Promoting Tokyo As an International Financial Center

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Part I. Why Should Tokyo be Promoted As an International Financial Center?

Japan's Potential

- 2nd largest economy (US$4.3 trillion, 11% of global GDP) and high level of per capita income (US$34,000) in 2006

- 2nd largest total financial assets held by resident financial intermediaries (US$24 trillion) in 2006

=> 2nd largest households' financial assets (US$13 trillion)

- 2nd largest stock market in terms of market capitalization by the Tokyo Stock Exchange (US$4.6 trillion, 10% of world market capitalization

- Presence of a large number of internationally competitive manufacturing firms

- Proximity to the rapidly growing Asia

Should Tokyo be one of the Top International Financial Center?

(1) Rapidly-aging society and tight pension budgets make it important for households to manage their financial assets more efficiently

(2) Promotion of the financial and business sector as an engine for Japan's future growth (tertiary sector already accounting for 70% of GDP and employment)

(3) Active use of Tokyo as a common Asian plat to support the growing population and economic sizes in neighboring Asia => provision of stable financial sources for official and private entities, as well as financial products and services to investors => investing Asian money within Asia and creating a win-win situation in the region

(4) Expansion of the foreign exchange market between yen and other local currencies and active cross-border flows of funds will reduce the heavy dependence of Asia on the US dollar => common exchange rate arrangement, regional bond market initiatives

Part II. Has Japan Taken Any Comprehensive Reforms to Make the Tokyo Market More Competitive?

Background

Period of the 1980s: Largest market capitalization (over 30% of world capitalization) and the biggest international financial center in Asia, but was not as comparable as the New York and London markets

⇒ Debate about whether Tokyo should be a more competitive international financial center by introducing comprehensive, drastic reforms following the London's Big Bang => did not materialize

Period of the 1990s: (1) Decline in the market share of the Tokyo Stock Exchange since the collapse of the bubbles (stocks and land) and (2) Criticism against the supervisory and inspection capacity of the government in response to the injection of US$6 billion public funds to "*Jusen*" (non-bank financial firms specializing in housing loans)

⇒ Excessive regulations limited competition and deterred banks from advancing financial skills and offering diverse financial services

⇒ In 1996, the then Prime Minister Hashimoto announced "Japanese version of the Financial Big Bang"

Under the Financial Big Bang

- Principles of "*Free*, *Fair*, *Global*"

- Two parts of the reform programs:

(1) Revision of the Foreign Exchange Law in 1997 (effective in 1998)

=> abolition of authorized foreign exchange banks, shift to ex-post reporting system on foreign exchange business, liberalization of opening foreign deposit accounts and transacting foreign exchanges

(2) Deregulation on cross-entry barriers, competition, transparency

⇒ Deregulation on various services and products (e.g., *ETF*, *J-REIT*)

⇒ Establishment of financial holding companies

⇒ Liberalization of brokerage commissions, insurance premium rates

⇒ Disclosure system to align with the international standards

Impact of the Financial Big Bang

- Increase in financial transactions; increased holdings of stocks and other risky assets (decline in brokerage commissions, insurance premiums, and monthly bank fees)

- Expansion of investment asset management businesses (e.g. investment trusts, J-REITs, investment management contracts)

- Formation of 3 mega financial groups through mergers (*Mizuho Financial Group*, *Mitsubishi UFJ Financial Group*, and *Sumitomo Mitsui Financial Group*)

- Emergence of new types of specialized banks (Japan Net Bank, IY Bank, Sony Bank)

- Banks' greater reliance on non-interest income (e.g., a sales of investment trusts and insurances and underwriting private placement bonds, formation of syndicated loans and liquidation of assets, provision of derivative instruments)

- Growing presence of foreign investors in stock markets (about 30% of market capitalization)

- Increase in foreign exchange transactions, decline in transaction costs (spread)

Part III. Present Performance of Financial and Capital Markets in Japan

1. Trends of Stock Market

- Market capitalization of Tokyo Stock Exchange declined from 33% in 1990 to 10% in 2005

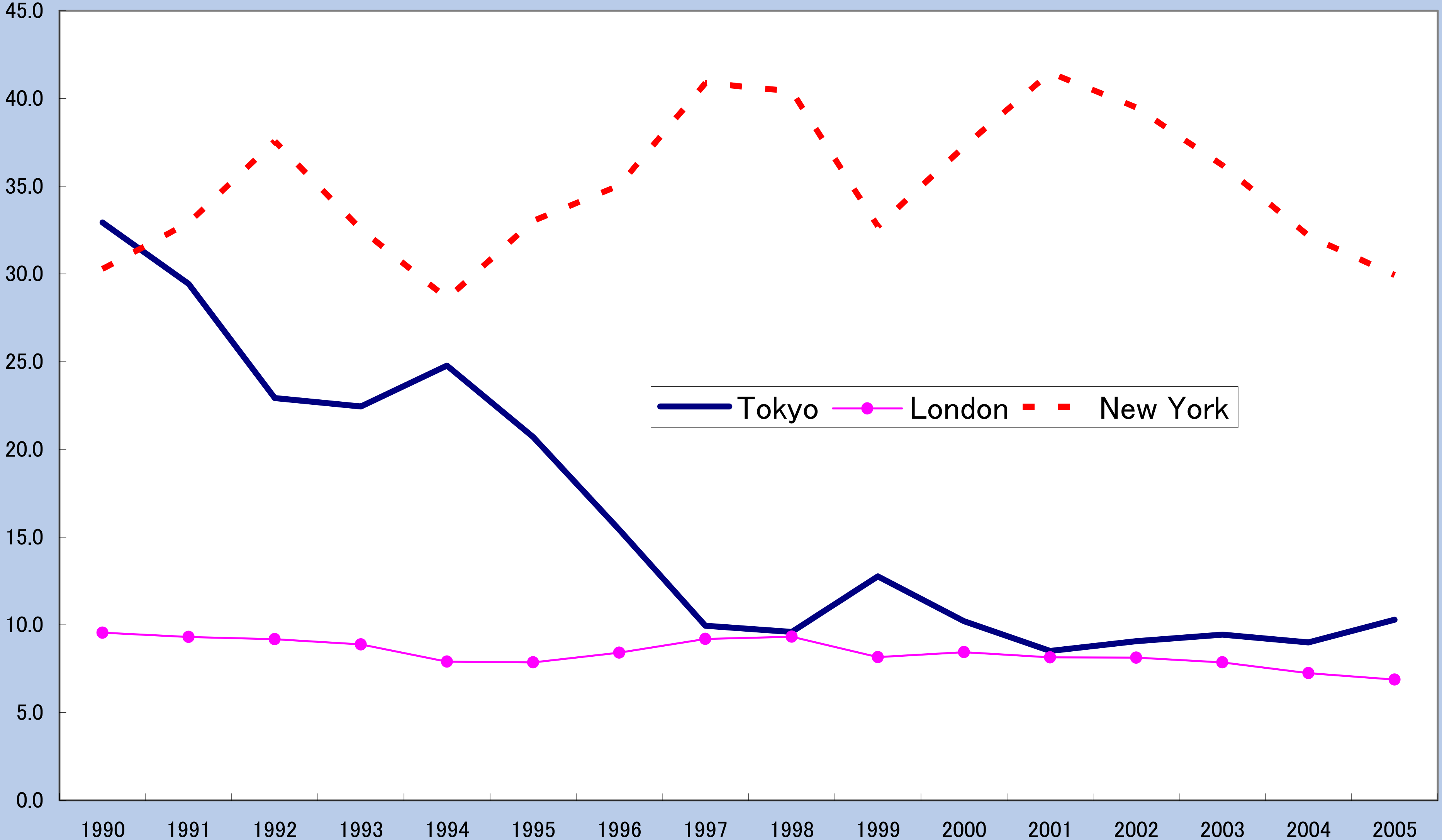
=> 2nd largest size but the gap with New York Stock Exchange has grown from 0.9 times in 1990 to 3 times in 2005

- Liquidity: 4th largest in terms of the value of share trading, but the growth rates had been volatile and largely sluggish in 1990s

- Growing presence of foreign investors, but domestic investors (institutional investors, households) remain to show low risk appetite

- Limited Foreign Issuers (less than 30 firms, only 3 from Asia)

Share of Market Capitalization by Top 3 Stock Exchanges (% of World Total)



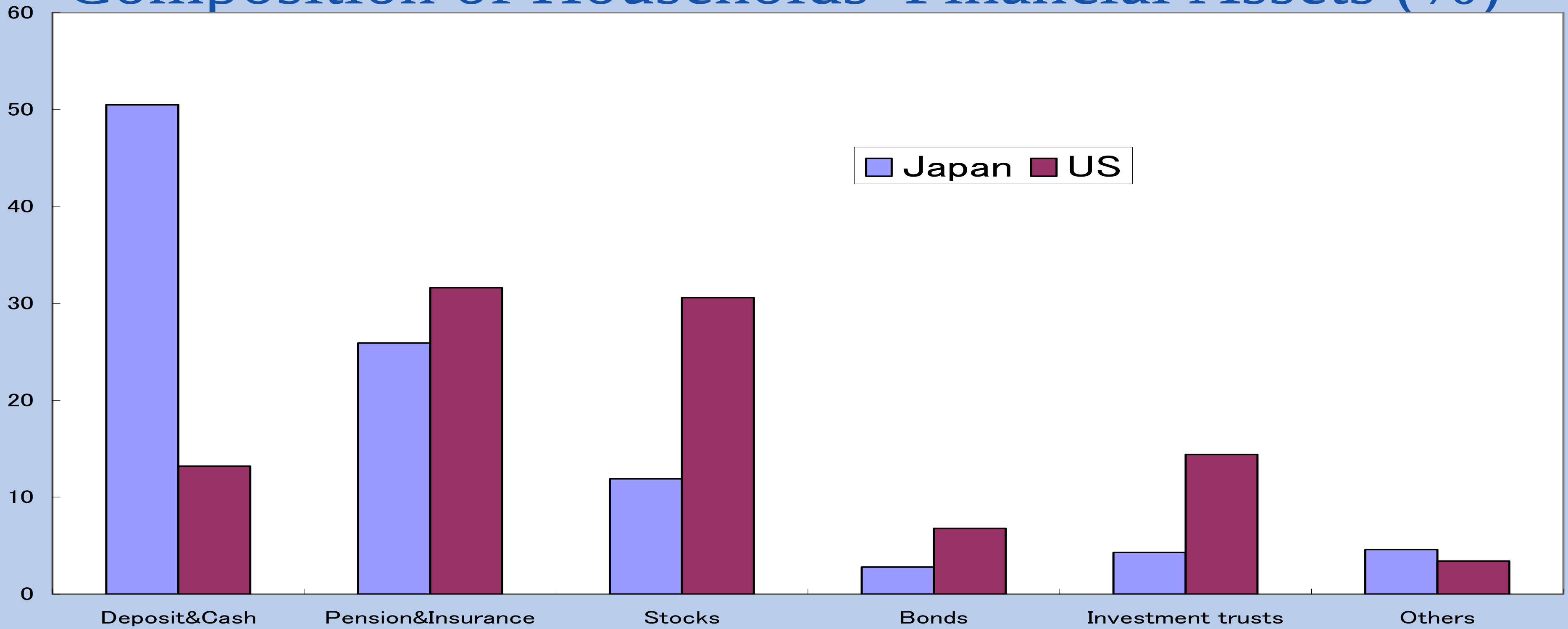
Japanese Assets Held of Non-Residents

	1996	2006	1996	2006
	(JP¥ Trillion)		(% of Total Liability)	
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		

Ratio of Foreign Investors to Market Capitalization

	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

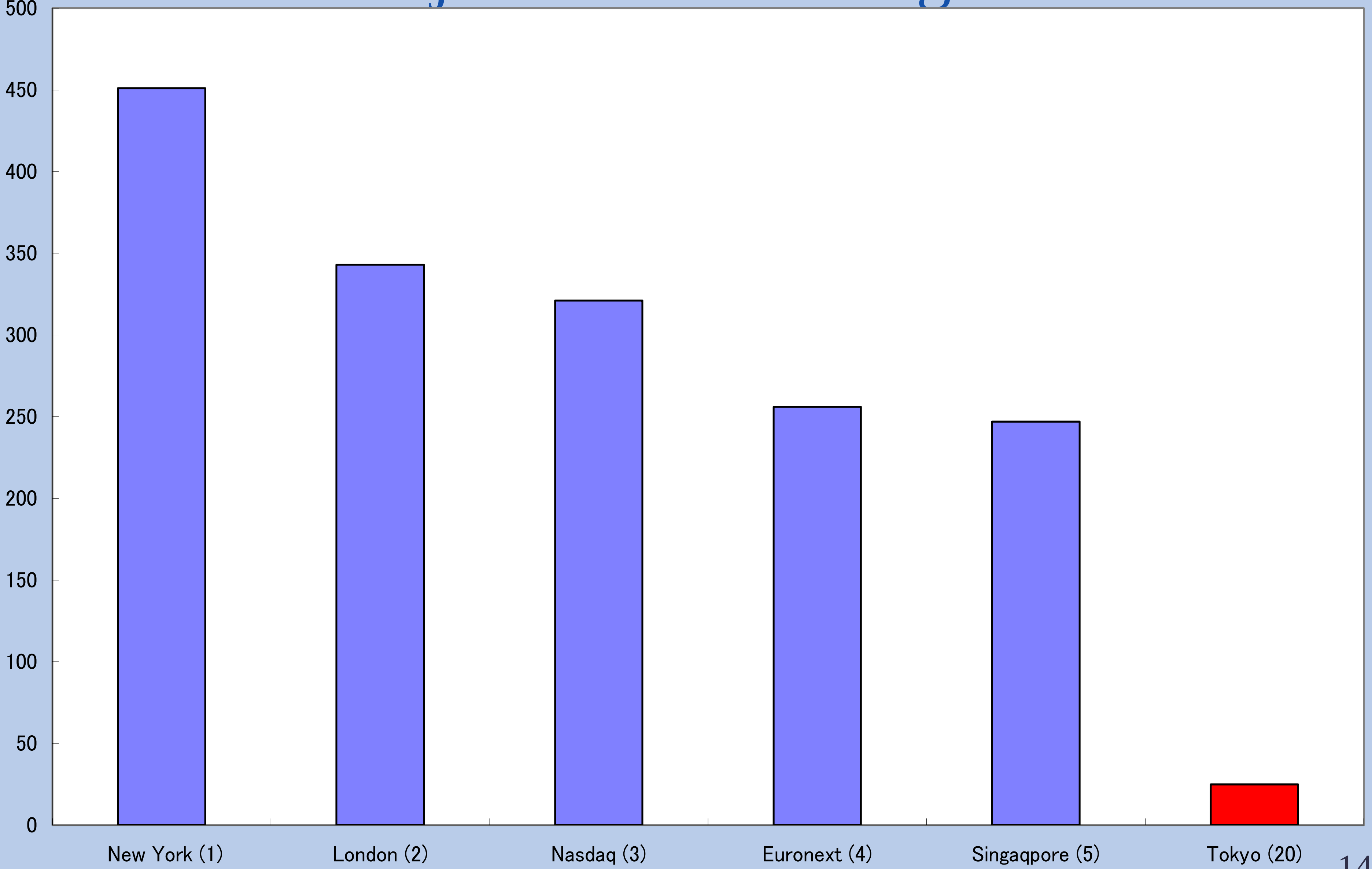
Composition of Households' Financial Assets (%)



Asset Composition of Major Institutional Investors

	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

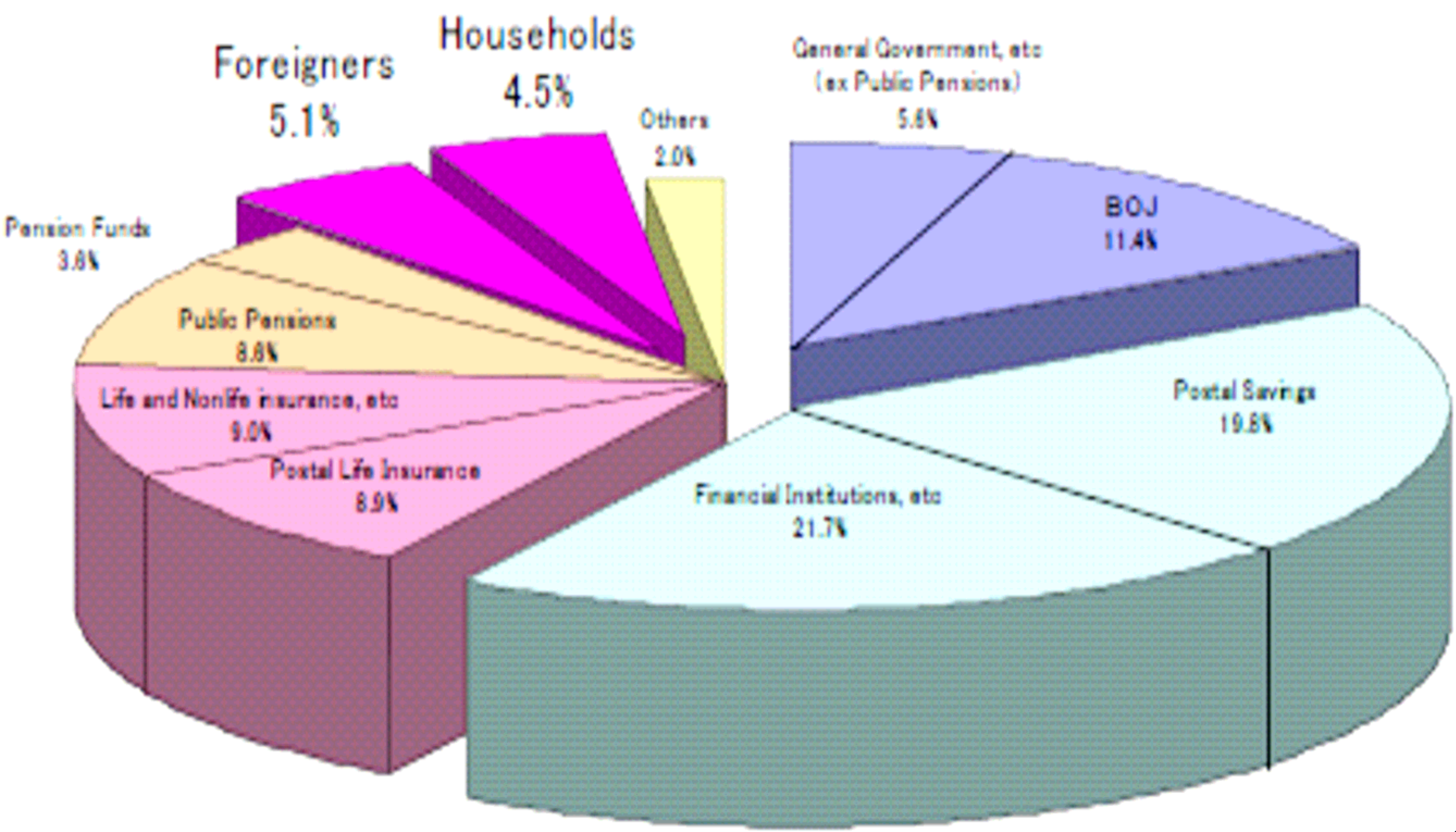
Number of Foreign Firms Listed in Major Stock Exchanges



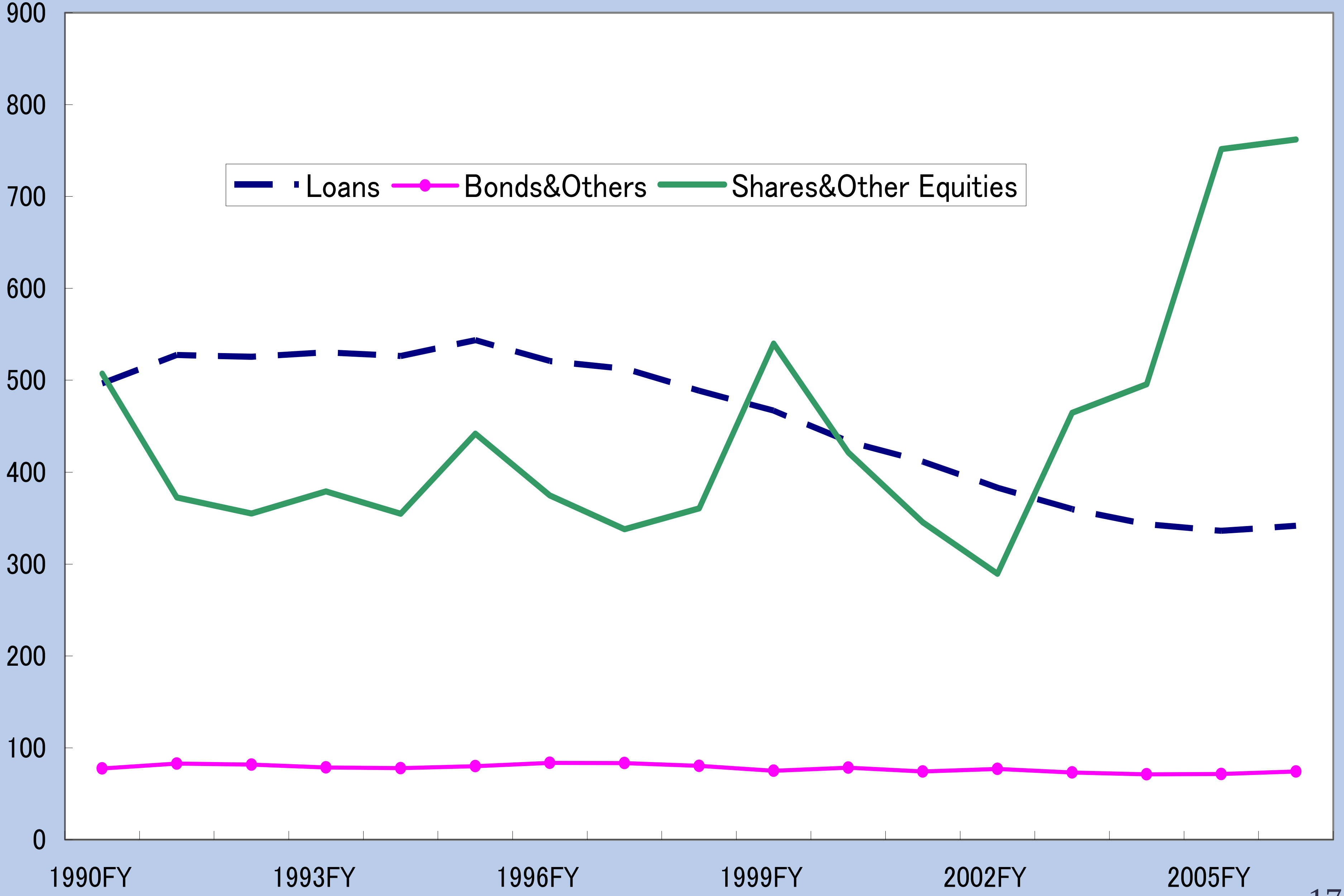
2. Trends of Bond Market

- Dominated by Japanese Government Bonds (JGBs) => 90% of total bond market in Japan
- Public and its related sector (general government, BOJ, public pension, postal savings, postal life insurance) hold over 50 % of JGBs => households (4.5%), foreign (5%)
- Inactive corporate bond market => firms' dependence on banks and stocks, non-existence of market for below-investment grades, portfolio regulation imposed on public pension funds

Composition of Outstanding Issuance of JGBs by Investors (June 2006, %)



Sources of Liabilities by Non-Financial Firms



3. ETFs and Securitized Markets

- Limited number of ETFs (stock indices only in the Tokyo Stock Exchange): only 11 ETFs listed

- Growing markets for mortgage-backed securities, asset-backed securities and CDO, but the market sizes are much smaller relative to United States

- Market for credit derivatives is largely inactive => affected by the lack of market volatility and liquidity in the debt markets, too tight credit spread, regulatory factors, a limited number of brands

Outstanding Securitized Securities (US$ Billions)

	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

4. Capital Flows, *Samurai Bonds* and Offshore Markets, and FX Markets

- Foreign capital inflows concentrate on publicly issued stock investment, while Japan's foreign capital flows concentrate on bonds (e.g. US Treasury securities) and loans

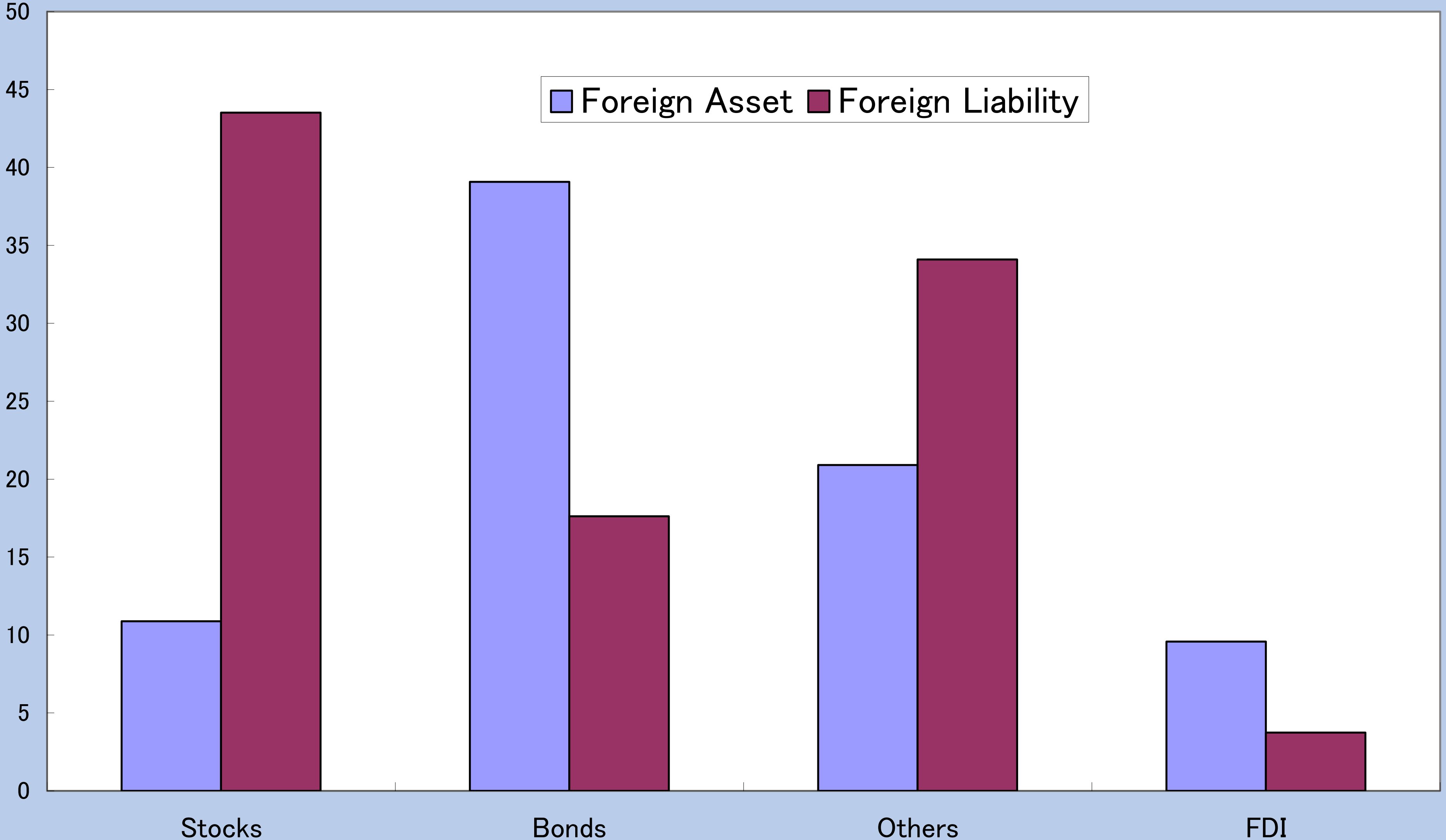
- Decline in the size of the market for yen-denominated foreign bonds (*Samurai Bonds*)

- Shrinking offshore market (both yen- and foreign-currency denominated)

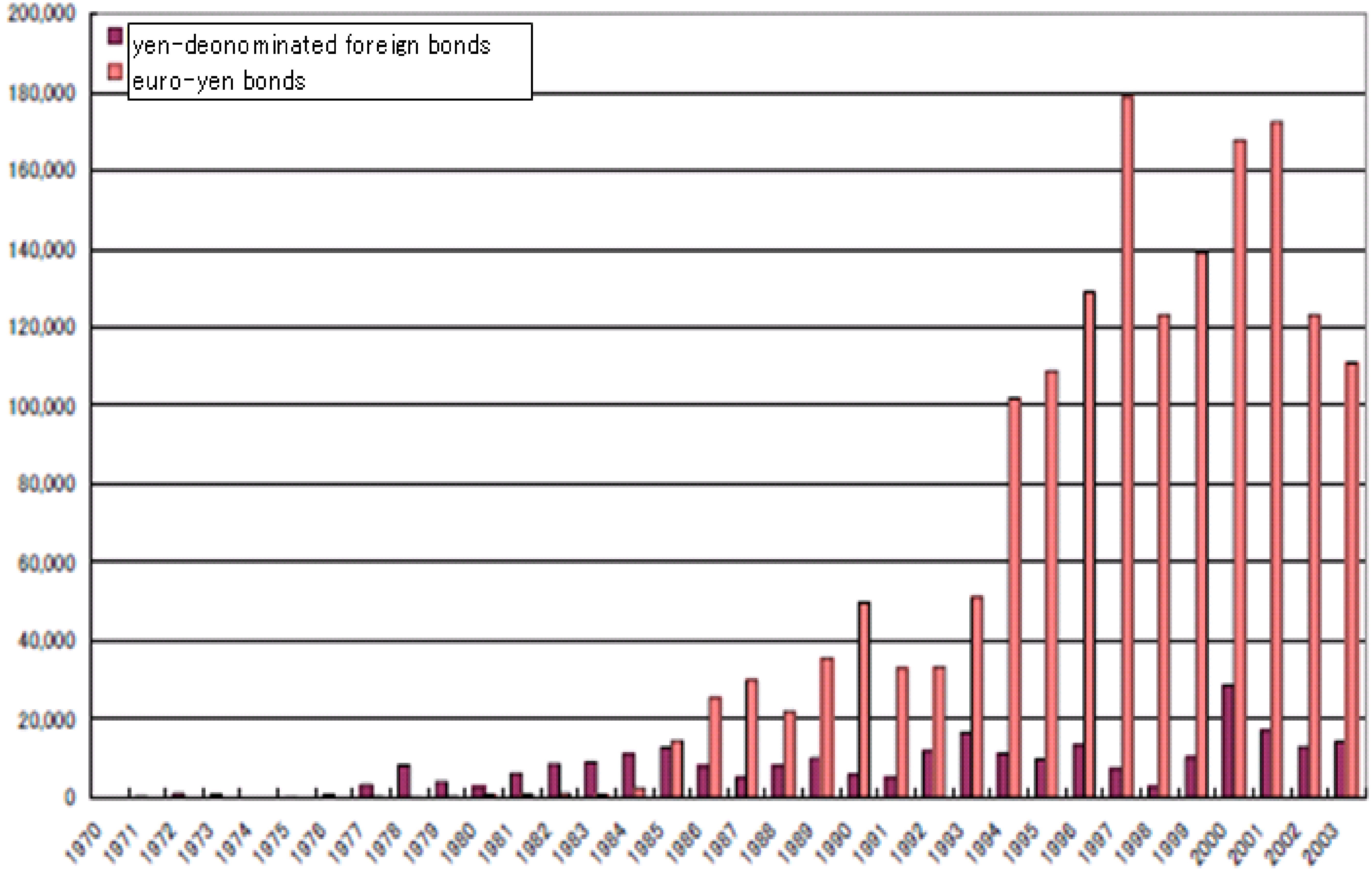
- Declining share of Japan as a foreign exchange market place (in terms of turnover) and the yen as a transaction currency (in terms of currency distribution of foreign exchange market turnover)

- A similar pattern is observed for the case of foreign exchange OTC market and OTC interest rate derivatives

Composition of Japan's Foreign Assets and Liabilities (% of Total)



Outstanding Yen-Denominated Foreign Bonds and Euro-Yen Bonds



Distribution of Foreign Exchange Market Turnover (%)

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

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

Part IV. What is the Government Vision in view of Marking Tokyo More Competitive?

-Report prepared by the WG of the Council on Economic and Monetary Policy in April-

(1) To Turn Tokyo into a Common Asian Plat

- New financial products (commodity, real estate, J-Depository Receipt)
- Establishment of comprehensive exchanges and a holding company
- Strengthening of payment and settlement systems by (a) international harmonization; (b) reducing settlement times from 3 days to 1 day; (c) advancing financial *Electronic Data Interchange*, and (d) improving a crisis management system (e.g., backup systems)
- Establishing markets for professional investors
- Convergence of accounting standards and disclosure by Japanese firms based on *International Financial Reporting Standards*
- English language disclosure, provision of information in English
- Attract foreign participants by reviewing regulatory and taxation
- Strengthening Tokyo's overall capacity (human resources, regulatory environment, business infrastructure including airport access)

(2) To Promote Innovation by Participants

- Removing firewalls among bank, securities, and insurance
- Permission of special licenses for *narrow banking* (settlement operations) and *captive insurance company* (underwriting the issuance of a specific organization)
- Increased freedom of investment for public pension funds and strengthening fiduciary duties
- Integration of taxation applied to various financial asset incomes and introduction of individual investment accounts
- Development of professionals with expertise in finance (e.g., bar exams, CPA exams, civil service exams, courts)
- Creation of an environment to secure top talent from overseas

(3) To Improve the Transparency and Predictability of Regulatory Supervision

- Deregulation on markets for professionals
- Regulatory and supervisory methods based on *principles*
- Improvement of *no-action letter system* and introduction of *Safe Harbor Rules*
- Fostering of dialogue between financial supervisory authorities and financial business people
- Enhancement of functions and structure of self-regulatory organizations without generating regulatory duplication
- Promotion of personnel exchanges between government and private sector and prevention of conflicts of interest
- Introduction of cast-benefit analysis into regulations