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Small Supply of Risk Funds in Japan

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Japanese stock exchanges are lagging behind the world's major stock exchanges in the area of raising risk funds. Risk funds are essential for innovation. For the government to achieve the goal for productivity improvement, which it set in its Basic Policy for Economic and Fiscal Reform: 2007, the stock exchanges have a major role to play. Without doubt, it is important for the stock exchanges to improve the processing capability of their systems to prevent such serious troubles as the suspension of trading. They need to enhance their fundamental function of supplying risk funds to the market.

Derivatives Market Lags Behind

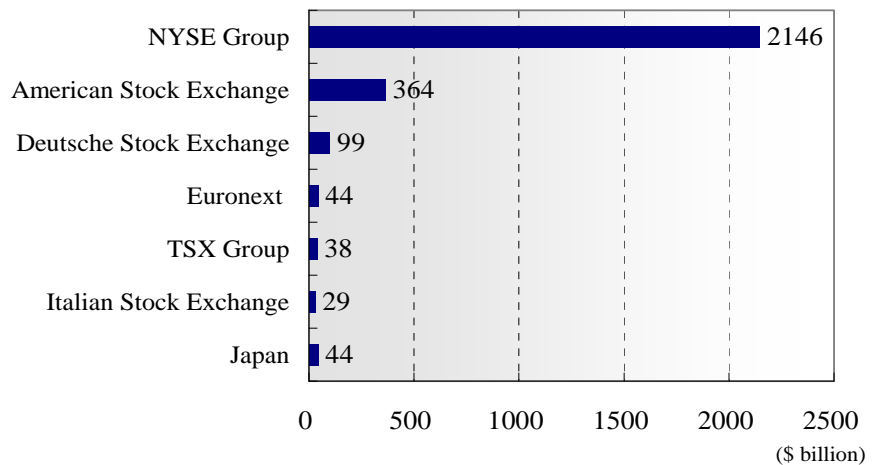
In the financial derivatives market, which has been developing dramatically in recent years, the serious shortcoming of the Tokyo market emerges in high relief. Financial derivatives, such as options and futures, have a strong affinity with information and communication technology (ICT). Consequently, they have been developed one after another in step with the development of ICT. The trading volume of financial derivatives has increased globally, having almost doubled between 2002 and 2006. With the surge in resource prices in recent years, trading in commodities futures, in particular, has increased sharply.

The presence of the Tokyo market is hardly being felt, and Tokyo has been left far behind by the major stock exchanges in the United States and Europe. It is even lagging behind the Hong Kong, Singapore and South Korean markets. In terms of the value of option trading, for example, exchanges in the United States occupy top positions, with the International Stock Exchange in first place, the Chicago Board Options Exchange in second place and the Philadelphia Stock Exchange in fifth place. The Sao Paulo Stock Exchange in Brazil is in third place and fourth place is occupied by Eurex, which is an options exchange under the umbrella of the Deutsche Stock Exchange.

Of the Japanese exchanges, the Osaka Stock Exchange sits in 23rd place and the Tokyo Stock Exchange in 25th place. They are smaller than the exchanges in Hong Kong, India and Taiwan. Even the combined trading of the Tokyo and Osaka Stock Exchanges is smaller than the trading of Taiwan's stock exchange. It appears that Japanese exchanges have failed to mount the global current of trading expansion.

The same holds true with respect to exchange-traded funds (ETFs). Although the Tokyo Stock Exchange has stated that it would put large weight on ETFs, its trading in ETFs in 2006 amounted to a mere 26.0 billion dollars. As in the case of stock options, the trading volume of ETFs is very small. The combined total of 44.0 billion dollars for the Tokyo and Osaka Stock Exchanges (the latter at 18.0 billion dollars) is less than half of the trading volume of the Deutsche Stock Exchange (Figure1).

Figure 1 Trading Volume of Exchange-Traded Funds (ETFs) (2006)



Note: The figure for Japan is the combined total of Tokyo and Osaka Stock Exchanges.
Source: World Federation of Exchanges

This is due to the small number of ETFs listed on these exchanges. At the end of 2006, only 14 products in total were listed on the Tokyo and Osaka Stock Exchanges. In August 2007, the Osaka Stock Exchange listed a gold ETF and the Tokyo Stock Exchange is slated to follow suit in the spring of 2008. Even so, the number of products will be far smaller than the 135 for the New York Stock Exchange (NYSE), 205 for the American Stock Exchange and 171 for the Deutsche Stock Exchange. The Euronext, whose trading volume of ETFs is at the same level as that of Japan, lists 160 products. It has been pointed out that because sales commissions on ETFs are smaller than those on other instruments, financial institutions do not aggressively sell them. In order to attract new investors, it is imperative for Japan's exchanges to offer a larger selection of products by increasing the number of ETFs.

A Multi-purpose System Is Needed

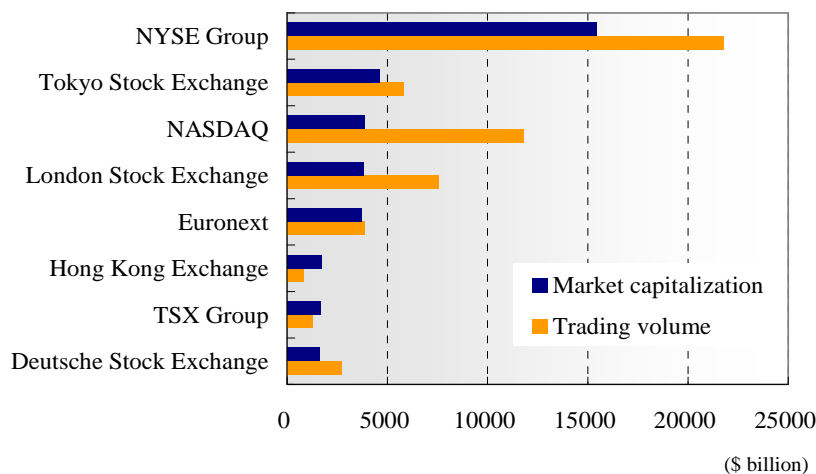
The announcement of the merger of the New York Stock Exchange and Euronext in 2006 astounded the world. Recently, the battle between NASDAQ and the Dubai Stock Exchange over the OMX Group, which is based in Scandinavia, has become increasingly fierce. This is against the backdrop of the need to make enormous investments in systems due to the introduction of ICT. The exchanges in the United States and Europe are competing with one another in terms of processing speed at the level of one-1,000th of a second.

The order-processing time equipped at the Osaka Stock Exchange, which boasts the highest processing speed in Japan, is 100-1,000ths of a second. In contrast, that at Euronext is five-1,000ths of a second. In addition to this enormous gap, the suspension of

trading at the Tokyo Stock Exchange due to a system failure in January 2006 has left a strong impression that enhancing the processing capability of the system is essential.

Needless to say, it is important to render the market more convenient for investors by enhancing its system capability. However, priority should be placed on raising more funds to increase the depth of the market. For the future, a multi-purpose system is needed so that it will also be able to deal with trading in a wide range of products, including derivatives, which are likely to be listed.

Figure 2 Market Capitalization of Stocks and Trading Volume of the World's Major Exchanges (2006)



Note: Market capitalization is that of domestic shares (as of Dec. 31, 2006).
Source: World Federation of Exchanges

Relatively Small Trading Volume

In stock trading, the Tokyo Stock Exchange has a large presence, ranking second in the world in terms of market capitalization and fourth in terms of trading volume (Figure 2). Although it is far behind the NYSE Group (which includes the world's largest exchange, the New York Stock Exchange), it is on a par with the London Stock Exchange and Euronext, both of which are leading markets in Europe.

The trading volume at the Tokyo Stock Exchange is small relative to its market capitalization, indicating that trading is not very active. In the ranking of world financial centers released by the City (London's financial district) in March 2006, Tokyo ranked ninth. It was assessed to be behind New York, London and Hong Kong. This may indicate that the Tokyo Stock Exchange is not very easy to use. One may thus assume that the world's investors are asking the Tokyo Stock Exchange to make itself more convenient to users.

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