Japan's Securities Market

By Masahiko Sone

International position rising fast

The Japanese securities market has grown rapidly in the 1980s. Its expansion and the progress of liberalization and internationalization have been especially remarkable in the past few years. At the end of 1985 Japan became the world's largest net creditor nation, a clear sign of the country's fast rise as a major financial power. Tokyo is solidifying its position as one of the world's largest financial centers, on a par with New York and London.

Four points can be singled out as primary factors behind the rapid development of the Japanese securities market. The first is progress in the liberalization of interest rates. This was caused first and foremost by massive offerings of government bonds and their swelling outstanding balance since 1975. Liberalization of the terms of these instruments was inevitable if the government was to continue to place huge new offerings and to smoothly distribute the ballooning outstanding bonds. Accordingly, there has been steady progress in the liberalization of coupon rates and other issue terms, both on the public and corporate bond market as a whole and on the short-term capital market.

The second factor has been the progress in market internationalization. When the new Foreign Exchange and Trade Control Law took effect in December 1980, it touched off rapid liberalization of Japan's capital transactions at home and abroad. The expansion of the primary and secondary bond markets—both domestic and foreign—was further fueled by the liberalization of capital and financial markets promoted under an agreement reached by the Japan-U.S. Yen-Dollar Committee in May 1984.

The third element has been the accumulation of financial assets and rising investor preference for better yields. While Japan's economic growth rate has slowed, its financial assets have been expanding at a rate of nearly 10% a year. The result has been a growing orientation toward better investment returns on the part of both corporate and individual investors. As a consequence, fund management using free-interest financial instruments or bond and stock transactions has surged. An especially notable development during the past few years has been the practice of managing financial assets not only on domestic but also on overseas markets as Japan's capital exports have risen in concert with the growth of the country's current account surplus.

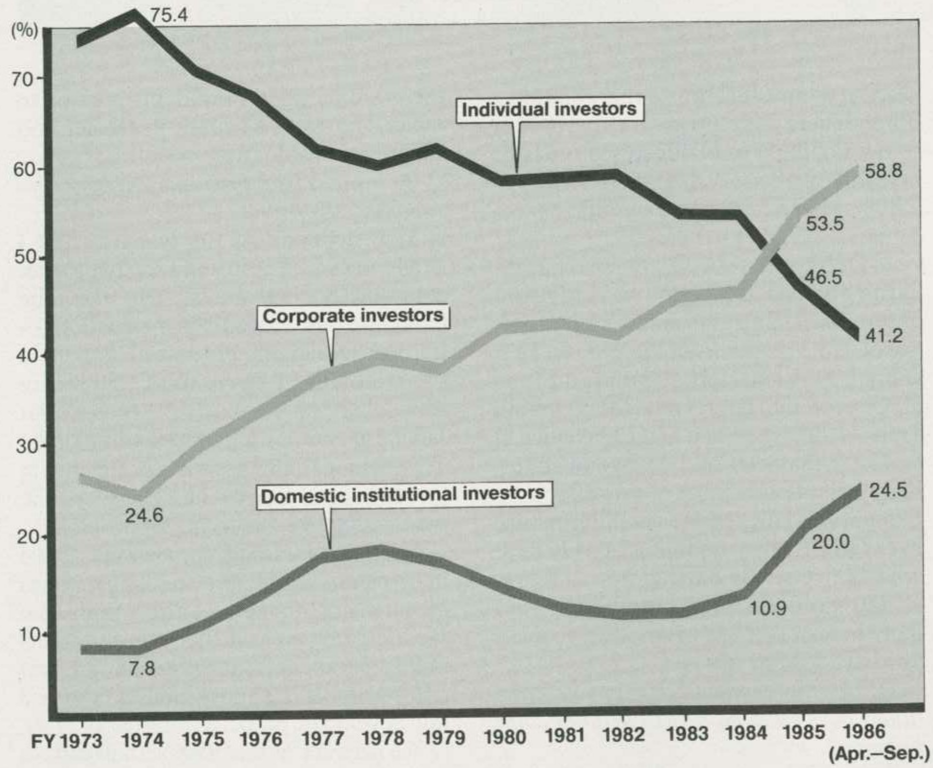
The fourth and final key factor is progress in market mechanization, specifically the introduction of electronic equipment. This has contributed to the expansion of the securities market through the development of new financial instruments and increased availability of information. Now it promises to make 24-hour trading a reality.

The primary and secondary securities markets today

The stock market

Stock offerings have maintained a low profile on the primary securities market of late (Table 1). The main reason is that businesses, adjusting to the lowest interest rates in Japan's history, have put

Fig. 1 Ratio of Stock Trading by Investor (in numbers of shares)



Notes: Domestic institutional investors = insurance firms + banks + investment trusts.
Corporate investors = domestic institutional investors + business firms + foreigners + other corporations.

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Table 1 Corporate Fund Raising in Domestic and Overseas Securities

(¥ billion; %)

	1982	Share of total	1983	Share of total	1984	Share of total	1985	Share of total
Domestic markets	2,865.3	69.6	2,203.5	52.3	3,019.5	54.8	3,506.5	51.0
Straight bonds	1,166.1	28.3	666.6	15.8	837.3	15.2	890.2	12.9
Convertible bonds	447.5	10.9	832.0	19.8	1,208.5	21.9	1,901.0	27.6
Stock issues	1,207.7	29.2	694.9	16.5	960.7	17.5	705.3	10.2
Overseas markets	1,250.8	30.4	2,011.0	47.7	2,491.0	45.2	3,375.7	49.0
Straight bonds	403.3	9.8	679.0	16.1	598.3	10.8	1,593.9	23.2
Convertible bonds	636.0	15.4	1,130.8	26.8	1,377.9	25.0	1,049.0	15.2
Warrant bonds	94.0	2.3	117.6	2.8	466.7	8.5	713.6	10.4
Total	4,116.1	100.0	4,214.5	100.0	5,510.5	100.0	6,822.2	100.0

Note: Figures are one-way totals (not adjusted for redemptions and conversion into stock).
Source: Monthly Bulletin (June 1986), Bank of Japan

Table 2 Stock Market Transactions and Market Value in 16 Key Countries and Regions

($ billion; percentage shares in parentheses)

	Japan*	U.S.*	Britain*	W. Germany*	Others	Total
Transaction						
1975	51.2 (21.2)	133.7 (55.4)	19.6 (8.1)	11.1 (4.6)	25.9 (10.2)	241.5 (100)
1980	157.2 (23.0)	380.5 (55.6)	36.0 (5.3)	15.2 (2.2)	94.5 (13.8)	683.4 (100)
1985	321.2 (20.4)	970.5 (61.6)	70.2 (4.6)	75.5 (4.8)	138.3 (8.6)	1,575.7 (100)
Market value of all outstanding stocks						
1975	135.1 (11.5)	683.6 (58.0)	77.7 (6.6)	51.5 (4.4)	230.2 (19.5)	1,178.1 (100)
1980	356.6 (15.4)	1,240.0 (53.4)	189.7 (8.1)	71.3 (3.1)	463.0 (20.0)	2,320.6 (100)
1985	909.1 (22.5)	1,955.4 (48.4)	328.3 (8.1)	179.0 (4.4)	667.3 (16.5)	4,039.1 (100)
Sep. 1986	1,826.8 (33.6)	2,093.1 (38.5)	374.8 (6.9)	227.7 (4.2)	912.1 (16.8)	5,434.5 (100)

Note: The key countries and regions covered are the U.S., Canada, Japan, Australia, Hong Kong, Singapore/Malaysia, Britain, West Germany, France, Switzerland, the Netherlands, Italy, Spain, Denmark, Sweden and South Africa (*Tokyo Stock Exchange first section for Japan, New York Stock Exchange for the U.S., London Stock Exchange for Britain and all markets for West Germany).
Source: Morgan Stanley Capital International Perspective

greater priority on convertible bonds and bonds with warrants to buy new shares rather than capital increases through public stock offerings. Proceeds from stock offerings accounted for only 10% of total funds raised by Japanese firms on both domestic and overseas capital markets in 1985.

In contrast, the secondary stock market has expanded dramatically in recent years. The market saw an unprecedented bull market last year as demand for shares far outpaced supply. The transaction value on the first section of the Tokyo Stock Exchange zoomed to ¥155.9 trillion last year, 2.1 times that of 1985 and 3.2 times that of 1981. The total market value of all oustanding stock on the first section was ¥277.1 trillion at the end of 1986, 1.5 times the level of the previous year and 3.2 times that of 1981.

The Tokyo stock market is the world's second largest, after New York, both in transactions and market value of shares (Table 2). Tokyo's market value of shares was nearly 90% that of New York in dollar terms at the end of September 1986, in part reflecting the yen's sharply increased value against the U.S. currency. The price/earnings ratio (PER), a yardstick of stock price levels in relation to corporate profits, is sharply higher in Tokyo than in U.S. and European markets as prices have continued to soar thanks to a tight supply/demand situation. This has prompted investors to start using the ratio of net assets to stock prices and other yardsticks to supplement the PERs.

One major characteristic of the Japanese stock market is the growing weight of corporate investors in stockholdings. As of March 31, 1986, the end of fiscal 1985, financial institutions accounted for 38.6% of all outstanding shares, and other business corporate investors for 25.6% compared with individual investors who held 25.4%. The ratio of individual holdings is also on the decline in the U.S., but was still nowhere near 64.5% on a market value basis at the end of 1985. The rise in corporate stock ownership is explained partly by the practice of Japanese companies holding each other's stocks, and partly by the fact they increased financial institutions' holdings of their shares to encourage closer mutual ties and to stabilize stockholdings.

Despite their low share of total stockholdings, individual investors nonetheless used to play a relatively major role in the secondary stock market. Stock trading on the part of corporate and institutional investors who possessed stocks was inactive because their holding of issues was mainly for strategic reasons. But corporate stock trading has surged in recent years, with the result that the ratio of trading by individual investors slipped below 50% in fiscal 1985 (Fig. 1).

Nonfinancial firms have increased portfolio investments in the face of low interest rates that render fixed-interest instruments far less attractive, while financial institutions have stepped up such investments to offset sluggish demand for loans. A move toward high returns even at the cost of higher risk has set the pace for the management of financial assets. The weight of institutional investors is also likely to grow in the wake of an expansion of corporate pension funds, the speedy growth of investment trusts, the start of sales of variable insurance and the enforcement of a new law regulating the investment advisory business.

The bond market

Both primary and secondary markets for public and corporate bonds have expanded rapidly during the past decade

The London Stock Exchange sees heavy trading in Japanese government bonds.

(Table 3). Annual new bond offerings swelled 2.9 times, outstanding bonds 4.4 times, and annual turnover an astonishing 46.4 times. Especially noteworthy is the central role of government bonds in the bond market, mirroring the massive offerings since fiscal 1975. Government bonds accounted for 36% of all new bonds issued, 51% of total outstanding bonds and 94% of turnover in fiscal 1985. Obviously, the liberalization of the Japanese bond market over the past 10 years has focused on government bonds.

In April 1983, the Finance Ministry gave the go-ahead to sales of new public bonds by financial institutions, followed by permission to trade in existing public bonds in June 1984. As a result, the volume of public bond dealings rocketed from ¥750 trillion in fiscal 1984 to ¥2,500 trillion in fiscal 1985.

Also noteworthy was the inauguration of a government bond futures market in October 1985. The futures market initially underwent wild price swings, but has since developed at an impressive pace. The volume of futures trading in 10-year government bonds was actually exceeding that of spot trading by July 1986. The futures market is used to hedge against interest rate changes and price fluctuations. But futures trading has also come to be used more often as a tool for scoring capital gains by brokerage houses, commercial banks and other market participants.

The corporate bond sector, meanwhile, is seeing a rapid unification of the domestic and overseas primary markets. Businesses are placing increasing priority on minimizing fund-raising costs, and now select from a variety of bond-issuing forms on the primary market, both at home and abroad. Companies are shifting their fund raising from capital increases through stock offerings to bond flotations, as well as moving from the domestic to overseas markets (Table 1).

Bond offerings abroad are outpacing those at home for several fundamental reasons. These include lower issue costs, coupled with easier procedures and the absence of collateral requirements. Another reason is the availability of various new products (such as swaps and dual-currency bonds) that hold down costs. But recently there has been a trend to shift from overseas back to domestic markets for convertible bond offerings. This is a direct outcome of new incentives introduced to the domestic primary market, including a softening of issue terms, relaxation of qualifications for unsecured offerings and reductions in various issuing fees. This shows that the domestic market can compete on an equal footing with overseas markets. The next major task in this regard is to reinvigorate the inactive domestic primary market for straight bonds.

One feature of the internationalization of Japan's bond market is the rapid expansion of yen and foreign currency bond offerings on the Tokyo capital market by nonresidents, and the increase in Euroyen bond issues. Competition has also intensified between the domestic and overseas markets for bond offerings by nonresidents. In fiscal 1985, Euroyen bond offerings exceeded yen-denominated offerings in Tokyo. The Euroyen bond market enjoys a competitive edge in costs and issuing procedures following the relaxation of requirements for nonresident Euroyen bond issues, implemented in December 1984 in accordance with the recommendations of the Japan-U.S. Yen-Dollar Committee. Further improvement of the market climate is necessary if the Tokyo yen-quoted bond market for nonresidents is to perform as an international capital market on the same level as the Euroyen bond market.

Investment trusts

One of the most remarkable phenomena of 1986 was the booming sales of investment trusts. The net assets of these trusts ballooned to ¥32.1 trillion by the end of 1986 from only ¥20.0 trillion a year before–an increase of ¥12.1 trillion, or 61%. This clearly reflected growing moves among investors to seek financial instruments with better returns at the cost of some risk due to the unusually low interest rates. Both stock- and bond-oriented investment trusts sold well, with the former's sales increasing remarkably.

Among major factors behind the brisk stock investment trust sales are the diversification of the kinds of trusts available and tightened requirements for disclo-

Table 3 Public/Corporate Bond Issues, Turnover and Balance (¥ trillion; %)

	Gov't bonds	Gov't-guaranteed bonds	Other public bonds	Total public/corporate bonds	Percentage share of gov't bonds to the total
New issues					
FY 1975	5.7	0.4	2.2	20.9	27.6
FY 1980	14.5	1.5	2.1	36.1	40.3
FY 1985	21.9	2.7	2.3	60.7	36.2
Turnover					
FY 1975	1.3	1.3	13.2	57.6	23.3
FY 1980	168.3	11.7	29.8	289.9	58.1
FY 1985	2,500.1	29.8	23.9	2,672.1	93.6
Balance					
End of FY 1975	14.9	2.4	7.1	59.0	25.4
End of FY 1980	70.5	7.4	17.4	152.6	46.2
End of FY 1985	133.4	16.0	20.7	260.4	51.2

Source: Monthly Bulletin, Bond Underwriters' Association sure of trust performance information such as yields achieved. The former is a result of investment liberalization, as shown by easing or elimination of registration requirements for incorporating into trusts over-the-counter stocks or second section-listed stocks, Euroyen and warrant bonds. Also contributing to diversification was the appearance of stock-index funds and other new trusts devised by companies seeking to beat out the competition. Such liberalization of trust incorporation and investment will trigger fierce competition for higher yields between not only the investment trusts themselves but also different instruments, including special money trusts, the so-called "fund trusts" and the new variable insurance.

Securities investments by Japanese and foreigners

A notable trend in securities investment by both Japanese and foreign investors is the recent fast expansion of Japanese investments in foreign securities (Table 4). Bonds are the main overseas investment target. Investment in foreign bonds posted a net increase of $84.1 billion in the first 11 months of 1986, already exceeding the $53.5 billion net increase for all of 1985. The 1985 net gain was equivalent to ¥13.3 trillion, more than the net ¥12.8 trillion increase in the year's outstanding government bonds.

Participants in overseas bond investments are diverse, ranging from financial institutions and institutional investors to business corporations. Both financial institutions and institutional investors are continuing to make massive investments in foreign bonds because these groups are unable to meet their investment objectives at home. Their outstanding holdings of foreign bonds are estimated to have topped $200 billion at the end of 1986.

Trading in foreign bonds has accelerated as a result of the broadened range of investors and swelling holdings. This can be seen in the rapid expansion of the domestic secondary market for foreign bonds, as well as by the huge investments themselves—$235 billion in purchases and sales between January–November 1986. Foreign bond trading in Japan's over-the-counter market totaled $54.4 billion in 1984, $176.1 billion in 1985 and $321.6 billion in the first nine months of 1986, suggesting the same increasingly active short-term trading seen for domestic bonds. Given the active trading in Japanese government bonds in London and New York, 24-hour trading could be said to have already begun, at least as far as bonds are concerned.

Investments in Japanese securities by foreign investors showed a $364 million net decline in the first 11 months of 1986. This was largely due to a sharp jump in stock sales resulting from a buoyant stock market and the yen's sharp appreciation against the dollar. Over the long term, foreign institutional investors are thus expected to steadily expand their investments in Japanese stocks and bonds.

Table 4 (a) Japanese Securities Investments Abroad ($ million)

	Total capital outflow	Securities investments	Stocks	Bonds	Yen-quoted bonds, etc.
1980	10,817	3,753	–213	2,996	970
1981	22,809	8,777	240	5,810	2,727
1982	27,418	9,743	151	6,076	3,516
1983	32,459	16,024	661	12,505	2,858
1984	56,775	30,795	51	26,773	3,971
1985	81,815	59,773	995	53,479	5,299
1986 (Jan.–Nov.)	116,053	91,397	5,498	84,097	1,802

Table 4 (b) Foreigners' Securities Investments in Japan ($ million)

	Total	Securities investments	Stocks	Bonds	External bonds issued by Japanese companies
1980	13,141	13,113	6,546	5,331	1,236
1981	13,137	13,220	5,916	5,936	1,368
1982	12,449	11,860	2,549	5,030	4,281
1983	14,759	14,148	6,216	2,359	5,663
1984	7,124	7,194	–3,610	3,454	7,350
1985	17,273	16,741	–673	4,524	12,890
1986 (Jan.–Nov.)	–357	–364	–16,284	–1,923	8,160

Source: Balance of Payments Table, Bank of Japan

Growing foreign presence in the financial market

The number of foreign banks and securities firms operating in Japan has increased steadily with the progress in the liberalization and internationalization of Japan's financial and capital markets. Tokyo has become an international financial center too important to ignore. By the end of 1985 there were 77 foreign banks in Japan with 114 branches and 116 representative offices, and 20 foreign securities companies with 22 branches and 117 offices. The number of foreign securities companies and their branches had shot up to 34 and 36, respectively, by the end of the year.

Foreign banks and securities firms are naturally looking for business areas with good growth potential. Six brokerage houses were authorized in December 1985 to obtain Tokyo Stock Exchange membership. In April 1984, foreign securities firms were allowed to underwrite new government bond offerings for the first time. The Finance Ministry had already made it clear in December 1984 that foreign securities companies not operating in Japan could still lead-manage Euroyen bond issues.

The Tokyo stock market today is playing an increasingly international role. There are mounting expectations that the stock market, as well as the bond market, will emerge as an important center for international fund raising in the wake of the sharp rise in Japanese investments in foreign stocks last year (Table 4). Already the number of foreign businesses listed on the TSE is increasing fast. The 21 listed firms at the end of 1985 had swelled to 52 a year later and their number is expected to reach 100 at the end of 1987. Japan's financial marketplace has clearly claimed its place in the international arena. ●