energy, industrial metals and rubber). In addition to these commodity exchanges, there is *Tokyo Financial Exchange* that deals with interest and foreign exchange derivatives. Over the past years, several improvements were achieved over the regulatory environment pertaining in the commodity exchanges. The *Amendment to the Commodity Exchange Law* was passed in 2004 and became effective from 2005, which would provide better protections for customers, give greater financial strength for brokers, and encourage the development of central counterparties in the clearing process (Fulscher, 2005).

Tokyo Commodity Exchange was a front runner over the revision of the law under the recognition that modernization of the industry is necessary. In 2004, therefore, Tokyo Commodity Exchange established the first clearinghouse for commodity futures. Prior to this move, there was no central counterparty to reduce credit risk so that each broker was exposed to the risk of default by another broker. Tokyo

Commodity Exchange also adopted several measures to attract foreign traders by providing electronic access to its products and demanding the Government to remove the regulation that prohibited foreign brokers from becoming members of the exchange. The failure of *Tokyo General*, one of the largest commodity futures brokers, enhanced the voices to call for the Amendment of the Commodity Exchange Law. In line with the Amendment, the *Common Clearing House (JCCH)* was established in December 2004 as an independent centralized clearing-house operating place. It is organized as a stock company owned by all Japanese commodity exchanges and the Japan Commodity Futures Industry Association. It began providing clearing and settlement services for the transactions of all commodity exchanges in Japan.

These new measures contributed to increasing the number of transactions and attracting foreign players at the commodity exchanges. Among futures and options transactions, the total volume of commodity derivatives contracts is much larger than that of financial derivatives contracts in Japan. In 2007, for example, the number of contracts with respect to futures and options reached 47 million at Tokyo Commodity Exchange, (42.6 million at Tokyo Financial Exchange,) 18.8 million at Tokyo Grain Exchange, 6.5 million at Central Japan Commodity Exchange, and 0.1 million at Kansai Commodities Exchange. While Osaka Securities Exchange achieved the largest volume (109 million contracts) among all exchanges in Japan, the volumes of Tokyo Commodity Exchange (and Tokyo Financial Exchange) exceeded the number of contracts at Tokyo Stock Exchange (33 million).

Despite the improvement of the commodity exchanges, it has been pointed out that these commodity exchanges are being left behind the world exchanges in terms of global active transactions and price making role. In face of growing mergers among exchanges abroad, moreover, there are growing voices to promote mergers among various exchanges operating in Japan among Japanese policy makers and academics. In particular, the idea of merging various exchanges centering at Tokyo Stock Exchange appears to be a most promising option given its dominance in the stock market and a high name-recognition rate in the world (although getting behind Osaka Securities Exchange in terms of derivative trading).

In April 2007, therefore, the Government's *Council on Economic and Fiscal Policy* released the first report entitled "*Toward the Establishment of Truly Competitive Financial and Capital Markets*." It has stressed that vitalizing the commodities exchanges is essential to foster an international financial center in Japan. The recommendations included (1) a realization of commodity exchanges under a holding company of a stock exchange (possibly, Tokyo Stock Exchange) in order to enable flexible organizational realignments, (2) a reorganization of commodity exchanges from a membership system to a joint-stock corporation (and listing of stocks) in order to strengthen their governance, (3) an introduction of restrictions concerning the re-employment of officers from supervisory agencies at the exchanges in order to ensure discipline in the relationship between the supervisory agencies and the exchanges, and (4) an abolition of the need for permission for listed products from the ministry in charge (it should be left to the self-regulation of the

exchanges). Subsequently, *Economic and Fiscal Reform 2007*, which was decided by the Cabinet in June 2007, also pointed out the examination of measures to develop exchanges that cover a wide range of products (stocks, bonds, financial derivatives, commodity derivatives, etc.) as one of the important policies.

Regarding the merger of exchanges, strong rejection and caution opinions have been raised by other exchanges against a forced merger centering Tokyo Stock Exchange. Moreover, various exchanges are supervised by different ministries. This makes it difficult to generate quick actions from the relevant ministries, especially when there are rivalries over authority among them. Namely, stock exchanges and financial derivatives are supervised under the jurisdiction of FSA; agricultural commodities are covered under the jurisdiction of Ministry of Agriculture, Forestry and Fisheries; and, metals are monitored under the jurisdiction of Ministry of Economy, Trade and Industry (METI).

For these reasons, the Government currently intends to focus on the measures to strengthen the international competitiveness of the existing exchanges by allowing them to expand the scope of products traded—rather than establishing a comprehensive exchange. While responses from the exchanges are slow, some changes are observed recently. In June 2008, the Central Japan Commodity Exchange and the Kansai Commodities Exchange have concluded a MOU with the Osaka Securities Exchange, agreeing to adopt the trading platform of the latter. When the link takes place, it would be the first such venture between commodity exchanges and a financial exchange. Moreover, Tokyo Commodity Exchange decided to change the structure from a membership organization to a stock company (demutualization) in July 2008. Based on the approval from the METI, it became the first commodity exchange that became demutualized in Japan in December 2008. The demutualization is expected to speed up the decision-making process and allow more flexible fund raising.

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