PROMOTING TOKYO AS AN INTERNATIONAL FINANCIAL CENTER

Professor, Faculty of Policy Management, Keio University
Visiting Professor, Sciences Po, France
Dr. Sayuri SHIRAI

Abstract

Japan's economic power is widely recognized worldwide—thanks to it being the worlds 2^{nd} largest economy (US$4.3 trillion equivalent GDP in 2006) and having a high per capita income (US$34,000 in 2006). According to Flow of Funds accounts, the amount of total assets held by resident financial intermediaries was about US$24 trillion at end-2006 (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). This substantial financial wealth was the 2^{nd} largest after the United States.

Relative to its economic power, however, Japan's financial and capital markets have not realized their full potential. 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. This paper analyzes the current performance of these markets and discusses the possibility of promoting Tokyo as a top international financial center. It also looks at the Japanese version of a *Financial Big Bang* launched in 1996 and reviews the visions proposed most recently by the Japanese Cabinet and discusses the remaining agenda.

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Relative to its economic power, however, Japan's financial and capital markets have not realized their full potential. 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. This paper analyses the current performance of these markets and discusses the possibility of promoting Tokyo as a top international financial center. The paper is in four sections. Section I briefly provides background information and issues associated with the Tokyo market. Section II looks at the Japanese version of a *Financial Big Bang* launched in 1996 and its impact on financial and capital market developments. Section III takes an overview of the current financial and capital markets in Japan. Finally, Section IV reviews the visions proposed most recently by the Japanese Cabinet (led by the then Prime Minister Shinzo Abe) and discusses the agenda remaining.

I. BACKGROUND

The Period of the 1980s

The period of the 1980s was a time when the Japanese economy was in great shape, reflected by its persistent current-and trade account surpluses and high economic growth driven by TFP (total factor productivity) growth (which exceeded 4% and was higher that those of the United States and United Kingdom). At the same time, a strong yen and the rising asset values of banks, securities firms, and insurance companies (reflected in their high stock values) encouraged them to move their assets out of the country, particularly to the United States and Europe. This helped Japan to become the world's largest external creditor. In the domestic capital market, stocks were being actively traded and Japan's market capitalization had become the largest in the world, accounting for about one third of the world market capitalization—far beyond its relative GDP size (13% of global GDP). A number of overseas banks and securities firms rushed in and opened branches and offices in Tokyo to expand their financial operations, while overseas firms attempted to list their stocks on the Tokyo Stock Exchange. Also, this was the time when Ezra Vogel published his well-known book entitled "*Japan as Number One*," which boosted Japanese confidence.

In retrospect, Tokyo was indeed not only the biggest international financial center in Asia, but also had the potential to become one of the top three global financial centers in the world, along with New York (whose main advantages arising from being in the largest economy with deep financial/capital markets) and London (whose main advantages arising from various cross-border transactions in diverse currencies). In those days, there was debate about whether Japan's financial and capital markets should be actively promoted to become a more competitive international financial center—by introducing comprehensive and drastic reforms, as had already been done in the United Kingdom in 1986 (the so-called "Big Bang"). This debate reflected a concern that relative to the sizes of GDP and market capitalization, the Japanese financial sector had not been as efficient and so was not as attractive as those of New York and London. Despite active discussions, the Japanese Government did not take the opportunity to undertake reform, mainly because of resistance coming from the banking, securities, and insurance industries.

Background Behinds the Financial Big Bang Initiative

It took another decade until the Japanese Government finally launched at comprehensive reforms. In 1996, the Cabinet of the then Prime Minister Ryutaro Hashimoto announced its intention to introduce the "Japanese version of a Financial Bing Bang." It set up a clear goal of promoting Tokyo to become an international financial center comparable to those of New York and London. This decision was motivated by the awareness that during the so-called "lost decade" (10-year economic stagnation beginning in 1991) of the 1990s, Japan's financial and capital markets had rapidly waned as they suffered from the effects of the collapse of financial bubbles (the Nikkei Index and the urban land price both declined about 60% in the 1990s) and the resultant accumulation of non-performing loans. By 1994-95, the non-performing loan problems were first revealed through so-called "*Jusen*" or non-bank financial companies specializing in housing loans; this led to the Government having to implement financial counter-measures of JP¥ 680 billion (US$ 6 billion) in 1996.[1]

This situation invited harsh criticism of the supervisory and inspection capacities of Japan. Some claimed that excessive regulations by the Ministry of Finance (particularly to avoid excessive competition) and inadequate disclosure requirements resulted in not only weakening the soundness of financial institutions but also limiting competition. Such a regulatory framework deterred banks from advancing financial skills and offering diverse financial and product services. It is true that the regulations imposed on the Japanese

1 The Government later introduced emergency financial measures in 1997-98 in the face of the failure of Hokkaido Takushoku Bank and Yamaichi Securities in 1997—with public funds of JP¥30 trillion, of which JP¥17 (US$260 billion) was allocated for dealing with failures and bad-loans of banks of nonviable banks and JP¥13 trillion allocated for improving the capital base of viable banks.

financial and capital markets had been more stringent than those in London and New York. In these cities, deregulation has promoted competition and lowered commission fees, thus encouraging financial institutions to find alternative sources of income by developing innovative financial products and services. Moreover, Japan's deflation caused by a growing excess of demand for goods and services added to the deterioration of non-financial firms' profitability, thereby increasing non-performing loans and dropping stock values further. The plunge of Tokyo's presence as an international financial center was in stark contrast to the high-technology and knowledge-intensive manufacturing and software industries, which had managed to maintain and even strengthened international competitiveness throughout the 1990s. In response to the criticism, a series of structural reforms focusing on deregulation (as described in Section II) has been implemented under the catchphrase of "Japan's version of the Financial Bing Bang."

Reasons of Promoting Tokyo as an International Financial Center

Against such a background, it may be worthwhile to re-examine why Tokyo should even become one of the top international financial centers to begin with. There are at least the following four reasons that have been widely pointed out:

First, it is becoming increasingly important for Japan to utilize its substantial financial assets more efficiently to better cope with challenges posed by its rapidly progressing aging society. The ratio of population of people equal to or over 65 years old already accounted for 20.2% in 2005, and is expected to reach 31.8% in 2030 and 39.6% in 2050. This makes Japan the most rapidly aging society in the world. As of end-2006, household financial assets reached about US$ 13 trillion, the second largest after the United States where household assets registered US$42 trillion. However, for a long time these assets have not been efficiently utilized. This is evidenced by the fact that one half of these funds have been allocated to deposits & cash without really being channeled into stocks and investments trusts. Moreover, given that the Japanese Government has gradually reduced public pension benefits and postponed the eligibility age under tight pension budgets, households need to seek alternative and more diversified ways of accumulating assets for use after retirement. Given that higher returns mean higher risk, the domestic financial and capital markets should play a greater role in providing risk money for households.

Second, the promotion of the financial and associated business sectors is regarded as a crucial economic growth strategy by the Japanese Government. Currently, Japan's GDP growth rates have been constraint by sluggish TFP growth. The TFP growth rate has been only about 0.7% (of which, according to the Cabinet Office, 1.3% came from the manufacturing sector and a mere 0.1% by the tertiary sector)—the level being nearly half of TFP growth in the United States. Thus, the key for raising TFP and GDP growth lies in the tertiary sector, which already accounts for about 70% of GDP and total employment. The manufacturing sector, despite its past and present role as an engine for growth, has been constantly shifting its production and marketing locations to the United States and rapidly-growing emerging markets such as China, India, and Russia. Thus, the main source of future economic growth increasingly depends on the tertiary sector. Taking an overview of the successful experiences of the United States and United Kingdom, it is clear that the financial, business (i.e. law, accounting, consulting, and information provision), and communication sectors have been the main contributors to their successes.

Third, Tokyo could potentially become a common Asian platform to support current and future trends of growing populations and economic sizes in neighboring Asia. The abundance of funds in Japan and its advantageous location confirm Tokyo's potential role to provide Asian governments and corporations with greater access to diversified and stable financing sources. Asian investors with rising wealth would also benefit from portfolio diversification and innovative financial products and services if Tokyo would be able to meet their needs. The development of better financial infrastructure that would enable smooth cross-border financial and capital transactions could enable Asian funds to circulate within the region and thus enjoy greater regional investment returns–instead of making their funds take detours through the United States and Europe. It is widely known that Asian funds are currently invested largely in financial assets (through US and European financial intermediaries and settlement systems) in the United States and Europe, which in turn re-invest them back into Asia.

Fourth, related to the point raised above, if overseas financing and investment activities by Japanese financial institutions expand again, especially in Asia, they could be positioned as key players to promote the development of regional foreign exchange and financial markets conducting direct exchange rate transactions in yen and other Asian currencies. Japan's domestic financial institutions have finally recovered from the collapse of the bubbles by reducing their holdings of nonperforming loans and improving their financial intermediary capacity domestically and globally. Thus, they are in a position to able to take on this role. As well, encouraging Japanese banks to make yen- or local-currency-denominated loans and to issue financial bonds in the region will increase overseas use of the yen as well as promoting regional bond market development—just as development of the international banking market in Europe contributed to the internationalization of the euro. Because Japanese firms are increasing foreign direct investment (FDI) in Asia, the parallel role of Japanese banks is becoming important. If Japanese banks could establish financial networks in the region, overseas Japanese firms, their affiliates, and their partner companies would be able to develop efficient cash management mechanisms involving a networking system to pay just net gains from mutually held credits and liabilities. This would facilitate business activities and reduce operating and financial costs for all involved.

II. JAPANESE VERSION OF THE FINANCIAL BIG BANG AND ITS IMPACT

2-1. Overview of the Financial Big Bang

The then Prime Minister Hashimoto announced in November 1996 a basic policy of reforming Japanese financial and capital markets to become "*free, fair, and global*" to upgrade Tokyo to a level comparable to those of the London and New York markets by the year 2001. A broad list of measures with specific time schedules was subsequently announced in June 1997.

By the word "*free*," the Japanese Government meant to promote market principles and competition. This included (a) a reduction of the entry limitations in the banking, securities and insurance sectors through allowing the establishment of financial holding companies, (b) a removal of the separation of banking businesses between short- and long-term businesses, (c) a liberalization of fees and commissions in the brokerage and insurance businesses, and (d) a liberalization of asset management regulations. In particular, the one that had caught the attention of the public was the approval of establishing financial holding companies, under which financial institutions would be able to provide comprehensive and diverse financial services for the benefit of investors. The word "*fair*" referred to a market with greater transparency and equitable rules through a strengthening of disclosure requirements, self-responsibility principles, and enforcement rules. Finally, the word "*global*" reflected the Government's intention to align the accounting systems with global standards, establish better and more cooperative global supervisory capacity, and rationalize taxation in line with global trends. To adapt into the new regulatory framework, moreover, a *Financial Supervisory Agency* was established by splitting it from the Ministry of Finance in 1998, with the mandate of inspecting and supervising financial institutions and conducting surveillance over securities transactions. The *Securities and Exchange Surveillance Commission* (SESC) was transferred from the authority of the Ministry of Finance to the Financial Supervisory Agency. In 2000, the *Financial Services Agency* (FSA) was renamed after the Financial Supervisory Agency by taking over the function of planning the financial system from the Ministry of Finance. The FSA is currently operating as an external organ of the Cabinet Office.

The Financial Big Bang basically had two parts: one related to foreign exchange transactions and the other to cross-entry deregulation and strengthening of competition. The first part of the reforms was undertaken in 1997, while the second part of the reforms was implemented gradually from mid-1997 to 2001.

As for the first part of the Financial Big Bang, the Government introduced a new *Foreign Exchange Law* in 1997 (with effect from April 1998). Prior to the revision, authorized banks had monopolized the foreign exchange market, while being responsible for examining documents (i.e., letter of credits, shipping bills) to check the reasons for the entities' engagement in trading foreign exchanges.[2] The new law indicates a shift from a prior-checking system to an ex-post reporting system. Now, foreign exchange business can be performed freely by institutions other than authorized foreign exchange banks. No permission is needed before starting foreign exchange business; the submission of only an ex-post report is needed. Foreign deposit accounts can be opened freely both domestically and abroad with only requirement of subsequent notification. This revision means that companies (such as exporters, importers, and trading firms) and

2 In 1980, the Foreign Exchange and Foreign Trade Control Law of 1947 was revised to liberalize cross-boarder transactions, but capital and financial transactions were required prior application and approval. Furthermore, foreign exchange transactions were required to be performed through authorized banks. In 1984, the euro-yen bonds were allowed to be issued by resident firms and foreign firms (foreign governments and international organizations were already permitted to issue euro-yen bonds in 1979) in the euro market for the purpose of internationalization of the yen. An offshore market for yen was established in Tokyo in 1986.

individuals are able to purchase, sell, lend, and borrow foreign currencies without going through authorized banks.

The second part of the reform did not begin until the middle of 1997. The major changes and reforms are listed below:

Year 1997:

- Lifting of a ban on options transactions in specific stocks as well as trade and intermediation of unlisted securities by securities companies
- Introduction of *Cash Management Account*s placed with securities firms
- Lifting of a ban on a sales of investment trusts through renting floor space in banks
- Removal of a ban on the issuance of *subordinated bonds* by commercial banks
- Permission for issuing *perpetual bonds*
- Law permitting the establishment of *financial holding companies*

Year 1998:

- Liberalization of regulations related to *floating-rate term deposits* and the depositing period for CDs
- Deregulation of investment advisory and other asset-management services
- Introduction of corporate-type and private-placement investment trusts
- Introduction of *link bonds*
- Liberalization of non-life (property) insurance premium rates as well as stock brokerage commissions
- Deregulation of a series of cross-entry barriers—including the sale of insurance by securities companies, sales of investment trusts by banks themselves, trading of over-the-counter derivatives by banks and securities companies.
- Full liberalization of securities derivatives
- Shift from a license system to a registration system regarding securities business
- Shift from a license system to an approval system regarding investment trust firms

Year 1999:

- Further liberalization of cross-entry barriers—such as the issue of stocks and secondary trading business by banks securities subsidiaries; and pension trust business by securities companies trust subsidiaries
- Introduction of *Wrap Accounts* placed with securities firms
- Permission for issuance of *straight bonds* by commercial banks
- Introduction of a *discount broker system*

Year 2001

- Introduction of *ETFs* (linked to stock indices)
- Introduction of real estate investment trusts (*J-REITs*)
- Liberalization of regulation on participation in third-sector fields (sickness/medical insurance) by domestic life and non-life insurance companies
- Liberalization of non-life (property) insurance premium rates
- Partial permission for sales of insurance at bank counters (full permission to be implemented by

end-2007)[3]

- Permission for banks to hold insurance subsidiaries

Additionally, the Tokyo Stock Exchange since 1999 has required firms on its Mother's Section (section for venture firms) to release quarterly financial reports and since 2004 all other firms listed on other sections must do so—a tightening of disclosure rules by shifting from the release of biannual reports. Furthermore, in an effort to align the Japanese accounting system with international standards, consolidated accounting and cash flow statements were introduced in 2000. Moreover, the mark-to-market based accounting system was introduced for evaluations of financial assets in 2001 and on cross-holding shares in 2002; thereby making it difficult for firms to hide losses through subsidiaries.

2-2. Impact of the Financial Big Bang

Since then, the financial and capital markets have seen many changes. First, financial transactions have grown, as investors become more accustomed to the concepts of risk and returns. Japanese private (institutional and households) investors have increased holdings of stocks, and recently foreign assets, with a widening of interest rate differentials. The Financial Big Bang has provided households with a wider range of choices over their asset portfolios, helped by declines in brokerage commissions (particularly for internet transactions), insurance premiums, and monthly bank fees.

Second, investment asset management businesses have been booming. For example, the asset sizes of investment trusts for individual and institutional investors as well as investment management contacts for institutional investors have been expanding. Real estate investment business has also been growing. In particular, *J-REITs*, which were introduced in 2001, have become popular. This is because the low interest rates have enabled them to obtain low-cost finance for purchases of real estate, and at the same time, provide investors with higher returns than other assets, such as bonds. Some real estate investment funds, including foreign funds, participate in development projects (such as shopping malls, commercial facilities, and warehouses) from the beginning of projects by bringing in new financing sources procured through lower-cost securitization. Also, some real estate funds or investors have purchased hotels and resort facilities to improve operations and thereby increase profits. Other real estate investment funds have provided professional property management services to the office and commercial facilities they invested in and so have improved operational efficiency. Hedge fund investment has also expanded.

Third, several large city banks have merged with each other to form three financial holding groups (*Mizuho Financial Group*, *Mitsubishi UFJ Financial Group*, and *Sumitomo Mitsui Financial Group*) to provide full financial services. As the largest *financial group*, Dai-Ichi Kangyo Bank, Fuji Bank and

3 The liberalization of sales of insurance products through bank windows will be fully implemented by the end of 2007. Currently, banks are allowed to sell saving-type insurance products. By the end of the year, other insurance products— such as health, elderly care, term life, whole insurances—will be permitted to be sold through bank windows.

Industrial Bank of Japan agreed to establish a bank holding company in 1999 and so established *Mizuho Holdings* in 2000. In 2002, it reorganized their banks into the *Mizuho Bank* (targeting individual customers and domestic firms) and *Mizuho Corporate Bank* (focusing on large firms and investment banking). Also, *Yasuda Trust Bank* jointed the group as *Mizuho Trust Bank*; and, three middle-sized securities firms were consolidated into *Mizuho Security*. In 2003, the Mizuho Financial Group took over the operations of Mizuho Holdings. As the *second largest financial group*, *the Bank of Tokyo* and *Mitsubishi Bank* merged into the *Bank of Tokyo-Mitsubishi* in 1997; and subsequently, in 2001 the Bank of Tokyo-Mitsubishi, *Mitsubishi Trust & Banking* and *Nippon Trust Bank* established a bank holding company called the *Mitsubishi Tokyo Financial Group*. In 2002, Mitsubishi Trust & Banking merged with Nippon Trust Bank. In 2003, the Mitsubishi Tokyo Financial Group acquired *Kokusai Securities* and renamed it as *Mitsubishi Securities*. In 2005, the *Mitsubishi UFJ Financial Group* was formed by merging the Mitsubishi Tokyo Financial Group and UFJ Holdings.[4] Accordingly, the Bank of Tokyo-Mitsubishi and UFJ Bank merged as the Bank of *Tokyo-Mitsubishi UFJ Bank*. The Mitsubishi Trust & Banking and UFJ Trust Bank merged as *Mitsubishi UFJ Trust & Banking*. Mitsubishi Securities and UFJ Tsubasa Securities merged as Mitsubishi UFJ Securities. As the *third largest financial group*, *Sakura Bank* and *Sumitomo Bank* were merged to establish the *Sumitomo Mitsui Banking Corp.* (SMBC) in 2001 and then established the *Sumitomo Mitsui Financial Group* (SMFG) in 2002. In 2003, Sumitomo Mitsui Card Company, SMBC Leasing Company, and The Japan Research Institute became wholly-owned subsidiaries of SMFG. In 2005, SMBC reached agreement with *NTT DoCoMo* on its credit card business. In 2006, SMBC Friend Securities became a whole-owned subsidiary of SMBC.

As well as these three mega-groups, *Resona Holdings* was established by three middle-sized city banks as a regional oriented group. It was originally established in 2001 as *Daiwa Bank Holdings* through consolidating the *Daiwa*, *Kinki Osaka*, and *Nara Banks*. The company was renamed as *Resona Holdings* after acquiring *Asahi Bank* in 2002. In 2003, the Government injected public funds (about JP¥2 trillion) to this group because the bank's position was effectively insolvent. As a result of the Government becoming the largest shareholder, this support effectively realized the nationalization of the bank, and the existing management was sacked. In 2004, the bank's new management achieved a profit and announced a business revitalization plan aiming at ultimate repayments of public funds received through achieving sustainable growth with a differentiated strategy. Based on the results, in 2006, it announced a new revitalization plan for the period through the end of March 2000.

Moreover, new types of banks that provide specialized financial services have emerged. The first was *Japan Net Bank* established in 2000 (an internet bank established the former Sakura Bank in 1998 as a subsidiary, and now held by the SMBC and *Yahoo Japan Corp.* as major shareholders). In 2001, the

4 UFJ Holdings was established in 2001 by merging the Sanwa Bank, Tokai Bank, and Toyo Trust & Banking. In 2002, Sanwa Bank and Tokai Bank were merged into the UFJ bank; and, Toyo Trust & Banking was renamed as UFJ Trust Bank. In addition, Sanwa Security and Tokai Security were merged into UFS Capital Market Securities in 2001 and merged with Tsubasa Securities in 2002 by forming UFJ Tsubasa Securities. It became the fourth largest financial group.

following new banks emerged: *IY Bank* (established by the *Ito Yokado* group focusing in real trade business) specializing in payment and settlement services for individual customers, *Sony Bank* (established by *Sony Corp.* in cooperation with SMBC and JP Morgan) providing services through the Internet to individual customers), and *eBANK* (established by trading firms, insurance firms, and information service firms) specializing in small-amount payments using the Internet and portable phones). In response to the emergence of these new types of banks, the Financial Reconstruction Commission and the FSA released a guideline on the measures for licensing and supervising new types of banks in 2000.

Fourth, banks have become "universal" in a sense that they have begun to deal with securities and sell insurance through teller windows. In particular, major banks have increased the ratio of net non-interest income to operating profits, offsetting a decline in net interest income. Main sources of net non-interest income come from fees and commissions associated with new financial services, such as sales of investment trusts, insurance and underwriting private placement bonds. As well, fee incomes have risen from formations of syndicated loans and the liquidation of assets. Recently, banks have gained profits as well by providing derivative instruments to small- and medium-sized firms in response to their growing need for hedging financial risks. Brokerage firms have also begun to offer financing and investment services.

Fifth, foreign investors have increased investment in Japanese financial assets, particularly the stock market. Foreigners have been net purchasers of Japanese equities since 2003. As a result of domestic banks' reduction in holdings of stocks under the "*main bank system*", foreign participation in the stock exchanges has jumped sharply, accounting for nearly 30% of market capitalization in 2006. This participation ratio is greater than the United Sates (13%) and is equivalent with the United Kingdom (33%). While European and US investors are major foreign investors, Asian investors have recently increased their presence. Also, some foreign banks and securities firms have enlarged their operations in Tokyo as their profit and business size has expanded. Also, the number of buyout funds and resultant M&A has been growing, as exemplified by the case of the *Long-term Credit Bank of Japan* (nationalized in 1998, taken over by the US buyout group *Ripplewood* in 2000, reborn as *Shinsei Bank* in the same year). The move that a domestic bank became under foreign control was the first time in the Japanese history.

Sixth, the revision of the Foreign Exchange Law has encouraged trading firms to establish financial subsidiaries in Tokyo. As large trading firms have already financial subsidiaries in London and New York, this has enabled them to conduct financial trading 24 hours a day. In addition, the transaction costs of foreign exchanges, particularly those involving yen/US dollar, have declined, as evidenced by a decline in the bid-ask spread. The difference between spreads quoted by Japanese and non-Japanese quoters has narrowed as well (Ito and Melvin, 1999).

Macroeconomic Perspectives on the Financial and Capital Markets since the Financial Big Bang

Since 1996, a little more than 10 years has passed. Contrary to the initial expectation, nevertheless, it can be said that the vision of promoting Tokyo to become one of the world's top international financial centers has not materialized yet, as described in the details in Section III. The attractiveness of Japan's financial and capital markets has remained small in proportion to its economic size. From a macroeconomic perspective, this reflects at least the following four factors:

First, the Bank of Japan (BOJ) has not yet been able to fully normalize its monetary policy, even today in the face of mild deflation and mixed signals over economic growth from various economic indicators. In March 2006, the BOJ abandoned its so-called "*quantitative easing*" monetary policy that had been instituted for the 5 years following March 2001. This meant a shift of the monetary policy target—from the outstanding current account balance held at the BOJ back to the conventional uncollateralized overnight call rate. The restoration of the original target of uncollateralized overnight call rate indicated the explicit use of a short-term interest rate, which had been in effect "zero" since March 2001 under the quantitative easing monetary policy. In July 2006, subsequently, the BOJ terminated its "zero interest" policy by raising the target uncollateralized overnight call rate from virtually 0% to 0.25% and the basic loan rate from 0.1% to 0.4%. In February 2007, furthermore, the BOJ raised the target uncollateralized overnight call rate from 0.25% to 0.5% and the basic loan rate from 0.4% to 0.75%.

However, the BOJ has not since been able to raise its target short-term interest rate, contrary to its wishes. This is a clear contrast to the rest of the world, where the majority of central banks have raised their target interest rates since 2004-05. The growing interest rate differentials have promoted the so-called "*yen carry trade*" (borrowing in yen at low interest rates to invest in higher-yielding non-yen instruments) and the undervaluation of the yen. In such circumstances, Japan's financial and capital markets have been functioning simply as a provider of short-term finance for the yen carry trade, not as a place to manage and invest yen-denominated financial assets for overseas funds. A series of factors—such as the inactive use of the yen as an investing currency, (b) a withdrawal of Japanese banks and institutional investors from cross-border operations together with a decline in their credibility and reputation during the Lost Decade, as well as (c) a decline in the Japanese government's creditworthiness (due to its growing public debt and fiscal deficits)—all contributed to this phenomena. In other words, Japan has been unable to exploit rapidly-growing global financial activities and obtain more income arising from the provision of diverse financial services to the world. It is ironic that the Japanese public appears not to be bothered with this fact, notwithstanding Japan's economic size and position as the largest external creditor country.

Second, low interest rates, while easing firms' access to funding, have led to a narrowing of the spread on corporate bonds. Interest rates have been low in real and nominal terms on one hand, and in short and long terms on the other. This makes it hard for investors to obtain returns that could be justified on the basis of their investment risks. This indicates that the persistence of exceptionally low levels of interest rates has weakened the capacity of the bond market to distinguish issuing firms by the degree of their creditworthiness and so to properly price them. In addition, there are growing concerns that the prolonged low levels of interest rates might be promoting unproductive and excessive investment activities, thereby lowering capital productivity growth and slowing down the necessary structural reforms needed for firms to become viable. As a result, Japan's corporate bond market has remained small, accounting for only 7% of the world bond market (although this partly reflects that non-financial firms use accumulated retained earnings for financing their investment).

Third, 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. The markets for securitization and derivatives have been growing but not as rapidly and remarkably as those of other global financial centers.

Fourth, Japan's financial and capital markets have 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 still less than 30 overseas firms listed on the Tokyo Stock Exchange. A number of overseas hedge funds and other investment funds with strong interest in Japan as an investing market continue to place their operating strongholds in Hong Kong or Singapore that have offered them preferential tax treatments and low-cost infrastructure as well as limited regulations on financial businesses. Foreign workers engaging in financial services in Tokyo account for less than 5%, and there are shortages in the financially skilled labor market, including those with a good command of English. 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 sizes. In early 2007, the City of London released the *Global Financial Center Index* and rated Hong Kong and Singapore consecutively as the third and fourth international financial centers, following London (1st) and New York (2nd). Tokyo was rated only 9th, something of a shock to the Japanese Government and its political leaders.

III. PRESENT PERFORMANCE OF JAPAN'S FINANCIAL AND CAPITAL MARKETS

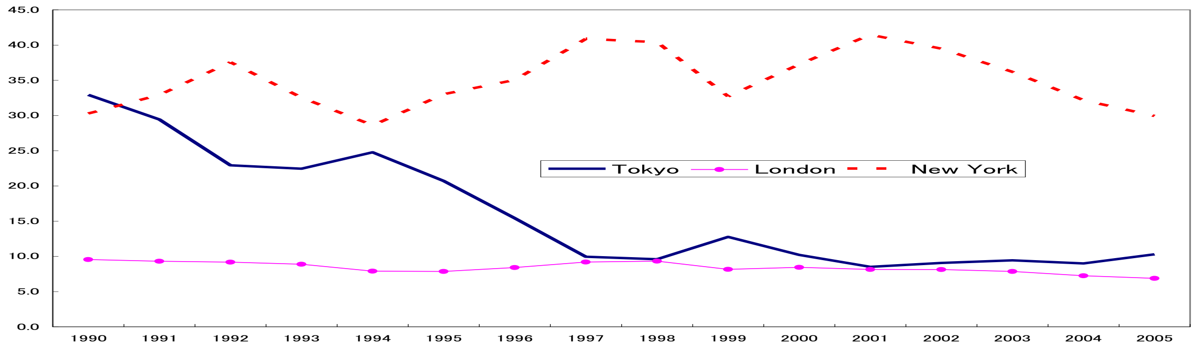
3-1. Trends of the Stock Market

Size of Market Capitalization

In the 1980s, the stock market capitalization of the Tokyo Stock Exchange was the largest in the world. Its market capitalization accounted for more than 30% of the world market capitalization. It dropped from 33% in 1990 to 10% in 2005 (see Chart 1). The size of the market capitalization of the Tokyo Stock Exchange was the second largest after the New York Stock Exchange as of end-2006. Nonetheless, the gap between the New York Stock Exchange and the Tokyo Stock Exchange has widened over the period, as evidenced by the increase in the market capitalization ratio of the former to the latter from 0.9 times in

1990 to 3 times in 2005. This suggests the rapid growth of the former relative to the latter. The stock market capitalization of the Tokyo Stock Exchange expanded only 1.6 times between 1990 and 2005—lagging behind the growth of the New York Stock Exchange (5 times). The sluggish growth of the Tokyo Stock Exchange is also pronounced compared to other stock exchanges, including the Nasdaq (11.6 times), London Stock Exchange (3.6 times), Hong Kong Stock Exchange (12.7 times), and Singapore Stock Exchange (7.5 times).

Chart 1. Share of Market Capitalization of the Top 3 Stock Exchanges (% of World Total, 1990-95)

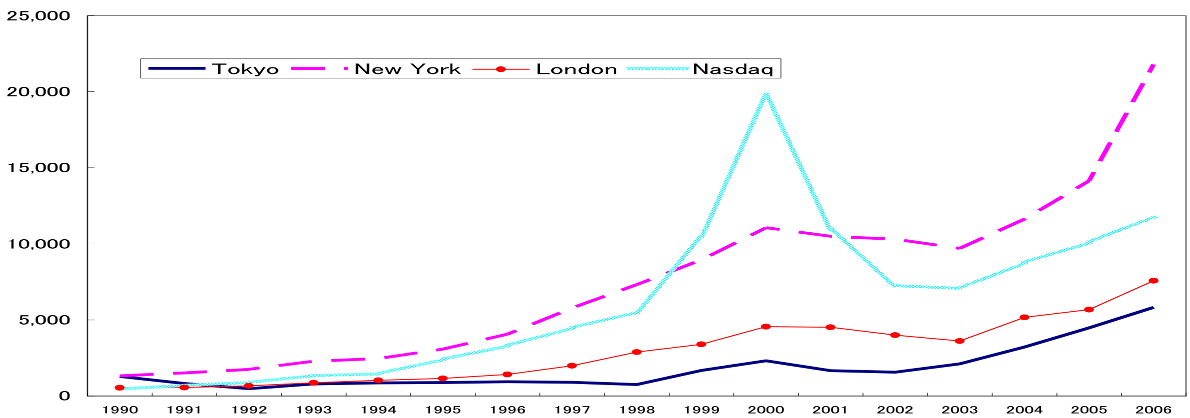


Source: Prepared based on data compiled by the World Federation of Exchanges.

Liquidity of the Market

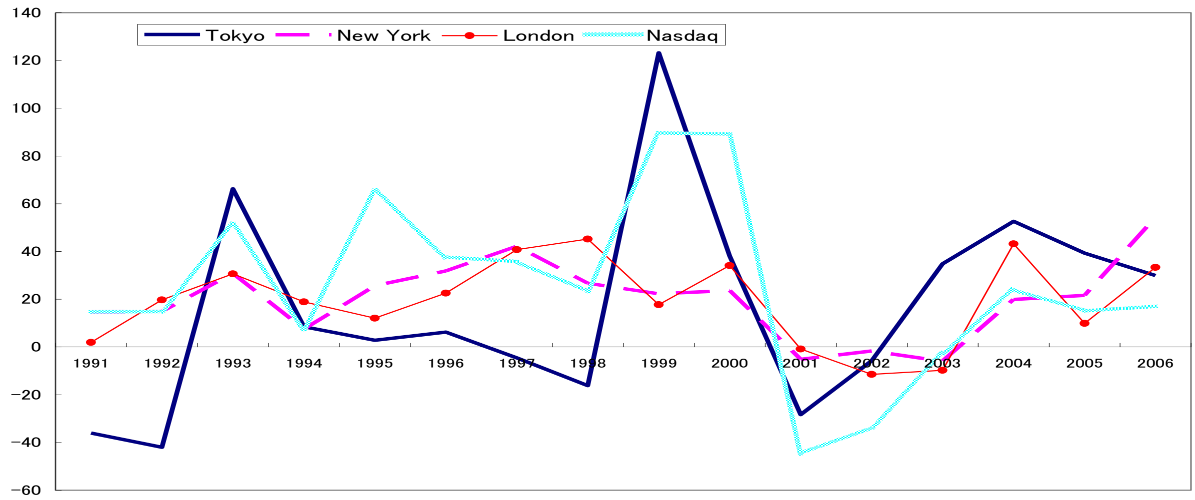
Relative to the size of its market capitalization, the liquidity of the market has been low. In 2006 the total value of share trading on the Tokyo Stock Exchange was the fourth largest in the world, following the New York Stock Exchange, Nasdaq and London Stock Exchange (see Chart 2). In particular, the expansion of trading in the two stock exchanges in the United Sates is remarkable notwithstanding the severe damage caused by the IT bubbles in the early 2000s. The growth rates of share trading value in Tokyo between 1991 and 2006 have been highly volatile and remained more or less sluggish until 2002 (see Chart 3). The growth rate for 2006 was 33%, but still ranked only 32nd in the world.

Chart 2. Total Value of Share Trading on Major Stock Exchanges (US$ Billions, 1990-2006)



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

Chart 3. Growth Rates of Share Trading Value on Major Stock Exchanges (%, 2001-06)



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

Growing Presence of Foreign Investors and the Low Risk Appetite of Domestic Investors

What is remarkable is that foreign (non-resident) investors have increasingly played an important role in activating transactions in Japan. 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).

Japanese assets held by foreign investors increased from JP¥ 204 trillion (US$1.9 trillion) in 1996 to JP¥ 343 trillion (US$3 trillion) in 2006. Over this period, the ratio of stocks to total Japanese assets held by foreign investors increased from 18% to 44% (see Table 1). Foreign investors increased their investment mainly in publicly traded stocks. As a result, foreign investors accounted for 27% of market capitalization in 2005 (see Table 2). Meanwhile, foreign investors' investments in private bonds and other structured instruments still represent less than 5% of foreign investments in Japan, reflecting the generally small size of these financial markets (IMF, 2007).

Table 1. Japanese Assets Held by Non-Residents (1996 and 2006)

	1996 (JP¥ Trillion)	2006	1996 (% of Total Liability)	2006
Stocks	37	149	18	44
Bonds	28	60	14	18
FDI	3	13	2	4
Loans and Other Investment	136	117	67	34
Total	204	343		

Source: Prepared based on the data compiled by the Ministry of Finance.

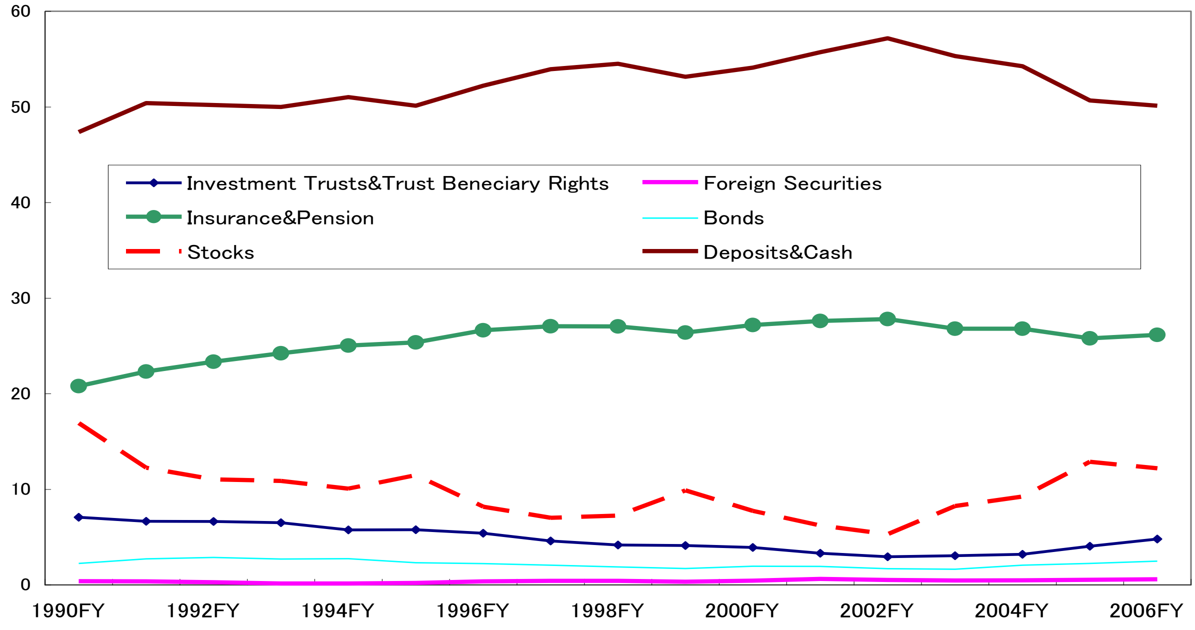
Table 2. The Ratio of Foreign Investors to Market Capitalization (%, 1991-2005)

	1991	1996	2001	2005
Japan	6	12	18	27
United States	6	7	10	13
United Kingdom	13	24	32	33
Germany	11	9	14	20
Korea	––	13	37	40

Source: Prepared based on the data submitted to the Financial System Council, FSA.

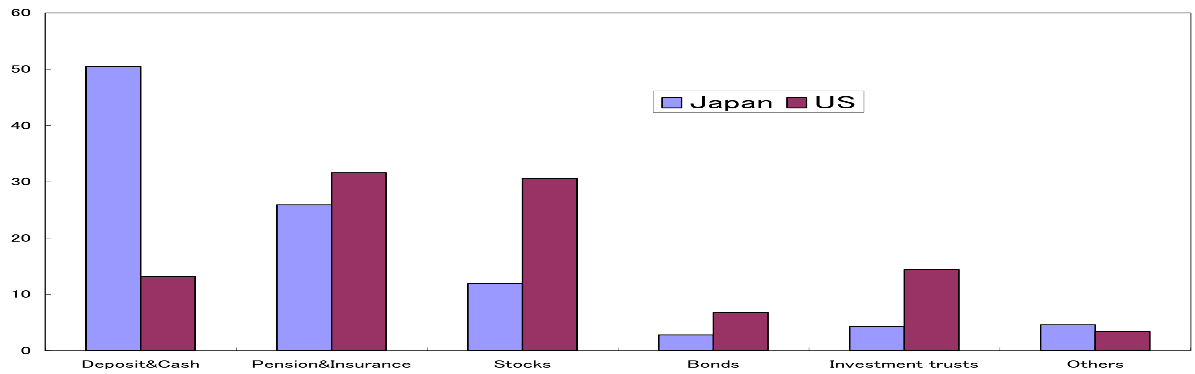
By contrast, households' holdings of stocks have accounted for less than 20% of their financial assets throughout the period, notwithstanding their increased holdings (see Chart 4). In 2006, households' holdings of stocks accounted for 12% of their total financial assets—much lower than those of the United States of 31% (see Chart 5). Japanese households continue to hold over half of their financial assets in the form of deposits & cash even after the Financial Big Bang had been implemented. 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 13% in the United States, 25% in the United Kingdom, 31% in France, and 36% in Germany. Thus, it is clear that households have not been the major contributors to the recent increase in the market capitalization as well as to the issuance of stocks by non-financial firms.

Chart 4. The Composition of Japanese Household's Financial Assets (% of Total, 1990-06)



Source: Prepared based on the flow of funds accounts compiled by the BOJ.

Chart 5. The Composition of Households' Financial Assets in Japan and the US (% of Total, 2006)



Source: Prepared based on the flow of funds accounts of the BOJ and Federal Reserve Board.

Moreover, major domestic institutional investors have been reluctant to invest in stocks (as well as foreign securities) as compared with bonds. There is a strong preference toward bond investment, as seen in Table 3. Of the bond holdings, the Japanese Government Bonds (JGBs) are the most popular bonds. JGBs account for 72% of total bond holdings in the case of *Social Security Funds* (largely consisting of public pension funds), 67% in the case of private pension funds, and 57% in the case of the insurance sector. Bonds are preferred due to their low market volatility and are seen as more secure assets in terms of income. By contrast, in the United States, pension funds as a whole invest 49% of their assets in stocks & investments (including foreign stocks) and only 14% in bonds. Institutional investors there, such as insurance firms, pension funds, and college funds, have been globally actively investing in stocks and other risky assets.

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 April 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 US$ 8.7 trillion at end-March 2006. But the GPIF has only been required to invest 11% in domestic stocks (and 8% in foreign ones, and 9% in foreign stocks), while allocating 67% to domestic bonds.[5] By contrast, the two best known public defined-benefit pension funds in the United States, *CalPERS* (the California Public Employees' Retirement System） and the *California State Teachers' Retirement System*, invest more than 40% in domestic stocks and more than 20% in foreign stocks.[6] There are a number of diverse professional investment management firms (or asset management firms) in this country, that these institutional investors could call on for advice.

5 The GPIF is the largest pension fund in the world in terms of the size of assets. It is followed by *Government Pension* in Norway (US$2.4 trillion), *ABP* in Netherlands(US$ 2.3 trillions), *National Pension* in Korea(US$2.1 trillions), and *CalPERS* (US$1.9 trillions).

6 However, the *Federal Old-Age, Survivors, and Disability Insurance* (OASDI) in the United States, which is financed by payroll taxes, invest most of their reserved funds in non-marketable treasury securities.

It should also be noted that other Japanese investors are also conservative. For example, while investment trusts allocated 44% of their assets to foreign securities, they largely consist of bonds, not stocks.[7] 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, it is certain that Japanese domestic investors on the whole have been very conservative.

Table 3. Asset Composition of Major Institutional Investors in Japan (% of Total, March 2007)

	Deposits & Cash	Stocks & Investment	Bonds & Others	Foreign Securities
Social Securities Funds	3	14	43	15
Pension Funds	6	31	33	25
Insurance	1	12	54	11

Source: Prepared based on the flow of funds account compiled by the BOJ.

It has also 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% (*Pension Fund Association,* 2007). 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.

Inactive Listings by Foreign Firms

The Tokyo Stock Exchange permitted the listing of foreign stocks in 1973 in line with the process of capital account liberalization launched by the Government. It has targeted mainly blue chip firms in the United States and Europe. Transactions have been performed in yen and financial reports are required to be released in Japanese. Many foreign firms decided to list their stocks in the Tokyo Stock Exchange for the purpose of raising their reputation in Japan because its market capitalization was then the largest in the world, as well as expanding business in then booming Japan. Double listings—listings on both the stock exchange of their home countries and the Tokyo Stock Exchange—have been commonplace.

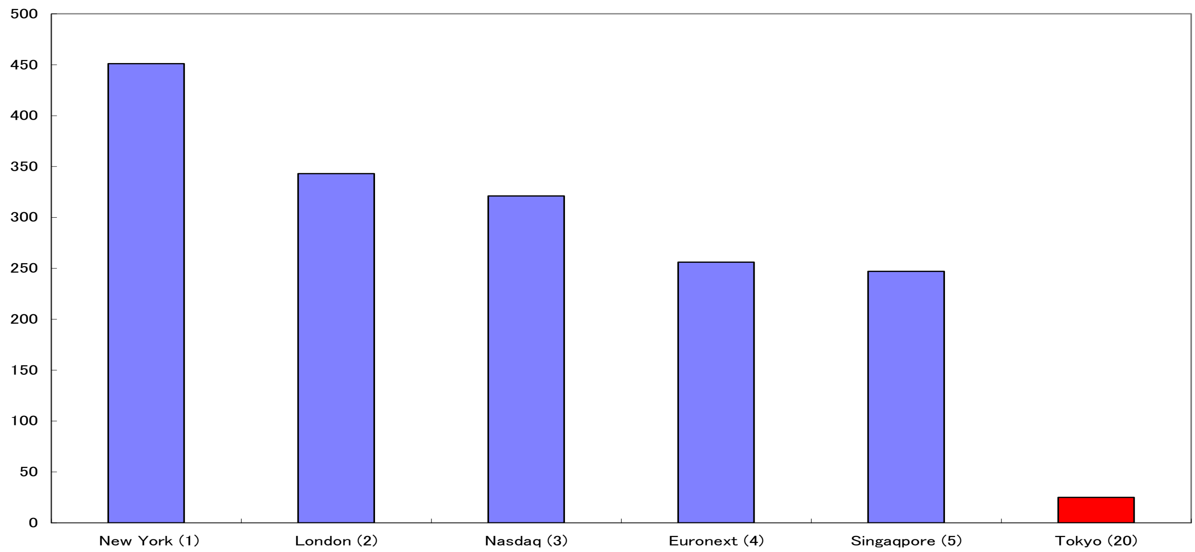
The number of listings grew rapidly in the 1980s, reaching the peak of 127 firms in 1991. Since then, the number has dropped to mere 25 firms by 2006, ranking it only the 20th in the world (see Chart 6). Among

7 As of end-2006, the amount of assets held by investment trusts reached US$7 trillion in the United States, while that of Japan reached es only US$888 billion.

those listed foreign firms, there are only 3 firms from Asia—far below the New York Stock Exchanges (72 Asian firms out of 451 foreign firms) and London Stock Exchange (39 Asian firms out of 343 foreign firms). Compared with the share of foreign investors in market capitalization, the share of foreign firms in the issuer base represents a large gap and supports the view that the Tokyo market has not really been internationalized. The decline took place in part because some foreign firms—such as Apple Computer, Daimler Chrysler, and Deutsche Bank—de-listed their shares in the face of economic stagnation and declining market size in Japan. It was also because some foreign firms increased recourse to *public offering without listing* (POWL) or obtaining funds from Japanese institutional investors without publicly listing—for the purpose of avoiding stringent disclosure requirements imposed by the Tokyo Stock Exchange and so enjoying lower issuing costs. Unlike publicly listed stocks, the transactions for these issues are made in local currencies, not in yen. Since 2003, the number of POWLs reached 36 (16 from China) and procured JP¥762 billion (US$6.6 billion), according to the information provided by the Tokyo Stock Exchange (2007).

Furthermore, the number of newly listed foreign firms was just 1 firm each in 2005 and 2006 (while the number of newly listed domestic firms was 98 firms and 113 firms, respectively). By contrast, the number of newly listed foreign firms was 19 firms in 2005 and 28 firms in 2006 in the New York Stock Exchange (while the number of newly listed domestic firms was 127 firms and 100 firms, respectively). The performance of the London Stock Exchange is even more remarkable, as evidenced by the number of newly listed foreign firms recording 21 firms in 2005 and 32 firms in 2006 (while the number of newly listed domestic firms registered 605 firms and 544 firms, respectively).

Chart 6. The number of Foreign Firms Listed in Major Stock Exchanges (2006)



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

3.2. Trends of the Bond Market

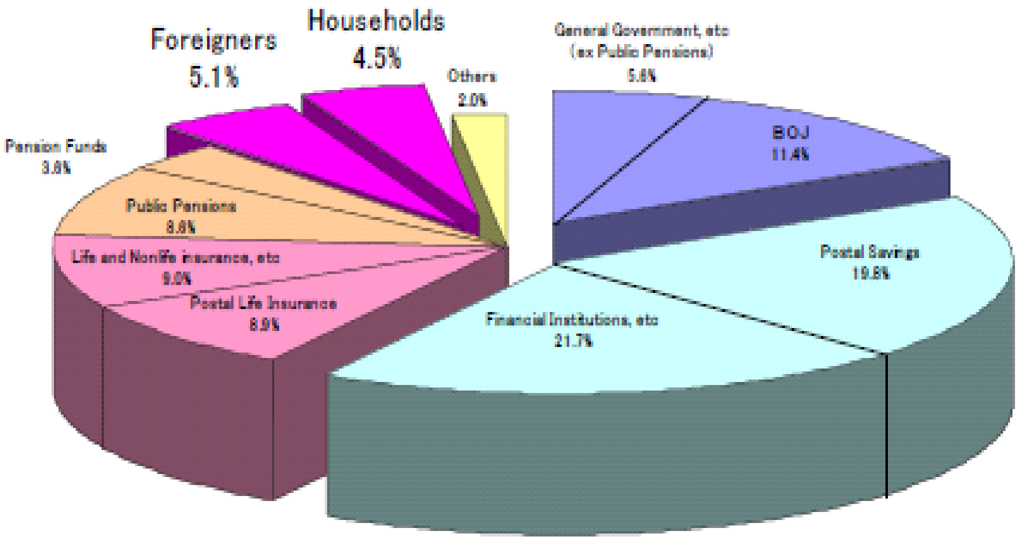
Japan's bond market has been dominated by the JGBs, as shown in Chart 7. Because of the deterioration of the fiscal balance since the collapse of the financial bubbles, the outstanding value of government bonds issued increased from US$ 2.8 trillion in 1998 to US$6.2 trillion in 2007. Accordingly, the ratio of government bonds to total outstanding bonds issued rose from 70% in 1998 to 90% in 2007. Japan's total outstanding public debt (including bonds) is the largest in the world. Despites its huge debt, the Government has so far found it relatively easy to find investors—mainly from domestic sources thanks to the conservative investment attitude of domestic investors. Chart 8 indicates that the public and public-related sector (including the Central Government, the Bank of Japan, Public Pensions, Postal Savings, and Postal Life Insurance) held 54% of the outstanding JGBs issued as of September 2006 (Chart 8). Households held only 4.5%. It may be said that households indirectly support the Government through making deposits and purchasing insurance, which in turn invest in the JGBs. Meanwhile, foreign investors held only 5%. This investor composition differs from the United States, where the Federal Government depends on foreign investors for 44% of its marketable treasury securities. The share of government bonds held by foreign investors is also high in other countries; France (29%), Germany (47%), and United Kingdom (27%) (IMF, 2007).

Chart 7. The Size of Outstanding Bond Issued (US$ Billion, 1998-2007)

Note: The data for 2007 refers to the figure as of June.

Source: Prepared based on data from Asian Bonds Online.

Chart 8. Composition of Outstanding Issuance of JGBs by Investors (June 2006)

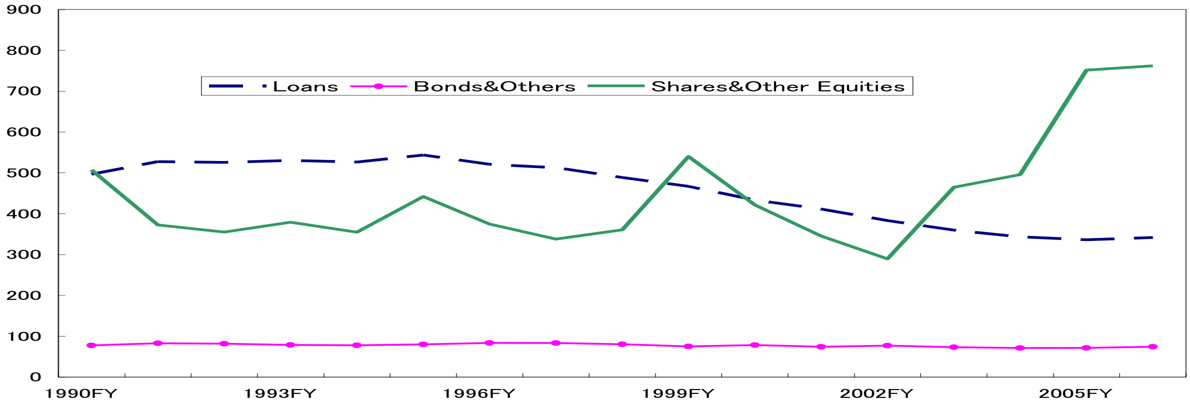


Source: Ministry of Finance http://www.mof.go.jp/english/bonds/ir/ir070308b.pdf.

By contrast, the corporate bond market has hardly developed. This is mainly because recently firms tend to raise funds by issuing stocks, as well as the traditional way of borrowing from banks (Chart 9). 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$ 682 billions in June 2007—far below the size in the United States where US$3.2 trillion was issued as of December 2006. The majority of issuers have been firms with investment grade (90% of total bonds). Namely, the market for bonds with below-investment grade, commonplace in the United States (accounting for more than 50% of total bonds), has hardly emerged. The Government Pension Investment Fund (GPIF) 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. 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 (for example as compared with the JGBs). 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.

Chart 9. Major Sources of Liabilities by Non-Financial Firms (JP¥ Trillions, 1990-06)



Source: Prepared based on the flow of fund accounts compiled by the BOJ.

3-3. Trends for ETFs and Securitized Markets

The types of financial assets listed on the Tokyo stock exchange are limited. As of end-2006, there were only 11 listed Exchange Traded Funds (ETFs) on the Tokyo Stock Exchange; all of which were ETFs related to stock indices. This number is smaller than the New York Stock Exchange (135) and London (39). It is even lower than the Korea Stock Exchange (12) and the Singapore Stock Exchange (13). Since ETFs are securities that track an index, a commodity, or a basket of assets and trade like a stock on the stock exchange, a wide range of EFTs can be created. Indeed, there are a large number of ETFs that have been listed on overseas stock exchanges, but not on the Tokyo Stock Exchange. These include a wide range of commodity indices (e.g., agriculture, gold, sliver, petroleum, and grains), REIT indexes, and funds.

The markets for securitized bonds, such as mortgage-backed or asset-backed securities, and collateralized debt obligations (CDOs) have been growing (see Table 4). In particular, mortgage-backed securities have been rapidly expanding. However, the size of the mortgage-related securities were just US$ 77 billion (of which, J-REITs accounted for 25%), which is much smaller than that in the United States of US$ 5.8 trillion in 2006. The size of the securitized bond market as a whole also accounts for just 3% of GDP. Also, liquidity in the secondary market is low. It has been indicated that the lack of information for third parties about the products available makes it difficult to properly analyze risks.

Markets for ETFs and securitized bonds could be expanded if the requirements imposed on public pension funds for portfolio management were loosened. Tight portfolio regulation has resulted in an unimpressive return performance and has thus affect the sustainability of the public pension system. Public pension funds in the United States and Europe actively invest in various securities by utilizing asset management funds, hedge funds, private equity funds, and other types of funds. Tight regulation in Japan hinders the development of investment trusts and various other funds as well as the increase in human resources with professional skills.

Moreover, the market for credit derivatives (i.e. credit default swaps) has been growing worldwide. The notional principal outstanding for all credit derivatives reached over US$20 trillion worldwide at end-2005. Credit default swaps provide a useful tool of hedging credit exposure for banks (thus reducing credit concentration and freeing up credit lines), and at the same time, providing useful credit pricing information. This emergence has created an environment where banks lend and sell through securitization—a change from the past when banks traditionally lend and hold credit until maturity. So far, Japan's market for credit derivatives has been inactive because of (a) a lack of market volatility and liquidity in the corporate bond/loans secondary markets, (b) a too tight credit spread (thus no incentive to hedge with credit derivatives), and (c) regulatory factors such as an accounting mismatch (between accrual-based accounting for loans and market-based accounting for derivatives hedging instruments) and regulation to limit big loans to a borrower (*International Swaps and Derivatives Association* [ISDA], 2007). There are also a limited number of brands associated with credit derivatives.

Table 4. Outstanding Securitized Securities Issued in Japan (US$ Billions, 1995-2006)

	Mortgage Backed	Asset Backed	CDO	Total
1995	0	0	0	0
1996	0	0	0	0
1997	1	0	0	1
1998	5	0	0	5
1999	8	0	0	8
2000	9	0	0	10
2001	17	2	0	19
2002	26	5	1	32
2003	34	11	3	48
2004	43	13	8	64
2005	55	25	17	97
2006	77	36	27	139

Source: Prepared based on Asian Bonds Online.

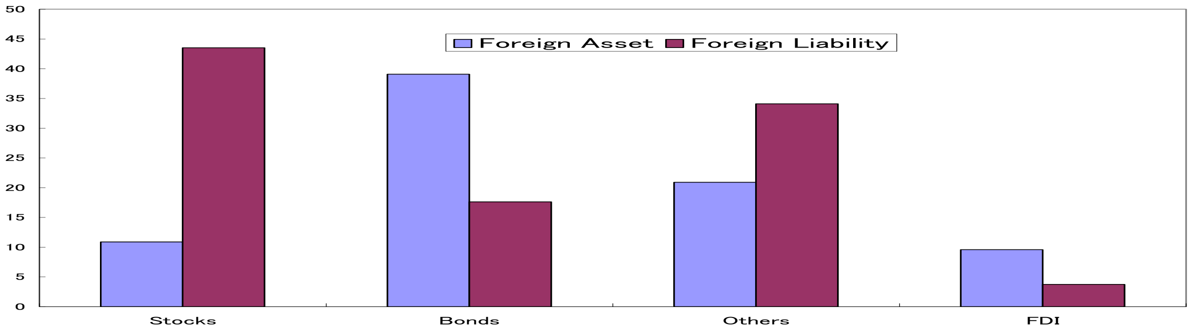
3.4. Cross-Border Market Developments and Internationalization of the Yen

Capital Inflows and Outflows

Japanese investors have increasingly been paying attention to the possibility of overseas investments being lucrative. Their holdings of foreign assets have almost doubled from 2000 to about US$5 trillion in 2006. However, foreign assets have concentrated largely in debt securities rather than stocks—a sharp contrast to the fact that Japanese assets held by foreign investors concentrate largely on stocks (Chart 10). Loans and bonds account for 40% of total foreign assets held by Japanese investors in 2006, because of investors' risk-averse attitudes (Table 5).

Among holders of foreign assets (excluding FDI, trade credits and official foreign reserves), banks have remained major investors and account for 53% of foreign investment in securities and credits. But their investments mostly reflect lending operations, owing to easier provisioning regulations abroad and an extension of "*relationship banking*" to the foreign subsidiaries of domestic clients (IMF, 2007). Pension and life insurance companies as a group are the next largest investors (14%) but their investments are constraint by the internal exposure limit as indicated above. Households increasingly invest in foreign assets, but do so mostly through mutual funds. The expansion of investment trusts, though to a lesser extent compared with the United States, is assisted by the deregulation of sales of mutual fund products at bank branches in 1998 and subsequently at the branches of the *Japan Post* in 2005. Indeed, sales through bank windows account for more than half of the total assets under investment trust management.

Chart 10. Composition of Japan's Foreign Assets and Liabilities (% of total, 2006)



Source: Prepared based on data compiled by the Ministry of Finance..

Table 5. Foreign Assets Held by Japanese (1996 and 2006)

	1996 (JP¥ Trillion)	2006	1996 (% of Total Liability)	2006
Stocks	18	61	8	19
Bonds	91	218	6	11
FDI	30	53	10	10
Loans and Other Investment	144	117	47	21
Foreign Reserves	25	106	8	19
Total	308	558		

Source: Prepared based on data compiled by the Ministry of Finance.

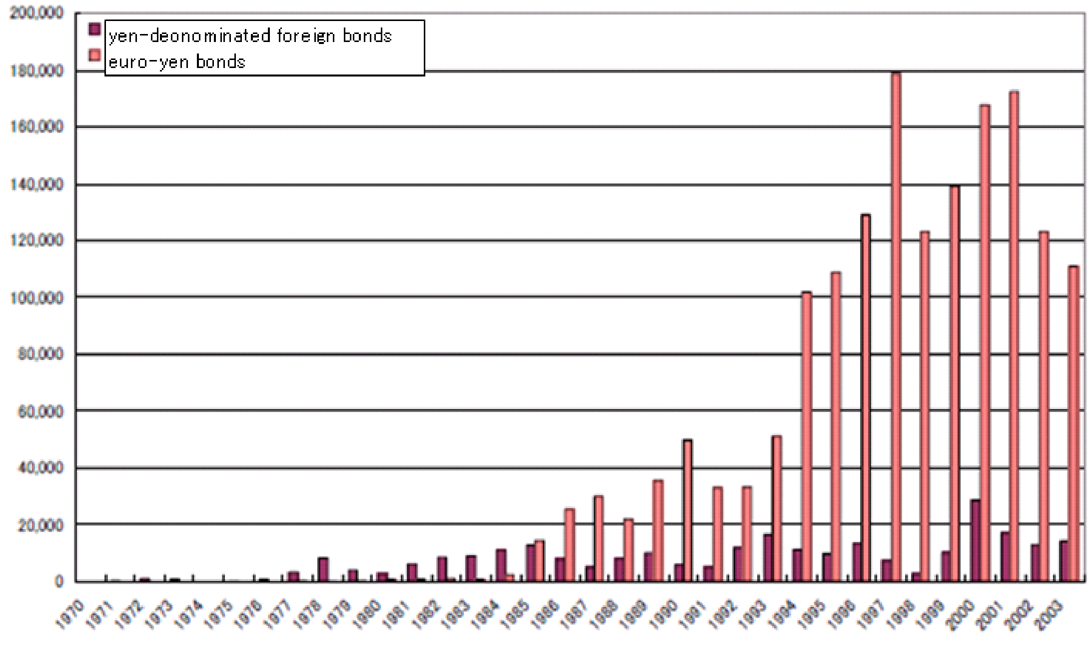
Yen-Denominated Bond Markets (Samurai and Euro-yen Markets)

The market for yen-denominated foreign bonds (bonds issued by foreign entities, so-called "*Samurai bonds*") in Japan was liberalized in the early 1970s. The first issuer was the *Asian Development Bank* in 1970, followed by the *World Bank* in 1971. The major issuers of Samurai bonds have shifted from foreign governments (such as those of Greece, Turkey, and Hungary in the first half of the 1990s) to the private sector from the United States and Europe (recently also increasing from Asia). Foreign securities firms that have operational activities in Japan (such as Goldman Sachs and Merrill Lynch) have increased the issue of Samurai bonds (Kawashima and Fukushi, 2006). This trend is evident notwithstanding that there was a large-scale issue by the governments of Argentina and Brazil in 2000. Major investors of Samurai bonds are domestic investors.

Furthermore, the euro-yen market emerged in 1979 to circumvent stringent issuing procedures and disclosure requirements, as well as withholding taxes imposed on interest income. The first issuer was the *European Investment Bank*. The euro-yen issue by nonresident entities other than foreign governments and international organizations (i.e. foreign firms)—as well as by resident (domestic) firms—was liberalized in 1986. The gap between the markets for Samurai bonds and the euro-yen bonds has rapidly widened since the second half of the 1980s. This reflected greater liberalization of issuing terms in the euro market and no withholding tax imposed on interest income of euro-yen bonds (see Chart 11). Since then, issuing terms in Tokyo have also been liberalized (for example, by easing the eligibility criteria of issuers' rating from equal or over A to equal and over BBB in 1994) have become almost comparable to those of the euro-yen market. But, the cost related to issuing bonds (such as lawyers' fees required to prepare contractual documents, the requirement of preparing documents in Japanese and its English translation), has remained high, hampering the increased diversification of foreign issuers (Iijima, 2005). The euro-yen bond market has also declined in recent years, after experiencing a surge in 2000 (i.e., by the issue of international organizations). Major investors of euro-yen bonds are also Japanese investors.

Moreover, the share of both Samurai-bonds and euro-yen bonds outstanding has declined from 17-18% in 1994-95 to less than 1% in 2005. This reflected that issuing volume of yen-denominated bonds has declined while the issuing volume of other currencies-denominated bonds has rapidly grown. The emergence of the large euro market in 1999 has made it easier for European governments to raise funds within Europe, thereby reducing the need to seek recourse to other markets, including the yen market. Also, the lack of investment demand for yen-denominated bonds by foreign investors (due to low interest rates) has helped lower the issue of yen-denominated bonds by foreign entities both in the Japanese and euro markets.

Chart 11. Yen-Denominated Foreign Bond and Euro-Yen Bond Markets (JP¥ 100 Millions, 1970-2003)

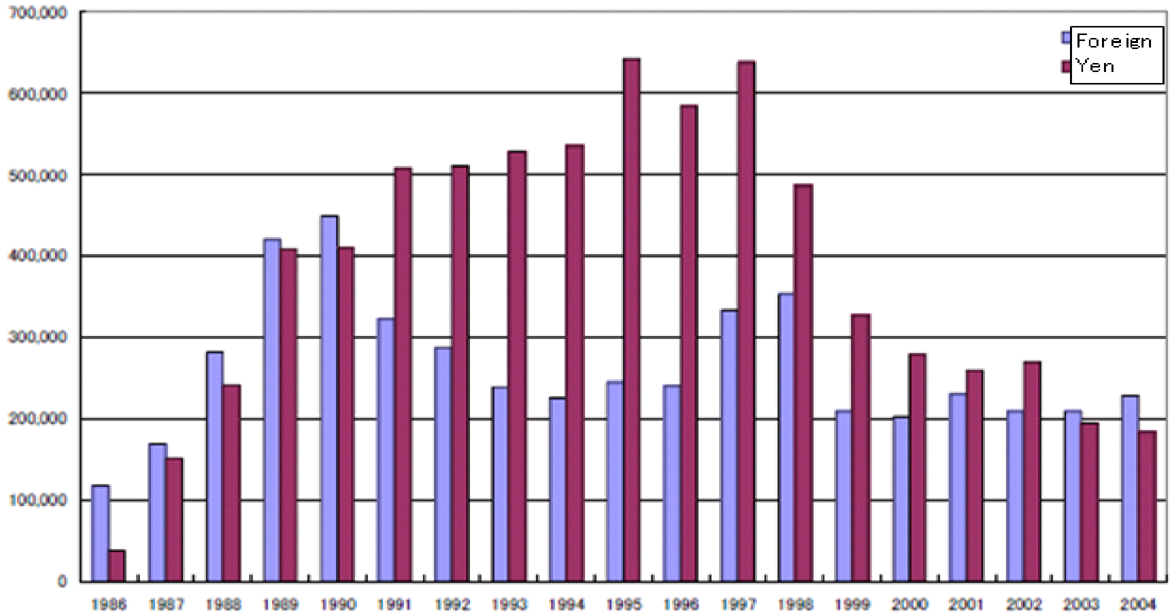


Source: Iigima, T. (2005).

Tokyo Offshore Market

In 1986, the Tokyo offshore market was introduced as a platform for out-out financial transactions. In the offshore market, disclosure requirements related to the issuance and resale of securities are usually exempted; regulation on foreign exchange management is limited; tax exemption on interest and dividend incomes is provided; and statutory reverse requirements are exempted. The Tokyo offshore market refers to an *International Banking Facility* (IBF), where participating banks establish IBF accounts separately from the accounts for general markets and use them only for IBF-related transactions with both non-residents and residents. The IBF-type approach differs from that in London, where transactions for residents and non-residents are fully integrated. The participants in the Tokyo offshore market mainly consist of domestic banks and financial institutions approved by the Government, foreign branches held by domestic banks, sovereign entities, international organizations, and foreign firms. The activities such as lending and depositing in any currencies have been conducted. The offshore market expanded in the 1990s. Since then, however, the market particularly for the yen has rapidly shrunk (see Chart 12).

Chart 12. Y en- and Foreign Currency-Denominated Offshore Market (JP¥ 100 Millions, 1986-2004)



Source: Iigima, T. (2005).

Traditional Foreign Exchange and OTC Markets

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 Table 6). The ratio of the turnover in the United Kingdom to world turnover expanded from 27% in 1992 to 34% in 2007. 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 (and recently Switzerland).

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 (Table 7). 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%), as shown in Table 8. The share of the US dollar/yen pair has declined during 1995-2007, while that of the US dollar/sterling has rapidly expanded.

Table 6. Geographic Distribution of Reported 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 based on BIS (2007).

Table 7. Currency Distribution of Reported 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 based on BIS (2007).

Table 8. Reported Foreign Exchange Market Turnover by Currency Pair (Daily Averages in April, US$ Billions, %, 1995-2007)

	1995		1998		2001		2004		2007	
	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share
US dollar/euro					354	30	501	28	840	27
US dollar/yen	242	21	257	18	231	20	296	17	397	13
US dollar/sterling	78	7	118	8	125	11	245	14	361	12
US dollar/deutsche mark	51	4	58	4	--	--	--	--	--	--
US dollar/ECU	18	2	17	1	--	--	--	--	--	--
US dollar/other EMS	104	9	176	12	--	--	--	--	--	--
US dollar/other	200	17	338	23	349	30	532	29	1061	36
All currency pairs	1137	100	1430	100	1173	100	1773	100	3081	100

Source: Prepared 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% (Table 9). 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%.

Table 9. Geographic Distribution of Reported OTC Derivatives Turnover (Daily Average in April; US$ billions and %, 1998-2007)

	Total (Billions US dollars)				% Share			
	1998	2001	2004	2007	1998	2001	2004	2007
Japan	42	22	39	88	9	3	3	4
United States	90	135	355	607	19	18	24	24
United Kingdom	171	275	643	1,081	36	36	43	43
Germany	34	97	46	93	7	13	3	4
France	46	67	154	183	10	9	10	7
Total Turnover	475	764	1,508	2,544	100	100	100	100

Source: Prepared based on BIS (2007).

Among foreign currencies, the US dollar is the most-actively transacted one-side currency in the foreign exchange OTC market (including forward and swaps contracts). The euro is the second most traded one-side currency in the foreign exchange OTC market, but is the most-frequently used denomination currency for interest rate derivatives (followed by the US dollar). The yen is the third traded one-side currency in the foreign exchange OTC market (followed by the sterling pound), but the fourth denomination currency for interest rate derivatives (after the pound sterling).

The above observations suggest the importance of the United Kingdom and United States in the foreign exchange and OTC derivatives markets. In terms of currency, the US dollar remains the dominant transaction currency, followed by the euro. By contrast, the presence of Japan as a market place as well as the yen as a transaction currency has been declining. This makes it difficult for Japan to play an increasingly important role in Asia, with a view to reducing the region's heavy dependence on the US dollar and making progress toward future common exchange rate arrangements. Asian countries use various types of exchange rate arrangements. However, the local currencies in many countries have remained linked, to a significant extent, to the US dollar and this is particularly so on a day-to-day trading basis.[8] The common adherence to the US dollar reflects the dominance of the US dollar in trade and capital transactions as an invoice currency as well as foreign exchange, financial and capital markets as an intermediary currency.

IV. GOVERNMENT VISION FOR THE TOKYO MARKET AND THE REMAINING AGENDA

The Vision of the Government for Revitalization of the Tokyo Market

There are two types of government documents with respect to the revitalization of the Tokyo market. The first report—called "Interim Summary Issues (Phase 1)—was released by the *Study Group on the Internationalization of Japanese Financial and Capital Markets* of the FSA in June 2007. The second report is called "*Toward the Establishment of Truly Competitive Financial and Capital Markets* (the interim report)" prepared in April 2007 by the *Working Group on Financial and Capital Markets* of the *Council on Economic and Fiscal Policy* (CEFP).[9] The essence of this report is reflected in the "Direction and Strategy for the Japanese Economy 2007 (drafted by the CEFP and adopted subsequently by the Cabinet in June 2007). While the reports overlap each other and stress a vision of developing the Tokyo market into a top international financial center, the latter is written within the broader perspective of seeing the revitalization of the financial and capital markets as an engine for Japan's growth strategies.

In the first report by the study group of FSA, attractive markets are defined as those that could offer diverse products and services (particularly markets for high-yield bonds and credit-related products), accommodate various market players; and fulfill market functions underpinned by strict self-discipline of market participants. It identifies regulatory environmental issues that should be tackled to develop Tokyo

8 For example, McKinnon and Schnable (2002) showed that high frequency (day-to-day) linkage to the US dollar has become as robust after as it was before the crisis. Using the Swiss franc as a numeraire for measuring exchange volatility for any East Asian country, the exchange rates of each of the nine East Asian currencies were regressed on the US dollar, the Japanese yen, and the German mark (as a leading currency for the European currency system, representing the euro) and for three periods: pre-crisis (from February 1994 to May 1997), crisis (June 1997 to December 1998) and post-crisis (January 1999 to April 2002). The nine East Asian currencies include the Chinese yuan, Hong Kong dollar, Indonesian rupiah, Korean won, Philippine peso, Singapore dollar, Taiwan dollar, Thai baht, and Malaysian ringgit. The study indicated that degree of linkage to the US dollar declined during the crisis period, the weights of the US dollar have again become close to unity and stable after the crisis.

9 The CEFP is a consultative organ placed within the Cabinet Office for the purpose of facilitating full exercise of the Prime Minister's leadership and sufficiently reflecting the opinions of private-sector experts in economic and fiscal policy formation. The CEFP is headed by the Prime Minister, and includes the Chief Cabinet Secretary, the Minister of State for Economic and Fiscal Policy, other relevant ministers, Governor of the Bank of Japan, and four private-sector experts.

as an attractive market. Those include (1) further clarification of rules, enhancement of information on laws/regulations in English and Japanese, improvement of regulatory authority's skills, enhancement of collaboration with overseas authorities, and enhancement of roles and functions of self-regulation, (2) review of the penalty system and enhancement of the dispute resolution system, (3) review of firewall regulations for banking and securities business, and (4) overhaul of the financial and securities tax system with the aim to minimize the distortion of the market by the tax system.

Suggested measures to increase financial assets include a diversification of products tradable at exchanges and an expansion of trading opportunities for shares of foreign firms' in Japan, such as *Japan Depository Receipt* [JDRs]. The JDRs refer to ownerships of foreign stocks that are issued by Japanese depository banks and can be traded like shares of foreign firms, but carry prices in yens and pay dividends in yen. Infrastructure-related measures cover a stimulation of transactions among professionals, as well as improvements in the security, efficiency, and convenience of settlement systems in response to the advancement of the IT industry and growing cross-border financial and capital transactions. The report also stresses an enhancement of the Japanese version of *401K* (defined contribution pension plan) system, as demonstrated by the *Individual Retirement Account* (IRA) in the United Stats and *Individual Savings Account* (ISA) in the United Kingdom. The IRA refers to a retirement plan account that provides some tax advantages for retirement savings in the United States. Meanwhile, the ISA refers to an account which can be used to hold many types of savings and investment products (e.g., cash, life insurance and stocks and shares). There are strict rules regarding the maximum amount allowed for each component and the overall amount that can be invested in any one tax year. The returns earned in an ISA (capital growth and income) are tax-free.

In the second report prepared by the working group of the CEFP, a clear and detailed vision for upgrading Tokyo as an international financial market is described in detail, as shown in the Box below. In particular, the report stresses measures to promote diversified financial assets that could be listed on stock exchanges—such as commodity futures to be included in investment trusts and the ETFs. At the same time, it is pointed out that the organization of existing multiple commodity exchanges should be reviewed given that they are being left behind the global expansionary trends observed in overseas exchanges. For example, their role in price making has been lost to other countries. To strengthen the governance of these exchanges, it is important not only to increase competition and merge among domestic exchanges, but also to shift these exchanges from a membership system to a joint-stock corporation and eventually list their shares. Once these measures are implemented, the regulatory environment should be adjusted accordingly. For example, restrictions should be imposed on the re-employment of officers in the supervisory agencies at the exchanges. The need for permission regarding listed products from the minister in charge must be abolished and should be left to the self-regulation of the exchanges.

To further develop the J-REIT market, moreover, the report stresses that overseas real estate should be included. There are no legal stipulations forbidding the inclusion of overseas real estate as management assets for J-REITs in Japan. However, there are no established methods for evaluating overseas real estate. As a result, stock exchanges have forbidden such listings by issuing listing provisions. As well, a *Japan Depository Receipts* (JDR) should be permitted to increase shares from Asian countries, such as China and India.

A creation of a market for professionals with limited regulations and greater emphasis on the principle of self-responsibility should also be considered to promote innovation in financial products and services. Such a market enables firms to raise capital through the issue of specialist securities (including debt, convertibles and depositary receipts) to professional or institutional investors. This type of market is already demonstrated by the *Professional Securities Market* (PSM) in London, following EU deregulation in 2005. The PSM is a listed, exchange-regulated market, where issuers benefit from a flexible and pragmatic approach to regulatory requirements, and institutional investors gain the assurance of investing in listed securities. To introduce such a market in Tokyo, professional market participants must establish firm compliance and internal governance and satisfactorily accept the disciplines of professional liability. The rules regarding the fiduciary duty of institutional investors that manage the assets of ordinary investors need to be clarified as well.

<Toward the Establishment of Truly Competitive Financial and Capital Markets>

(1) To turn the Tokyo market into a common Asian platform

- Creation of new financial products by incorporating gold spot and commodity futures as assets in investment trusts and ETFs, as well as overseas real estate as an eligible asset for J-REIT investment
- Amendment of the *Financial Instruments and Exchange Law* as well as *Commodity Exchange Law* that would enable the establishment of comprehensive exchanges covering financial and commodity futures (and possibly, electricity and emissions), and the establishment of commodity exchanges under a stock exchange holding company
- Establishment of government and ministerial ordinances related to the JDRs
- Strengthen payment and settlement systems by (a) promoting their international harmonization with respect to English notation and *SWIFT* (Society for Worldwide Interbank Financial Telecommunication); (b) reducing settlement times from 3 days to 1 day;[10] (c) advancing infrastructure (financial *Electronic Data Interchange*[EDI]), and (d) improving crisis management systems (e.g., backup systems and *Business Continuity Plan*)
- Establish markets for professional investors and prepare differentiate regulations applicable to professional and general investors
- Improve secondary markets and information provision with respect to securitization products and syndicated loans by formulating disclosure criteria at the initiative of industry groups

10 In Japan, settlement time is T+3 for both treasury bonds and stocks, while that for treasury bonds is T+1 and T+3 for stocks in the United States.

- Promote convergence of accounting standards and allow disclosure by Japanese firms based on *International Financial Reporting Standards* (IFRSs).[11]
- Implement English language disclosure (of laws), provision of information in English, and establish specialist English-speaking contact points in government agencies and exchanges
- Attract foreign participants by reviewing regulatory and taxation systems
- Legislate *Public Company Law* with the aim at strengthening the governance of companies in the capital market[12]
- Strengthen Tokyo's overall capacity as a global financial center by improving human resources, the regulatory environment, physical access to international financial markets, and business infrastructure including airport access

(2) Promoting innovation by participants

- Revision of firewall regulations on banking, securities, and insurance
- Permission for special licenses to enable *narrow banking* (specializing in settlement operations) and *captive insurance company* (specializing in underwriting the issuance of a specific organization)
- Increased freedom of investment for public pension funds (such as GPIF) and strengthen fiduciary duties
- Integration of taxation applied to various financial asset incomes and introduction of individual investment accounts to promote securities investment
- Improve the basic abilities of the public to understand and utilize financial knowledge
- Develop professionals with expertise in finance (e.g., inclusion of finance-related topics to the subjects in choice of bar exams, introduction of CPA exams, modification of civil service exams, establishment of courts that specialize in handling finance)
- Creation of an environment to secure top talent from overseas

(3) Improving the transparency and predictability of regulatory supervision

- Deregulation of markets for professionals and full protection of individual investors
- Strengthen the function of the *Securities and Exchange Surveillance Commission* [SESC] (review the modalities of planning/design/supervision/inspection, and strengthen the SESC's independence and its quasi-judicial function)
- Utilize regulatory and supervisory methods based on *principles*
- Improve *no-action letter system* (scope of items, anonymity, and flexible timing of public announcements) and introduce *Safe Harbor Rules*[13]

11 The *International Bankers Association* [IBA] (2007) has recommended that the government and exchanges should relax the review process for acceptance of documents using the IFRSs and ease the Japanese SOX regulation applied to foreign firms which have already filed equivalent reports in other major markets. Currently, Japanese firms are allowed to adopt consolidated balance sheets based on US accounting standards (US GAAP), but not on International Financial Reporting Standards.

12 The *Public Company Law* is recommended by the *Japan Association of Corporate Directors* (JACD). It is pointed out that the benefits include a simplification of double regulations caused by the Financial Instruments and Exchange Law and Company Law (in principle by integrating the latter into the former), an establishment of full-scale management systems over subsidiaries through better internal controls and risk management, and a possibility of (consolidation-based) dividend payment (JACD 2007).

13 In the United States, exemption of the registration requirement over securities transactions among professionals (such as bonds issued in the United States by non-residents and bonds privately placed to qualified institutional investors) is covered by a guideline called "Regulation D". Regarding the exemption for disclosure requirement, the rule applicable to the domestic professional securities market is covered under the 144A regulation (a safe harbor rule) and to the

- Foster dialogue between financial supervisory authorities and financial business people
- Enhance functions and structure of self-regulatory organizations (i.e., *Japan Securities Dealers Association*, stock exchanges) without generating regulatory duplication
- Promote personnel exchanges between government and private sectors and prevent conflicts of interest
- Introduce cost-benefit analysis into regulations

Recent Initiatives by the Government

Regarding the cross-entry barriers, further deregulations have been launched. First, the *bank agency business system*—through which nonblank financial institutions can perform intermediating functions, such as depositing and lending—has been allowed since 2006. In response, a few securities firms and insurance firms have established their bank business agencies. For example, the bank business agency established by the *Nomura Securities*, the largest securities firm in Japan, has begun to intermediate depositing and remittance services on behalf of its affiliated *Nomura Trust Bank*. Second, the FSA allowed banks and insurance firms to conduct a part of fund businesses (i.e. constructing/ offering/investing in the funds targeting own loan credit and the funds investing in preferred stocks) through their own subsidiaries from end-September 2007, not only through already-approved separately-managed banks under the financial holding firms. Such a move is likely to expand the market for funds.[14]

Also, the Osaka Securities Exchange, one of the largest stock exchanges in Japan (Tokyo, Osaka, and Nagoya), has begun to list the gold-price-linked ETF in August 2007. This is the first commodity-linked ETF listed in the Japanese stock exchanges. The Tokyo Stock Exchange, meanwhile, will introduce the JDRs by end-2007 as one of the strategies to revitalize its foreign stock market (so far, only Depository Receipts issued outside Japan such as American Depository Receipts can be listed through depository linkage).

From May 2007, the provision of the *Corporation Law* allowed a foreign firm to merge or acquire a Japanese firm through its subsidiary in Japan in an effective "stock swap" (under the so-called *Triangular Mergers*). This enables a foreign firm to complete acquisitions in Japan using their parent firms' shares. Suppose a foreign firm wishes to merge a Japanese firm operating in Japan through this system, it needs to establish a subsidiary in Japan and needs to get approval from the (merged) Japanese firm's shareholders at the general meeting. Also, certain disclosure requirement on the foreign firm and shareholders' rights must be satisfied. Then, Japanese shareholders of this merged Japanese firm can exchange their shares

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offshore professional securities market under the "Regulation S". The Rule-144A qualified bonds issued by domestic firms consist of two types: one sold domestically (under the Rule 144A offering rule) and the other sold to non-residents (under the Regulation S offering rule). The former is settled through the Depository Trust Company, while the latter through the International Clearing and Settlement Depository. This indicates that the United States already prepared rules linking domestic transactions among professionals and cross-boarder transactions in the 1990s (National Institute for Research Advancement [NIRA], 2007).

14 However, they are not allowed to establish buyout funds for the purpose of avoiding corporate controls by banks and insurance firms. The maximum amount allowed to invest in ordinary shares is 5% (of outstanding issued stocks) for banks and 10% for insurance firms. The same regulation is applied to their own subsidiaries as well.

with the shares of the parent firm of the foreign subsidiary. If the foreign firm is already listed on the Tokyo Stock Exchange, it would be easier for the foreign firm to obtain approval at the general shareholders' meeting for a triangular merger.

Moreover, in line with the Government vision, the *Ministry of Economy, Trade and Industry* (METI) announced in June 2007 its intention to introduce detailed strategies in the near future to improve the competitiveness of the commodity markets (such as listing oil and metals) under its jurisdiction; thereby, promoting inflows of capital from domestic and Asian sources. The measures include an introduction of a 24 hour-transaction system and the *loss cut rule*, an expansion of listed products, deregulation on price setting and position, and an enhancement of the settlement system. The *Ministry of Agriculture, Forestry, and Fisheries* (MAFF) has also begun to examine a strategy to revitalize the grain and food commodity markets under its jurisdiction.

As for a market for professionals, the *Financial Instruments and Exchange Law*–with effect from September 2007, to protect investors by requiring quarterly information disclosure and internal control reports, and covering various financial assets—has distinguished general investors and professional (qualified institutional) ones, and loosened regulations on the latter related to sales promotion (such as exemption of requirement to provide investors with written explanations about risks). By extending this view, the FSA is now examining if such a distinction could be applicable as well to the market itself, as already demonstrated in the United Kingdom and the United States. As well, the permission for information disclosure only in English and a simplification of the audit certification prepared by auditors will be considered. If these considerations are implemented, the Tokyo market will have a new market for private securities traded in the market—one that will lie between publicly listed and private securities.

With respect to the penalty system, the government in June 2007 expressed its intention to revise the Financial Instruments and Exchange Law regarding the strengthening of the penalty system in cases of false information disclosure in the 2008 Diet. An increase in penalties, a greater coverage of false practices and types of businesses, a reduction of penalties in cases of voluntary reporting are expected to be discussed.

Important Agenda Remaining (1): Incentives to Promote the Entry of Foreign Entities

Some measures to promote important foreign players (such as hedge funds and other types of funds) could be considered. Hedge funds are likely to provide new sources of financing for Japanese firms, support a robust economy by providing additional liquidity to the market, and improve the market's corporate culture through promoting sound governance of portfolio companies.[15] The United Kingdom and

15 According to the TASS Database, the residence of hedge funds is concentrated on the United States (52%), the United Kingdom (19%), Bermuda (6%), France (3%), and Hong Kong (1%). Japan accounts for only 0.4%, which is smaller than Hong Kong, Singapore, and Australia. The factors, such as the residence of investors, tax benefits, and regulations, have affected this geographical contribution.

Singapore have successfully attracted hedge funds with preferential treatments. In the case of the United Kingdom, the tax authority created an *Investment Manager Exemption* that allows the profits of an eligible nonresident hedge fund not to be included in the UK's tax net. It only taxes the profits of the agent, the UK investment adviser, rather than the profits of its principal, the offshore head fund. Singapore created a hospital regime for fund managers to setting up operations there to manage hedge funds. Considering these global moves, Japan's tax regime could be revised to make it clear that hedge fund managers' activities, within certain guidelines, do not cause the funds they manage to become subject to tax. The *International Bankers Association* [IBA] (2007) claims that hedge fund managers should be permitted a broader range of discretionary activity in Japan without the risk of the managed funds being deemed to be a permanent establishment. Moreover, it claims that the laws that aggregate partnership holdings for purposes of determining whether such partnerships exceed large-scale thresholds and are thus subject to taxation of gains should be considered for review.

Furthermore, different regulations could be applied to different investment vehicles. In the United States, for example, hedge funds are not subject to the same regulations as other investment vehicles due to the limited numbers of investors (e.g., frequently exempted from registration and reporting requirements). By contrast, in Japan, a license is required to act as an investment company so hedge funds would also be subject to periodic disclosure requirements. Also, the Government should focus on Asian firms through special government incentives and better marketing. To attract foreign firms for listings, consideration could be given to establishing a sub-exchange under the Tokyo Stock Exchange for growth-oriented Asian firms, as suggested by the IBA (2007). Such a market would also attract foreign investors that willingly take risks associated with investment in such firms.

Important Agenda Remaining (2): Abolition of Cross-Entry Regulations

The already-implemented *Financial Instruments and Exchange Law* does not include the complete removal of distinctions between banking, securities, insurance, and trusts. The abolition of cross-entry barriers needs to be discussed. Since the Financial Big Bang, cross-entry barriers have been deregulated by allowing the establishment of financial holding firms, but separate management of various financial businesses has remained a requirement. The concerns over conflicts of interest and possible abuses exercised by banks have deterred the move toward the integration of various financial services or a *universal banking* system for a long time. The United Kingdom has already made much progress in this area. Even the United States, which used to maintain the stringent *Glass-Steagal* (GS) *Act* of 1933, passed the *Gramm-Leach-Bliley Act* in 1999 to replace some parts of the GS Act. The global trends towards integrated financial services concur with the view that integration would encourage greater efficiency by allocating resources and managing risks at a lower cost. These countries have attempted to mitigate potential conflicts of interests by enforcing internal control mechanisms and corporate governance (for example by separating underwriting departments and brokerage), as well as forcing financial institutions to disclose more information to investment analysts, credit rating analysts, and auditors for their analyses and auditing (*European Business Council in Japan*, 2007).

There are some entry deregulations that have been demanded by foreign market players. For example, allowing asset management companies to place orders on behalf of overseas affiliates as well as promoting off-shore funds for related companies without additional licensing have been suggested. Furthermore, certain investment activities of investment advisors, such as stock lending, could be considered for deregulation. Currently, separate licenses are required for hedge funds and for the advisors to such funds, discouraging fund professionals to establish operations in Japan.

Important Agenda Remaining (3): Improving the Regulatory Framework

The regulatory environment needs to be improved with greater emphasis toward a *principles-based* system.[16] In particular, regulatory transparency with respect to the process of enacting regulations, formulation of regulation drafts, and enforcement by regulatory agencies is crucial to increase and diversify financial services. It has been claimed that it is difficult and costly to introduce innovative financial services in Japan due to the lack of regulatory transparency with respect to tax treatment and interpretation of laws and regulations, while such a problem hardly exists in other advanced international financial centers. The *European Business Council in Japan* (2007) stresses that it is important to boost the use of no-action letters and written advice concerning the general interpretation of laws without the need to pre-negotiate content; that information regarding the interpretation of laws given to one entity should be generally available to the industry as a whole; and that FSA guidelines should be updated regularly to reflect the content of interpretative statements. The *American Chamber of Commerce in Japan* (2007) recommends the realization of no-action letters within 30 days by increasing personnel in charge, and reforms of the Administrative Procedure Act (such as application of government-submitted laws to public comments, extension of public comment offerings to 60 days, prohibition of announcements of the drafts of law within 30 days from the end of public comment offerings).

Indeed, the Institute for Management Development (IMD) has ranked the Japanese banking regulation (indicator measuring the degree of whether it does not hinder business development) as 44th out of 61 countries in 2006. This ranking is below Hong Kong (2nd), the United States (9th), Singapore (17th), Thailand, (25th) and the United Kingdom (35th). As for the indicator for financial institutions' transparence (the degree of implementation), Japan is ranked 45th out of 61 countries, far behind Hong Kong (4th), the United States (11th), Singapore (13th), and United Kingdom (36th). These indicators suggest that there is room for Japan to improve its regulatory framework.

16 There are two approaches: rule-based and principle-based (FSA 2007). The former aims to improve the predictability of market participants with respect to regulations by setting rules in detail. By contrast, the latter aims to encourage the voluntary efforts of market participants while ensuring management freedom by laying down key principles and demanding that those principles be observed. The report by the FSA states that two approaches should be implemented in a mutually complementary, balanced manner, as demonstrated in the United States and United Kingdom. While the CEFP stresses the utilization of regulatory and monitoring measures based on principles, it appears that its intension is consistent with that of FSA.

Moreover, an introduction of careful cost-benefit analyses into regulations is important given that the United States has weakened its competitiveness in the markets due to excessive cost burdens caused by the adoption of the *Sarbanes-Oxley (SOX) Act* (CEFP, 2007). Issues such as firms' compliance costs and the effect on the competitive environment should be carefully examined and possibly quantified analytically. The *Regulatory Impact Analysis* will become mandatory from October 2007 at the time of new regulations are introduced or existing rules modified. The effectiveness of this requirement needs to be ensured.

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