Revisiting the Debate over the Competitiveness of Japan's Markets and the Global Financial Center Concept

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Resurgence of the Global Financial Center Debate

Ten years have already passed since Japan formally announced that the goal of its "Big Bang" was to make the Tokyo market competitive with the New York and London markets within five years. A number of dramatic security market reforms have been implemented over the past 10 years, including deregulation of brokerage commissions and the move to a registration system from a licensing system for securities firms. Although way beyond the original deadline and still leaving much room for improvement, Japan enacted the Financial Instruments and Exchange Law (FIEL), a comprehensive set of financial legislative reforms, in 2006. Additionally, the reforms that Japan has conceptualized or implemented over these past 10 years, including the electronic (paperless) share certificate system that has been on fast track development and is slated for implementation in January 2009, can rightly be viewed as more comprehensive and more revolutionary than the original Big Bang in the UK.

As for whether Tokyo's market has become competitive with that of New York and London, because problems with nonperforming loans in Japan's banking system became more serious following announcement of Japan's Big Bang project, not only has Tokyo's market failed to threaten the preeminence of markets in the US or UK for most of the past 10 years, it has at times even threatened itself with the prospect of crisis. During this time, the New York market has undergone a series of tests, beginning with the dot.com bubble and followed by 9/11 and a series of corporate financial scandals led by Enron, but it has been quite strong of late, setting a succession of all-time highs.

Under supervision of the Financial Services Authority (UK FSA), the London market has put in place a regulatory framework different from that governing the US market, substantially raising its presence as a global financial center. Increasing integration of the EU the over the past 10 years has brought growth to Europe's financial and capital markets and contributed greatly to improving the status of London, its central market. As we will explain later, and New York market, fearful of becoming less competitive relative to London, is attempting to learn from the UK's regulatory environment.

Not content with the London market's competitive position, the UK (actually the Corporation of London) issued a research report on London's status as a global financial center, first in 2003 and again in 2005.[1] In 2006, Chancellor of the Exchequer Gordon Brown took the initiative and launched a mechanism to further solidify London's position as a global financial center.[2]

In October 2006, he held the initial meeting to address the issue, between the High-Level City Group, made up of influential financial executives, and top bureaucrats, including Mr. Brown himself. The major issues taken up in this meeting were (1) adherence to principle-based regulation, (2) the realization of a wholesale insurance market, (3) an increase in the level of professional skills in London, and (4) the promotion of London in India, China, and other important overseas markets.[3]

There a strong sense that in the 10 years since Japan's Big Bang, Japan has not only failed to narrow the gap between its markets and those of Europe and the US, but neighboring markets in Singapore, Hong Kong, and Shanghai have stepped up their efforts to improve their status as global financial centers to the point where those markets now threaten the position of Japan's markets.

For example, Shanghai's city government announced on 27 November 2006 its "11th Five-year Plan on Building a Shanghai Global Financial Center." The plan contains several numerical targets, including boosting the market capitalization of the Shanghai Stock Exchange (SSE) to 7 trillion Yuan by the year 2010. Because the market capitalization of the SSE (tradable A and B shares) was 1.6 trillion Yuan at end-2006, achieving this target would mean an increase of 4.4x, or ¥106 trillion at the current exchange rate, over the next five years. This is equivalent to nearly 20% of the TSE-1 market capitalization at end-2006.

Furthermore, the 2006-07 government report announced on 11 October 2006 included a goal in the economic section from Donald Tsang, the chief executive of Hong Kong's government, of developing Hong Kong into a global financial center.[4] Specific goals include promoting the listing of overseas blue-chip firms, expanding the business conducted in Yuan, researching a commodities futures market, handling the offshore securities investment business of insurance companies on the Chinese mainland, and expanding the reinsurance market. In regards to the expansion of business conducted in the Yuan, it was reported early in 2007 that China's State Council has agreed to allow mainland China's financial institutions to issue Yuan-denominated bonds in Hong Kong.

With markets in the US and UK becoming more competitive, and markets elsewhere in Asia also working hard to improve their competitiveness, Japan's new Abe Administration, which took office in 2006, included in its platform the goal of "strengthening Japan's financial markets" to put them "on par with London and New

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1 Corporation of London, The Competitive Position of London as a Global Financial Centre, November 2005.

2 See the budget report released on 22 March 2006 and the paper released at the same time: Financial Services in London: Global Opportunities and Challenges; HM Treasury.

3 From the HM Treasury website.

4 2006-07 Hong Kong Special Administrative Region Report.

York." This author has expressed concerned in previous articles in this publication that the new administration may be considerably less committed to tangible reforms to financial and capital markets than was the Koizumi administration.[5] Nevertheless, specific discussions have already begun.

The Council on Economic and Fiscal Policy has established a Globalization Committee with the goal of making Japan's economy more internationally competitive, and that committee, in its first meeting on 28 December 2006, decided to establish a working group on financial and capital markets. There are five specific items to be discussed by this working group: (1) the best way to develop Tokyo's financial and capital markets to a level equal with those of New York and London; (2) the best methods and institutions for monitoring financial and securities transactions, in view of financial and securities transactions becoming increasingly complex and advanced; (3) the best way to reform and strengthen securities exchanges; (4) the best way to achieve global awareness of Japan's accounting standards, financial and securities taxation, and other relevant systems/regulations, and to strengthen supervision and corporate governance; and (5) how to best foster the development of financial and capital market talent.

The Financial System Council formed a study group on the globalization of Japan's financial and capital markets in January 2007, and that group has already begun deliberations.

As noted above, the reopening and reinvigoration of this debate comes at a very opportune time, given the more competitive environment that now confronts the Japanese market. Nevertheless, we cannot afford to repeat the cycle seen 10 years ago in which the debate became quite active, only to later be put on the back burner as the nonperforming loan problem became serious. Below I will venture my personal opinion as to what we need to focus on to prevent that from happening again.

The promotion of market-based finance is key

When considering that the functions of a global financial center upon which importance is placed today are not the traditional functions of deposit-taking, lending, and insurance, but rather the trading of securities and derivatives, it becomes clear that Japan must focus its efforts on developing what has come to be termed market-based finance.

During Japan's Big Bang, as well, immediately following Prime Minister Hashimoto's statement on the Big Bang made on 29 November 1996, the General Committee of the Securities Exchange Council proposed in its Summary of Discussions giving "securities markets a leading role in financial intermediation." This suggests that even back then, it was correctly recognized that reforming the

5 See Yasuyuki Fuchita, Capital markets that help an economy?, Capital Market Review, Fall 2006 issue.

money flow was essential to building a financial center comparable to that in New York and London.

Japan's Big Bang was originally aimed not only at securities markets but also at furthering deregulation of the entire financial sector, including banking and insurance, with an emphasis on becoming more competitive, and the report issued by the General Committee of the Securities Exchange Council did not include any wording alluding to the leading role of securities markets in financial intermediation.

The reform of securities markets was thus positioned as parallel to banking and insurance reform, although it is apparent that the people involved had fairly strong expectations that securities market reform would expand the flow of money through securities markets.[6] In fact, as already noted, the reform of securities markets has been considerably more radical than the Big Bang reforms in other financial segments, and the impact of those reforms on the market and the industry has been huge.

Nevertheless, as evidenced by the fact that ten years later, deposits still account for over 50% of individual financial assets despite considerable reform of securities markets, it is difficult to say that we have arrived at the point where market-based finance has become the heart of the system.

Looking back, it is evident that immediately following the Big Bang proclamation, the debate over Japan's becoming a global financial center rapidly faded into the background. This can largely be attributed to the deepening of the nonperforming loan problem, and the priority, far from promoting a market-oriented financial system, was on first injecting public funds into and rescuing the traditional bank-centric financial system. The financial crisis had the effect of snuffing out efforts to reform securities markets, including through a decline in stock prices.

The nonperforming loan problem had its roots in a financial structure that concentrated excessive risk in the banks, and a shift in the financial structure toward more market-oriented finance is essential not only to promote market-based finance but also to prevent the recurrence of the nonperforming loan problem in the future.

The Koizumi administration's policy objective of shifting funds from savings into investments remains unfulfilled, but the Abe administration does not seem to properly recognize this. Nevertheless, if Prime Minister Abe were to keep his administration's pledge and truly aim to increase the competitiveness of Japanese markets, he would have to position as a central issue the shift of funds from savings into investment.

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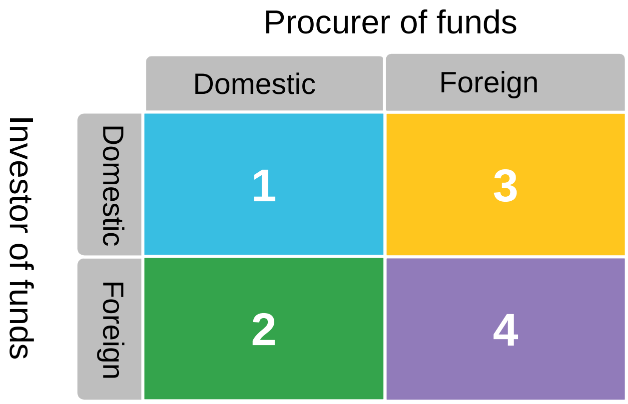
[6] See Yasuyuki Fuchita, *Shoken Biggu Ban* (Securities Big Bang), Nihon Keizai Shimbunsha, 1997 (in Japanese).

How should the goal of becoming a global financial center be pursued?

The reason that the priority should be placed on changing the financial structure to ensure that there is no reoccurrence of a serious nonperforming loan problem is that the financial business should contribute to the development of manufacturing and other non-financial industries in Japan, irrespective of the goal of becoming a financial center.

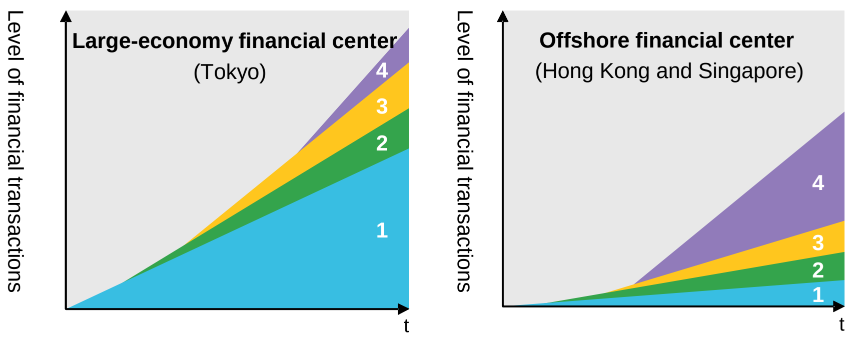
An examination of the relationship between the development of a country's economy and the development of its financial businesses suggests that the domestic financial business, as an agent for providing funds procurement and investment, grows in step with the development of the real economy, and the business of intermediating inbound financial transactions can only grow once other countries finally recognize that country's growth potential and trustworthiness. As that country's goods and services exports become more competitive and it begins to form a current account surplus, it can then add the business of intermediating outbound financial transactions. This will enable it to accumulate the financial expertise and skill required to intermediate financial transactions between two foreign countries (see Figure1).

Figure 1 Stages of development for financial markets



Source: Nomura Institute of Capital Markets Research

Figure 2 Types of global financial centers



Note: The numbers 1-4 correspond to the types of financial transactions shown in Figure 1
Source: Nomura Institute of Capital Markets Research

Japan had already followed the process of developing its financial businesses using development of the real economy as a base, but because of the nonperforming loan problem, the financial system wound up hurting rather than helping the real economy The process of overcoming this situation has essentially been that of disposing of the nonperforming loans, and this has left as the priority issue the rebuilding of the financial system so that it is capable of contributing to the real economy. In other words, the global financial center concept cannot be targeted solely at the expansion of financial businesses.

In contrast, Hong Kong, Singapore and other so-called offshore financial centers around the globe are based in real economies of limited size, and thus contributing to growth in the home country's nonfinancial industries is a relatively minor role for the financial business (Figure 2). With the return of Hong Kong to China in 1997, Hong Kong's market became able to develop into a financial center backed by a huge domestic economy, and in fact Hong Kong's role as an intermediary for both inbound and outbound financial transactions has been growing.

Nevertheless, Shanghai's market plays a more important role in purely domestic financial transactions, and a certain division of labor appears to be taking place at this time. As described earlier, Shanghai is also aiming to become a global financial center, and in step with the future development of China's domestic economy, Shanghai is likely to emerge in the future as a financial center patterned after New York and Tokyo.

Most important for Japan initially is to become a financial center that aids in the development of the domestic economy. From a longer-term perspective, however, given the certainty that the size of China's economy will eventually surpass that of Japan, it is important to keep in mind that in a comparison of the absolute level of financial transactions, the Tokyo market is going to eventually be a smaller global financial center than the Shanghai market within Asia.

When conceptualizing a global financial center within such a long-term outlook, it would be a mistake to extrapolate from the past and think of the center as dependent purely on the scale of Japan's real economy. Rather, a new conceptual framework is required. We offer below a proposal to leverage the financial stock that Japan has accumulated to achieve a market quality that evokes pride.

Building a high-quality market capable of turning accumulated financial stock into a strength

The size of China's economy is expected to surpass that of Japan in 2020 and that of the US in 2040. India's economy, meanwhile, is expected to surpass Japan's economy in size by 2035. By 2050, Japan's economy will be less than 30% the size of India's economy (versus about seven times larger in FY2005), a bit over 20% that of the US (versus a bit over 40%), and over 15% that of China (versus almost three times larger).[7] Within this context, it would be difficult for Japan to establish a financial center that rivals the US based on financial transactions driven by the needs of domestic, non-financial corporations. In fact, other financial centers in Asia are rapidly catching up with Japan.

Nevertheless, even though there are limitations on growth in the size of the transaction flow, the advantages brought by the financial stock accumulated from past phases of economic development are not going to just disappear. It is important that Japan give very serious thought to leveraging this stock as an effective weapon in inter-market competition.

To start with, Japan's ¥1,500 trillion in individual financial assets is second in the world behind only the ¥4,700 trillion of the US. These assets have not been effectively invested, however, as is evident from the high percentage that is still kept as cash or deposits. In that sense, as well, it is critical to craft a strategy to encourage the shift of these assets from savings to investments.

Currently the third highest percentage of individual financial assets, behind only cash & deposits and insurance, is kept in the form of pensions, and that share is steadily growing. Accordingly, there is a great deal of reliance on the institutions that manage pensions to invest those assets wisely.

Public pensions, which are recorded as part of the general government sector in the flow of funds statistics, totaled in excess of ¥200 trillion as of end-September 2006. About ¥150 trillion of this comprises welfare pension insurance and the national pension fund, both of which are managed by the Government Pension Investment Fund (GPIF) in accordance with medium-term objectives determined by the Ministry of Health, Labor, and Welfare (MHLW). While bearing in mind the public nature of these pensions, the GPIF is largely expected, from the pension finance perspective, to achieve some degree of efficiency in investing, and the fact that Japan has been able to establish such a high-level, refined organization for making investment decisions should count as a strength in Japan's status as a financial center. According to news reports, the MHLW, as part of a plan to unify pensions, is considering implementing the core portfolio, the targeted allocations used in the welfare pension insurance program used by private-sector salaried workers, in the mutual aid pension programs in which government workers are enrolled, which have over ¥50 trillion in total assets.

[7] See Jim O'Neill et al, "How Solid are the BRICs?", Global Economics Paper No:134, Goldman Sachs, December 1, 2005.

How these pension assets, which come to a huge total, are managed will have a substantial impact on not only the future of Japan's pension system but also on the very nature of Japan's financial and capital markets.

One of the biggest strengths of London's financial center is the many years of experience that has been accumulated in the asset management business, made possible by the accumulation of financial assets since the days of the British empire. Although the UK's domestic economy is small relative to that of the US, or possibly because it is small, the UK is considerably ahead of the US in the global diversification of investment, including investment in emerging markets. If Japan can effectively use the various types of pension assets it has accumulated, it should be able to develop a greater concentration of people with investment expertise, develop new technologies, and generate growth in peripheral businesses, thereby bringing a variety of benefits to participants in the market and the system. Not only would this contribute to the development of a financial center, it would also contribute toward the real objective of the entire system, which is to enable the citizens in Japan's aging population to enjoy a more stable old age.

As a way to achieve a shift from savings to investments, this author has pointed out in previous writings that it may be important to revise the deposit insurance program, which currently covers the entire amount of "settlement" deposits, as well as clarify to individuals any schemes that can receive this shift from savings to investments.[8] In the US, there is a long history of working with privately-owned individual asset building schemes supported by the government, such as 401(k)s and IRAs. Recently, President Bush proposed introducing private accounts within the social security system, and he has expanded the tax incentives associated with 529 plans and Health Savings Accounts. He also signed a corporate pension reform bill in 2006 to address the insufficiencies of pensions to cope with the aging population, as a result of stagnation in the growth of 401(k) enrollment and the inability to properly diversify the investment of assets in those plans.[9]

These types of investment accounts are also being developed in Europe. The UK has its Individual Savings Accounts (ISA) system, which offers tax incentives for investing in listed stocks and making deposits through those accounts.[10] The UK also introduced the Child Trust Fund (CTF), a tax-advantaged savings scheme for children, in April 2005. In addition to favorable tax treatment, the CTF receives a subsidy payment from the government twice, once upon opening the account and again on the child's 7th birthday.[11] France has a stock savings plan it calls a PEA (Plan d'Epargne

8 See Yasuyuki Fuchita, *Kin'yuu Chukai no Atarashii Katachi wo Hagukumu tame ni Posuto Banku Jidai e no Tenbou* (Fostering a New Format for Financial Intermediation -- Outlook for the Post-bank Era), Capital Market Quarterly, Winter 2005 issue (in Japanese).

9 See Akiko Nomura, *Beikoku no Kigyou Nenkin Kaikaku Hou* (Corporate Pension Reform in the US," Capital Market Quarterly, Fall 2006 issue (in Japanese).

10 See Ayumi Kobayashi, *Eikoku no Shouken toushi Yuuguu Zeisei* (Tax Incentives for Securities Investments in the UK) Capital Market Quarterly, Summer 2004 issue (in Japanese).

11 See Nasuka Hiramatsu, *Eikoku no Chochiku Suishin Seisaku to Chairudo Torasuto Fando* (The Child Trust Fund and Savings Promotion Policies in the UK," Capital Market Quarterly, Summer 2004 issue (in Japanese).

en Action). Dividends on the stocks and mutual funds purchased through the plan are tax-free if reinvested in the plan, as are capital gains on holdings of at least five years.

No discussion of global financial centers is complete without looking at the taxation of securities and individual investment accounts like these. In that sense, the taxation of dividends is also a very important issue. In Europe, there is a scheme to avoid double taxation of dividends based on the imputation method. In the US, the 2003 tax reforms lowered the tax rate on dividends in an attempt to alleviate the problem of double taxation. This provision was originally set to sunset (expire) in 2008, but tax reform legislation passed in May 2006 extended that to 2010. The taxation rate on capital gains was lowered at the same time as that on dividends in the US, to eliminate the impact that a difference in the two rates would have on a firm's decision to retain earnings or pay out dividends.

Japan also needs to completely eliminate the double taxation of dividends, but given the impracticalities of doing so immediately, one conceivable option is to follow the US lead and lower the tax rate on dividends and capital gains. Germany is now in the process of lowering its corporate tax rates, and a tax reform bill has been proposed that would establish a ceiling on the amount of interest payments that can be deducted from income. It is worth noting here that Germany's proposal is also aimed at crafting a tax system that is neutral to corporate financial behavior.

Although the debate over financial and securities taxation in 2006 ended with the debate over tax incentives for securities, the decision to extend the incentives for an additional year should deepen the debate to include trends in other countries.[12]

If Japan continues to lack the sort of scheme, be it a tax-advantaged individual investment account as described above or favorable taxation of dividends, that has contributed so much to the growth of market-based finance in New York and London, not only will it never catch up with those markets, the gap will just get larger.

In getting the most from this financial stock, it is also important to move to market-based finance on the liability side. Japan has outstanding home loans of ¥180 trillion, but only a little more than ¥10 trillion of those loans have been securitized, whereas more than half of the ¥800 trillion in outstanding residential mortgages in the US have been securitized. Japan has over ¥200 trillion in municipal debts outstanding, but only ¥30 trillion have been procured in the form of securities. In the US, securities markets are the primary means of securing funding for local and state governments, which have bonds outstanding totaling ¥280 trillion. In addition to being an important part of portfolios held by institutional investors, RMBS and local government bonds are essential vehicles for investing the financial assets held by individuals by way of their inclusion in mutual funds.

[12] See Akiko Nomura, *Chouchiku kara toushi e no Nagare wo Sayuu suru Toshi Yuuguu Zeisei Enchou Mondai* (The Question of Extending Investment Tax Incentives Affects the Shift from Savings to Investment), Kin'yu Zaisei Jijou (Financial Affairs Weekly), 9 October 2006 (in Japanese).

As described above, it is imperative to both sustain growth in scale as a financial center and to focus on raising quality by making effective use of the financial stock. I have already emphasized the importance of improving the quality of markets and what that entails in an article in the Summer 2006 issue of this journal, so there is no need to repeat that here. I would, however, like to add a comment on regulatory oversight.

Considerable attention has recently been given to regulatory oversight in the context of the competitiveness of a global financial center, as is evident in the debate at the meeting held by Chancellor Gordon Brown on improving London's position as a global financial center, as well as in the report issued by the Committee on Capital Markets Regulation in the US. The latter recommended that the SEC and self-regulatory organizations (SROs) introduce regulations only after a cost-benefit analysis, and that the US follow the principles-based approach to regulation, an approach that the UK has become an even stronger proponent of as a way to maintain its position as a global financial center.[13]

Both of these topics are difficult to grasp, and neither has been sufficiently debated in Japan. In regards to principles-based regulation, authorities in Japan are frequently heard arguing that regulations need to be more clearly spelled out and made more all-encompassing. If market players were subject to regulatory action based on broad principles, as is done in the UK, it may lead to criticism that this would revive arbitrary governance and violate the legal principle of nulla poena sine lege (i.e., you cannot be pronounced guilty of an act that was not a crime under the law when committed).

As for SROs, unlike in the US and UK, SROs in Japan to do not set forth clear-cut guidelines. In the UK, the regulation of financial and capital markets has been concentrated, albeit while adhering to the tradition of decentralized government, in the Financial Services Authority (UKFSA), which has the characteristics of both an SRO and a governmental agency. In the US, the debate has continued to evolve, including the Concept Release Concerning Self-Regulation published by the SEC in November 2004, but a broad direction is starting to become clear, as evidenced by the announcement in November 2006 that the NYSE would spin-off its self-regulation unit and that it would merge its member oversight function with that of the National Association of Securities Dealers (NASD).

Under US securities regulations, the regulation of disclosures relies primarily on legislation written in 1933 and 1934, whereas the regulation of trader conduct relies largely on the SROs of the NASD and other exchanges. Hence the division of duties with governmental authorities is clear in a certain sense. And given that this is self regulation, it is not necessarily the force of law, but rather the use of strict rules, the denial of membership based on industry ethics, and penalties assessed on members that are the modus operandi.

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13 Yuta Seki and Masanobu Iwatani, *Beikoku Shihon Shijo no Kyousou Ryoku Teika to Kisei Kaikaku wo Meguru Giron* (The Debate over Regulatory Reform and the Declining Competitiveness of Capital Markets in the US), Capital Market Quarterly, Fall 2006 issue (in Japanese).

In Japan, rules of conduct are spelled out in the Securities and Exchange Act and in Cabinet Office directives, and even good faith practices and other areas which could be considered in the realm of industry ethics are monitored, with the force of law, by the Financial Services Agency (FSA). Within this context, we think one of the most important roles of self-regulation is to work with the governmental authorities to ensure that the regulations and guidelines they issue are practical. Within such an environment, we think it will probably remain difficult to accept the idea of SROs playing the leading role in governing the industry based on ethics and general principles.

Although it seems appropriate that one of the key issues being debated by the Council on Economic and Fiscal Policy's working group on financial and capital markets is the question of what the best methods and institutions for monitoring financial and securities transactions are, we would hope that the debate does not merely continue in the current direction of creating a Japanese version of the SEC and beefing up the staff at the FSA and the Securities and Exchange Surveillance Commission (SESC), but rather that it deepens to include a serious examination of the differences with the US and the UK, as described above.

Rome was not built in a day -- the spirit of perseverance.

After having pointed out a number of areas of concern in the debate over the competitiveness of Japan's markets and its role as a global financial center, we would like to close by offering a few comments on the direction, as opposed to the content, of the debate.

As noted in the introduction, the renewed focus on the competitiveness of Japan's markets and the issues affecting Japan's ranking as a global financial center is a welcome development. It is important, however, that this focus not be a temporary fixation, but rather an ongoing assessment of the market and how to improve it. When interest in financial reform has gained momentum in Japan in the past, the typical pattern has been for a report to be issued after about six months of debate, after which the entire matter is left to the bureaucrats and politicians, resulting in a substantial decline in the vigor of the debate and related research. Since the debate is often event-driven, be it a plunge in the stock market, a financial crisis, or some sort of scandal, the usual pattern is that as the public's interest in the initial event fades, so does the debate itself.

The process of building a better market requires ceaseless efforts, however. But just as Rome was not built in a day, sporadic periods of heightened interest, however often they are repeated, are unlikely to bring Tokyo's market to a level on par with that of New York or London.

The Corporation of London, after issuing its initial global financial center report in 2003, followed up with an update in 2005. Such research efforts by London do not have recent beginnings, and for a long time now London has done research on a variety of issues in a sustained fashion. In the early 1990s, it held its City Research Project, a thorough, three-year project aimed at improving the global competitiveness of London's financial services, concluding the project with a voluminous report.

The Committee on Capital Markets Regulation in the US was organized in September 2006, and in less than three months had already published a 150-page report. That report did more than just list recommendations, it provided a comprehensive review of the current literature on related subjects and provided a jump-off point for further debate. Stated differently, rather than just engaging in a concentrated debate over a period of less than three months, the committee was able to take the large body of research and analysis conducted on a sustained basis over many years and for the first time turn it into a polished report over a short period of time.

There is a possibility that the current debate over the competitiveness of Japan's markets, which is now attracting a level of attention it has not had in 10 years, may suffer from a rapid decline in interest from the political spectrum as the upper house elections in the summer of 2007 draw near. Even if that happens, however, there is hope that Japan can deal with the issues based on a commitment to sustain serious research and debate.