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A Note on Japan's Role in Regional and Global Consolidation of Financial Markets

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I. Recent Developments in Japan for Globalization/Regionalization

Listed below are recent developments in Japan for globalization and/or regionalization of the Japanese capital market.

A. Nasdaq Japan Market

The Nasdaq Japan Market (NJM) is operated in collaboration with the Osaka Securities Exchange (OSE). The OSE provides an order-driven trading system, clearing and settlement function, surveillance, and listing-related functions for NJM. NJM was created by Nasdaq Japan, Inc., which is a 50-50 joint venture by the US NASD and SOFTBANK CORP of Japan with 13 Japanese and foreign securities companies owning approximately 15% of its shares. Specifically, NJM has not evolved into a vehicle to provide Japanese investors with access to international securities. The only globalization aspect of Nasdaq Japan is its ownership structure. Although Nasdaq Japan has partial foreign ownership, it concentrates largely on the domestic market.

For comparison purposes, Nasdaq Canada is cited to compare and contrast two similar organizations in terms of globalization/regionalization. Nasdaq Canada is a cross-border market that provides Canadian investors with easier access to U.S. securities. Embedded in Nasdaq Canada's operations are significant globalization or regionalization features that include: (i) trading in U.S. dollars of all Nasdaq-securities in Canada (in Phase I); (ii) trading in both U.S.

and Canadian dollars and regulatory oversight by both U.S. and Canadian regulatory agencies (in Phase II); and (iii) true globalized linking of Nasdaq Canada with Nasdaq Japan and Nasdaq Europe (Phase III).

Nasdaq Japan boasts that the size of market capitalization (¥996 billion) is more than three times that of Mothers of Tokyo Stock Exchange and its trading value is about 7 times greater than that of Mothers. In my opinion, Nasdaq Japan's real challenge should be found not in the domestic market but in the regional and global markets.

B. MOUs Executed by Tokyo Stock Exchange

The Tokyo Stock Exchange (TSE) has signed MOUs with a number of exchanges, such as the Australian Stock Exchange (ASX), Korea Stock Exchange, New York Stock Exchange (NYSE), Philippine Stock Exchange, Singapore Exchange (SGX), and Stock Exchange of Thailand, for bilateral cooperation largely for information exchange. Beyond cementing bilateral relationships, little is expected for globalization or regionalization from these MOUs.

C. Exchange-Traded Funds

In an effort to increase cross-border access of Japanese investors to the U.S. market, an agreement was signed by the Nasdaq Stock Market, Inc. and the OSE in July 2000 to accomplish the following:

- a. exchange-traded funds (ETFs) such as the Nasdaq-100 Index Tracking Stock (Amex: QQQ) or similar Japanese

instruments such as a Japanese version of Nasdaq QQQ on the newly opened NJM¹.

- b. futures and options based on Nasdaq indices to be traded on the OSE derivatives market.

A similar MOU was also signed by OSE and Dow Jones & Company to list an ETF tracking the Dow Jones Industrial Average and related financial derivatives. This EFT is expected to trade in 2001.

D. Global Equity Market

The TSE has been participating in the global equity market discussions with NYSE, Hong Kong Exchanges and Clearing Ltd. (HKEx), ASX, Euronext (Amsterdam, Brussels, Paris), Toronto Stock Exchange, Bolsa Mexicana de Valores, and Bolsa de Valores de Sao Paulo. The idea of “global equity market” was proposed by NYSE in order to inter-connect participating exchanges’ trading systems and to develop market structure based on the principles of transparency, self-regulation, and auction price discovery.² Development and implementation of this initiative is dependent on a number of other issues, including regulatory approval, which may take longer than anticipated.

E. S&P Global 100

The S&P Global 100 is an equity index measuring the performance of 100 companies from three major exchanges: NYSE, TSE, and Deutsche Börse (DB).

¹ ETFs are similar to index mutual funds as both can track specific index movement and provide diversification. ETFs can be bought and sold like a stock of an individual company during the entire trading day. They can be bought on margin, sold short, or bought at limit prices, unlike index mutual funds.

² The market capitalization of participating exchanges amounts to over US\$20 trillion, of which the NYSE-listed companies account for approximately one-half.

The index is compiled by Standard & Poor's, under the collaboration of NYSE, TSE and DB. Barclays Global Investors is filing for regulatory approval to create investment products based on the S&P Global 100. If approved, the products will be traded in the three exchanges. A total of 70 companies of the 100 companies in the S&P Global 100 are NYSE-listed companies and the remaining 30 will be selected from TSE and DB.

F. EAOSEF Cross-Border Trading Access Study:

A working committee of EAOSEF prepared a report entitled "Beyond Cross-Border Trading Access: An EAOSEF Perspective," which was presented at its annual meeting in Wellington, New Zealand, in April 2000.³ Recognizing the increasing demand for and supply of cross-border investment and trades, the report recommended the following: all EAOSEF members implement effective market linkages with other members to create a virtual regional exchange. Although this recommendation is forward-looking and very sensible, it was non-binding. Data on foreign investor transaction was reported as follows:

Member Exchange	% of Foreign Investor Transactions	% of Transaction Value Attributed to Foreign Firms Listed
Australia	20.0	1.37
Hong Kong	31.0	0.20
Singapore	34.0	10.80
Philippines	42.7	0.48
Malaysia	16.2	0.38
Korea	8.0	0.00
Tokyo	29.1	0.03
Osaka	11.9	0.01
Taiwan	2.8	0.30
Indonesia	54.7	N/A
Thailand	32.9	0.00

³ EAOSEF denotes the East Asian and Oceanian Stock Exchanges Federation with 13 members exchanges from the Asia-Pacific region. Both TSE and OSE are leading members of EAOSEF.

New Zealand	50.0	12.10
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Source: EAOSEF (2000)

As indicated in the above table, foreign investors' access to the region's market is relatively high, ranging from 2.8% (Taiwan) and 8% (Korea) to 54.7% (Indonesia) and 50% (New Zealand). However, domestic investors' access to foreign markets within their home countries is limited as shown in the last column.

G. Personal Assessment

In my opinion, the Japanese market and market regulators must be more proactive and aggressive in responding to this upcoming challenge. Otherwise, the region will be isolated from global and regional competition. Recent developments in Japan for globalization/regionalization may be characterized as conservative, passive, and reactive.

Rapid advances in technology intensify the globalization and regionalization programs of the financial markets in the Asia-Pacific region, triggering increased cross-border activities. Intra-region consolidation among organized exchanges and over-the-counter markets in the Asia-Pacific region must be adopted and supported. The Japanese market must play a leading role in this effort.

Smaller economies and organized exchanges in the region proceed more aggressively than Japan. This is discussed in the following section.

II. Recent Developments in the Region for Globalization/Regionalization

A. Australia

Exploratory discussions are in progress for a merger between ASX and New Zealand Stock Exchange. A draft plan defining a post-merger operational framework is being prepared to facilitate further discussions. The important objectives include: (i) to promote the ability of Australian and New Zealand investors to trade the shares on both markets, which will improve liquidity and capital raising opportunities for both countries; and (ii) to promote a harmonized regulatory environment.

In addition, ASX undertook the following new initiatives: (i) an agreement with Bloomberg to trade North American stocks; (ii) an agreement with SGX to develop co-trading; and (iii) an agreement with Nasdaq to co-list companies on each other's boards. The Bloomberg proposal will enable Australian investors to place orders directly in North American stocks. This proposal should be operational by early this year, and co-trading link with Singapore will be implemented from July 2001.

B. Singapore

The most significant policy change by the Monetary Authority of Singapore (MAS) is the liberalization of its non-internationalization of the Singapore dollar (S\$). This policy was introduced in 1998. Since then, MAS allowed foreign corporations to list S\$-denominated shares and issue S\$ bonds, and swap the proceeds out of Singapore. MAS also lifted the S\$20 million consultation limit for repurchase transactions in Singapore Government Securities and S\$ bonds with non-residents. As of December last year, MAS further relaxed its non-

internationalization policy of S\$ by allowing banks to: (i) lend S\$ to non-residents for investment purposes in Singapore; and (ii) transact in S\$ currency options with other banks and financial institutions in Singapore.

SGX and the American Stock Exchange (Amex) will create a joint venture to list and trade Amex-listed ETFs and structured products on SGX. It will provide both retail and institutional investors the opportunity to trade ETFs across the North American and Asian time zones. They are also exploring the possibility of cross listing equities instruments.

In November 2000, SGX and the Australian Derivatives Exchange (ADX) announced their plan to: (i) establish co-operation that would enable their members and traders to have cross-access to the exchanges' electronically listed products; and (ii) co-clear such products with a target completion in mid 2001. Cross-access, cross-trading and co-clearing of their derivatives products are the core features of this collaboration.

C. Hong Kong

Hong Kong just completed a three-phase approach toward its new U.S. dollar clearing system in December last year as follows: (i) the U.S. dollar real-time gross settlement (RTGS) for interbank payment and delivery-versus-payment (DvP) settlement for U.S. dollar-denominated stocks were implemented in phase 1; (ii) payment versus payment (PvP) settlement for foreign exchange transactions between US dollars and Hong Kong dollars in phase 2; and (iii) DvP settlement of US dollar-denominated checks and debt securities and automatic intraday REPOs in the RTGS in phase 3. Thus, the foreign exchange risk related

to time zone differences is reduced.⁴ Hong Kong's dollar clearing system may be characterized as one of the most remarkable developments in the region that will speed up cross-border trading activities.

Beginning in May 2000, trading of seven Nasdaq stocks in Hong Kong began. The Nasdaq shares are admitted for trading only and are not listed in the Stock Exchange of Hong Kong (SEHK). This is an interesting pilot program introduced by HKEx and the Nasdaq Stock Market, Inc. to promote a 24-hour global trading. Other noted features include: (i) stocks are quoted and traded in Hong Kong dollars; (ii) trading of the stocks are subject to SEHK rules and Hong Kong law; (iii) four market makers are designated to provide two-way quotes; (iv) Nasdaq and SEHK entered into an information sharing agreement; and (v) clearing and settlement are handled under the agreement between the Depository Trust Corporation and the Hong Kong Securities Clearing Company, which makes it possible for the shares to be traded in Hong Kong dollars.

III. Regional Bond Markets: The Japanese Market Failed to Capitalize on the New Miyazawa Initiative

At the climax of the Asian financial crisis, the Japanese government introduced the new Miyazawa Initiative for which Japan pledged a total of \$30 billion, of which one-half of was made available for the medium- to long-term financing needs for Asian economies affected by the financial crisis. At least three measures under the Initiative were directly related to regional bond market activities. They were: (i) acquisition of sovereign bonds issued by Asian

⁴ Hong Kong Shanghai Banking Corporation, which was designated as the settlement agent, reported that a total turnover of US\$870 million from 2,771 transactions involving 56 participating institutions during the first day of trading. Refer to HSBC News Release dated August 21, 2000.

countries by the Japan Bank for International Cooperation; (ii) support for Asian countries in raising funds from international financial markets through the use of guarantee mechanisms; and (iii) possible establishment of an international guarantee institution.

Unfortunately, the Tokyo market failed to capitalize on these measures to promote itself as a global and regional financial center by expanding of the role of the *Gaisai* market.⁵ The amount of *Gaisai* bonds issued in the last 10 years, from 1991-2000, is far from the original expectation as summarized below. The issuance of Samurai bonds has not reached the pre-crisis highest level of ¥37.9 trillion in 1996, while no Shogun bonds have been issued since 1994. Foreign borrowers are expected to take advantage of the continued deflation in the Japanese price level and extremely low interest rates, but their fund raising activities in Japan has not been active as expected. Why did the Tokyo market fail to serve the region?

Without a fully developed domestic government bond market, it is difficult to serve the region. The Japanese government bond market suffers from weaknesses that include: (i) failure to tap the pool of global capital; (ii) violation of the rule of separation between government liabilities management and monetary policy; and (iii) incomplete primary and secondary markets infrastructures remain. Additionally, without a joint effort by the region's economies, Japan alone cannot create a truly regionalized bond market.

⁵ *Gaisai* is a general term assigned to all foreign- and yen-denominated bonds issued in Japan by non-residents. Yen-denominated bonds are called "*samurai*" bonds while foreign-currency-denominated bonds are known as "*shogun*" bonds.

IV. Policy Recommendations

A stronger, more assertive leadership role of Japan is missing in the on-going activities for globalization and regionalization of both equity markets and bond markets. On the equity market side, TSE and OSE must spearhead the programs of creating co-listing, co-trading, and co-clearing with Asian exchanges. Potential mergers are better options to explore. On the bond market, the ministries of Finance and Foreign Affairs and the Bank of Japan must support a comprehensive study that focuses on a number of regional market issues and come up with detailed implementation plans for Japan, Hong Kong, Singapore, and Australia. Without these efforts and programs, Japan and the entire Asia-Pacific region will be marginalized in globalization/regionalization activities.

***Gaisai* Bond Issuance**

Unit: ¥ trillion

Year	No. of Issues	Samurai Bonds	No. of Issues	Shogun Bonds
1991	27	7.11	1	0.41
1992	37	15.69	0	0
1993	49	12.30	1	0.59
1994	60	12.59	0	0
1995	85	21.09	0	0
1996	154	37.90	0	0
1997	66	15.82	0	0
1998	10	1.53	0	0
1999	24	8.67	0	0
2000*	41	7.74	0	0

* From March to October.

Sources: The Bond Underwriters Association of Japan, *Bond Review*,
and The Japan Securities Dealers Association, *Shokengyoho*