Roles of Finance in Economic Growth

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*Any views expressed in this presentation are those of the author, and are not necessarily the official views of the FSA.*
Outline

I. Roles of Financial Sector in Economic Growth
   (1) Promoting Economic Growth
       -The Action Plan for the New Growth Strategy-
       ▶ Supporting economic activities
       ▶ Leading the economy as a growing industry itself

   (2) Ensuring Financial Stability
       ▶ Post crisis status report
       ▶ Policy responses

II. Further Challenges for Economic Growth in Asian Countries
I. Roles of Financial Sector in Economic Growth

(1) Promoting Economic Growth
   -The Action Plan for the New Growth Strategy-

(2) Ensuring Financial Stability

II. Further Challenges for Economic Growth in Asian Countries
I.(1) Promoting Economic Growth
-The Action Plan for the New Growth Strategy-


Three Pillars of the Action Plan

- To supply funds to companies commensurate with borrowers’ size and stage of development
- To bridge between the Japanese and Asian economies
- To provide asset management capabilities to utilize Japanese national assets safely and effectively
To supply funds to companies commensurate with borrowers’ size and stage of development

- Restoring confidence in and activating markets for emerging companies
  - Encouraging use of “Green Sheet,” the venue for pre-listed stocks.
  - Establishing a list of companies which meets certain criteria of quality as candidates for future listing.
  - Preparing venues for delisted stocks, etc.

- Developing debt capital markets for professional investors
  - Expediting the establishment of a corporate bond market for professional investors (i.e. Tokyo Pro-Bond market).
  - Simplifying disclosure requirements, and allow documentation in English.

- Improving disclosure requirements
  - Developing disclosure rules for smooth implementation of “rights offering.”
  - Relaxing quarterly securities report requirements.
  - Reviewing guidelines of accounting standards and internal controls reporting systems to suit the actual circumstances of SMEs.

- Expanding availability of commitment line contracts for smaller companies

- Allowing banks and insurance companies to engage in finance leases
To bridge between the Japanese and Asian Economies

**Establishing Japan as Main Financial Market in Asia**

Make Japanese financial markets more reliable, convenient, and attractive to both domestic and foreign investors.

**Expanding the scope of English language disclosure for Foreign Companies, etc.**

- Foreign companies will be allowed to use their English language version of issuance disclosure documents and extraordinary reports.
  
  (Currently, only continuous disclosure documents are eligible for such exemption.)
  
  - To encourage foreign companies to raise capital in Japan
  - To provide greater opportunities for Japanese investors to invest in foreign companies

**Promoting the establishment of an integrated exchange handling securities and other financial instruments as well as commodities**
To bridge between the Japanese and Asian Economies

Expanding activities of Japanese financial institutions in Asia

Promoting policy coordination regarding financial and capital markets among Asian financial authorities

- Conducting a survey on the status of financial and capital markets in Asia.
- Sharing experience on and lessons from financial crises and regulatory/supervisory frameworks in Japan as a reference for further development in Asia.
- Increasing input to the international discussions on financial regulatory reforms through enhanced dialogues among Asian financial authorities.

Supporting activities of Japanese small- and medium-sized enterprises (SMEs) in Asia

- JETRO and JBIC will support Japanese financial institutions to further improve information and consultation service for Japanese SMEs and their overseas subsidiaries.
- To facilitate Japanese SMEs’ borrowing from foreign financial institutions: JBIC will provide loans to the local financial institutions; and Japanese financial institutions will provide loan guarantee to the borrowing SMEs.
To provide asset management capabilities to utilize Japanese national assets safely and effectively

- Relaxing the regulation on asset allocation of insurance companies
  - Abolishing the ceiling on the ratio of each type of asset held to total assets.
    - To enable flexible asset management

- Extending reduced tax rate on securities
  - Extending the reduced tax rate (20% → 10%) for dividend income and capital gains on listed shares until 2013
    - To activate financial markets
    - To ensure economic recovery

- Expanding profit/loss offset scope for tax purposes

- The Financial Services ADR (Alternative Dispute Resolution)
  - The Financial Services ADR was introduced in October 2010.
  - This system will work for fast, simple, neutral, fair complaint handling and dispute resolution for problems with financial institutions.
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   (1) Promoting Economic Growth
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   (2) Ensuring Financial Stability

II. Further Challenges for Economic Growth in Asian Countries
Exposure to subprime-related products was limited for Japanese financial institutions.

**Exposures to Subprime-Related Products (Book Value)**

- **End of March 2007:** 1,407bn
- **End of March 2010:** 355bn

**Damage:** -1,052bn

Source: Financial Services Agency, Japan
Limited Direct Impact on the Financial Sector

The loss of Japan’s financial institutions from toxic assets is significantly smaller than those of the American and European financial institutions.

<table>
<thead>
<tr>
<th>Core capital</th>
<th>Total amount of loss</th>
<th>Capital investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>8,400</td>
<td>7,400</td>
<td>U.S. Department of the Treasury</td>
</tr>
<tr>
<td>12,700</td>
<td>9,400</td>
<td>Abu Dhabi Investment Authority, etc.</td>
</tr>
<tr>
<td>107,000</td>
<td>87,400</td>
<td>Citibank</td>
</tr>
<tr>
<td>102,900</td>
<td>86,700</td>
<td>Government of Singapore Investment Corporation (GIC), Kuwait Investment Authority, etc.</td>
</tr>
<tr>
<td>4,900</td>
<td>20,900</td>
<td>Investors</td>
</tr>
<tr>
<td>4,600</td>
<td>5,700</td>
<td></td>
</tr>
<tr>
<td>5,900</td>
<td>11,800</td>
<td></td>
</tr>
<tr>
<td>4,300</td>
<td>3,700</td>
<td></td>
</tr>
<tr>
<td>15,600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4,400</td>
<td>3,700</td>
<td></td>
</tr>
<tr>
<td>2,700</td>
<td>15,600</td>
<td></td>
</tr>
<tr>
<td>3,200</td>
<td>8,500</td>
<td></td>
</tr>
<tr>
<td>3,200</td>
<td>20,200</td>
<td></td>
</tr>
<tr>
<td>3,400</td>
<td>3,600</td>
<td></td>
</tr>
<tr>
<td>4,200</td>
<td>5,300</td>
<td></td>
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<tr>
<td>3,900</td>
<td>11,800</td>
<td></td>
</tr>
<tr>
<td>2,700</td>
<td>4,500</td>
<td></td>
</tr>
<tr>
<td>2,700</td>
<td>3,500</td>
<td></td>
</tr>
<tr>
<td>3,500</td>
<td>2,900</td>
<td></td>
</tr>
</tbody>
</table>

Total amount of loss from subprime-related products

(Note 1) Total amount of loss is based on the disclosure report of each company.
(Note 2) The amount of loss is calculated mainly in relation to ABS-CDO, LBO finance, and subprime-related RMBS and loan backed. Foreign currency is calculated at rates of 1$=¥85, 1€=¥115, 1£=¥130, 1SF=¥85.
(Note 3) The values of core capital [Tier I] (net assets amount for investment banks) are those of the latest accounting terms. Accounting terms of Morgan Stanley, Goldman Sachs (excluding 2009), Lehman Brothers and Bear Stearns are shown in parentheses.
(Note 4) As for financial institutions which do not disclose amounts of losses, we do not update the data. In 2010, only 3 financial institutions disclose amounts of losses on their websites, and we exclude them in the “Total amount of loss” column. However, we do not include those values in the graph above as these are so small.

Reference: Major bankrupt or absorbed financial institutions
Limited Direct Impact on the Financial Sector

Japan implemented Basel II before the global financial crisis.

Basel II Implementation Date

- Japan: Implemented in end-March 2007
- Canada: Implemented in end-October 2007
- Europe: Implemented in end-December 2008 (in many member countries)
- US: Yet to be implemented

※ Under Basel II, unrated securitization exposures are deducted from capital in principle unless a bank can appropriately capture the risk profile of their underlying assets.
The small exposure to toxic assets limited the losses from these assets for Asian financial institutions in general.
Substantial Damage through the Real Economy

The global recession has led to a serious weakening of Japan’s real economy through the severe contraction of external demand.

Development of Real GDP (Quarterly), Seasonally Adjusted Series

Source: Bloomberg
Substantial Damage through the Real Economy

- Yen appreciated sharply vis-a-vis U.S. dollar.
- Stock prices dropped in a similar manner.

Nikkei Average and Exchange Rate (USD/JPY)

Source: Bloomberg
Valuation losses of equity holdings for Japanese financial institutions were about 10 times larger than those of sub-prime related products. 

Source: Financial Services Agency, Japan
Relatively large equity holdings by banks entailed significant risk.

Bank Equity Holdings and Bank Assets (All Banks in Japan)

<table>
<thead>
<tr>
<th>Year</th>
<th>Equity Holdings (market price)</th>
<th>Ratio of Bank Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>27,734</td>
<td>3%</td>
</tr>
<tr>
<td>2006</td>
<td>33,240</td>
<td>4%</td>
</tr>
<tr>
<td>2007</td>
<td>33,869</td>
<td>4%</td>
</tr>
<tr>
<td>2008</td>
<td>25,606</td>
<td>3%</td>
</tr>
<tr>
<td>2009</td>
<td>18,404</td>
<td>2%</td>
</tr>
</tbody>
</table>

Source: Bank of Japan
11 Major Banks: Profit and Loss

In FY 2008:
• Operating profits from core businesses covered losses from the disposal of NPLs.
• However, net income turned negative because of huge losses on equity securities.

<table>
<thead>
<tr>
<th></th>
<th>FY 2007</th>
<th>FY 2008</th>
<th>FY 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profits from core business</td>
<td>3,277</td>
<td>2,660</td>
<td>2,930</td>
</tr>
<tr>
<td>Loss from disposal of NPLs</td>
<td>-411</td>
<td>-1,911</td>
<td>-966</td>
</tr>
<tr>
<td>Net profits/losses on equity securities</td>
<td>-41</td>
<td>-1,561</td>
<td>62</td>
</tr>
<tr>
<td>Net income</td>
<td>1,453</td>
<td>-1,607</td>
<td>1,159</td>
</tr>
</tbody>
</table>

※ FY 2007 is the 12 month period ending in March 2008.  
Source: Financial Services Agency, Japan

The capital ratios of 11 major banks were not severely affected by the global financial crisis.

Transition of Capital Ratios

Source: Financial Services Agency, Japan

In U.S. and Europe, extraordinary actions with massive public support were taken such as:

- Large-scale Capital Injection
- Temporary Bank Nationalization
- Credit Guarantees by Governments

On the contrary, in Japan, policy measures taken against the global financial crisis focused on maintaining financial intermediary functions because of:

- Relative Soundness of Financial System
- Severe Weakening of Real Economy
Thus, **short-term policy measures taken in Japan** included:

- **Strengthening Financial Intermediary Functions**
  - The enforcement of the revised Act on Special Measures for Strengthening Financial Functions
  - ¥ 309 billion has been injected into 11 regional financial institutions

- **Helping Banks to Reduce Equity Holdings**
  - Resuming the operations by the Banks’ Shareholding Purchase Corporation to purchase stocks directly from banks (about ¥ 523 billion) at market price outside the market.
  - Similar action by BOJ (about ¥ 388 billion)

- **Facilitating Financing for SMEs**
  - To encourage financial institutions to accommodate requests from SMEs to ease credit terms on existing loans
Before the Global Financial Crisis...

- **Banks** had been under rigorous regulation and supervision to ensure their financial soundness to prevent systemic risk.

- **Securities firms** had been considered remote from systemic risk and hence had been under less stringent prudential regulation and supervision.
Impact of the Lehman Failure on Japanese markets

- Experienced certain fail or delay in securities and derivative transactions.

- Thanks to clearing system and DVP practice, there was limited market-wide effect for bonds and stocks. Markets normalized within a few weeks.

- For OTC derivative markets, which did not have central clearing system, market normalization was delayed and more painful.
Lessons Learned

- "Systemic risk" turned out to be no longer peculiar to banking sector.
- Central clearing is useful to contain risks.
Medium-Term Measures Taken in Japan

Enhanced prudential regulation of securities companies

>> Introducing early warning system (2008)

- In cases where a financial instruments business operator meets the prescribed criteria regarding:
  - Changes in the capital adequacy ratio
  - Changes in prices of securities
- Supervisors shall strive to quickly identify risks by holding a hearing and requiring the submission of a report.

>> Strengthening group-wide regulation and supervision of securities companies (Amendment of the FIEA, 2010)

- Large securities companies with total assets worth above a trillion yen
  a) Capital adequacy requirements on a consolidated basis
  b) Authority to order collection of reports from and inspection of parent, subsidiary, and sister companies of the securities companies
Medium-Term Measures Taken in Japan

**OTC Derivatives (Amendment of the FIEA, 2010)**

- OTC derivative transactions that **need to be cleared at CCPs** are determined no later than November 18th 2012.

  - Those OTC derivative transactions **need to be cleared by domestic CCPs**:
    - a) for which **clearing criteria relate closely to the bankruptcy procedures** under Japanese law.
    - b) of which **transaction volume** in Japan is **above a certain level**.

  - Others can be cleared by domestic CCP, foreign CCP or domestic CCP and foreign CCP under link arrangement.

**Reducing of settlement risk of JGB trading and stock lending**

- Introducing fail charge practice in November 2010.
- Shortening settlement Cycle from T+3 to T+2 by early part of 2012.
- Trust Banks to be covered by JGBCC by mid-year 2014.
  - ⇒most of JGB trading will be cleared at JGBCC.
- DVP settlements for securities lending will be in place in January 2014.
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II. Further Challenges for Economic Growth in Asian Countries
Japan's ODA, combined with trade and investment, has supported Asia’s economic growth.

✓ Poverty population (earning less than US$1 per day) in Asia has decreased by more than 700 million.

Characteristics

✓ Focus on economic/social infrastructure building and human resource development.
✓ Supported the development of the investment environment and the creation of the vibrant private sector.
✓ Timely assistance to areas suitable for the promotion of trade and direct investment.
✓ Contribution to productivity growth in Asia (together with trade and investment).

GDP per capita and poverty incidence in East Asia & Pacific and Sub-Saharan Africa

Poverty headcount ratio (%)

Source: World Development Indicators (World Bank, 2008)

Poverty headcount ratio: proportion of the national population whose incomes are below US$1 per day
## Japan’s contribution

*(USD 100 million)*

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Account</strong></td>
<td>1,657</td>
<td>1,705</td>
<td>2,104</td>
<td>1,566</td>
<td>1,421</td>
</tr>
<tr>
<td><strong>Foreign Direct Investment</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outward Investment (Net)</td>
<td>▲ 454</td>
<td>▲ 501</td>
<td>▲ 735</td>
<td>▲ 1,308</td>
<td>▲ 746</td>
</tr>
<tr>
<td>Inward Investment (Net)</td>
<td>32</td>
<td>▲ 67</td>
<td>221</td>
<td>245</td>
<td>118</td>
</tr>
<tr>
<td><strong>Foreign Portfolio Investment</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outward Investment (Net)</td>
<td>▲ 1,964</td>
<td>▲ 710</td>
<td>▲ 1,234</td>
<td>▲ 1,896</td>
<td>▲ 1,602</td>
</tr>
<tr>
<td>Inward Investment (Net)</td>
<td>1,831</td>
<td>1,985</td>
<td>1,965</td>
<td>▲ 1,029</td>
<td>▲ 562</td>
</tr>
<tr>
<td><strong>Foreign Reserve (Excluding gold)</strong></td>
<td>8,342</td>
<td>8,796</td>
<td>9,527</td>
<td>10,093</td>
<td>10,222</td>
</tr>
</tbody>
</table>

Source: IMF, Datastream  
(note) ▲ refers to outflow
China’s welcome new addition

(USD 100 million)

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Account</strong></td>
<td>161</td>
<td>253</td>
<td>372</td>
<td>436</td>
<td>297</td>
</tr>
<tr>
<td><strong>Foreign Direct Investment</strong></td>
<td>678</td>
<td>603</td>
<td>1,214</td>
<td>943</td>
<td>343</td>
</tr>
<tr>
<td>Outward Investment (Net)</td>
<td>▲113</td>
<td>▲178</td>
<td>▲170</td>
<td>▲535</td>
<td>▲439</td>
</tr>
<tr>
<td>Inward Investment (Net)</td>
<td>791</td>
<td>781</td>
<td>1,384</td>
<td>1,478</td>
<td>782</td>
</tr>
<tr>
<td><strong>Foreign Portfolio Investment</strong></td>
<td>▲50</td>
<td>▲675</td>
<td>187</td>
<td>427</td>
<td>387</td>
</tr>
<tr>
<td>Outward Investment (Net)</td>
<td>▲262</td>
<td>▲1,104</td>
<td>▲23</td>
<td>328</td>
<td>99</td>
</tr>
<tr>
<td>Inward Investment (Net)</td>
<td>212</td>
<td>429</td>
<td>210</td>
<td>99</td>
<td>288</td>
</tr>
<tr>
<td><strong>Foreign Reserve (Excluding gold)</strong></td>
<td>8,215</td>
<td>10,694</td>
<td>15,302</td>
<td>19,492</td>
<td>23,888</td>
</tr>
</tbody>
</table>

Source: IMF, Datastream
(Note) ▲ refers to outflow
Preparations on the Receiving Side

- IMF WEO update (July 2010)

  “Lower risk appetite could initially reduce capital flows to emerging and developing economies”

- IMF GFSR (Oct 2010)

  “...some countries in Asia and Latin America continue to experience a potential buildup of risks stemming from strong capital inflows”

<table>
<thead>
<tr>
<th></th>
<th>(Projections)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008</td>
</tr>
<tr>
<td>World Output</td>
<td>3.0</td>
</tr>
<tr>
<td>Developing Asia</td>
<td>7.7</td>
</tr>
<tr>
<td>China</td>
<td>9.6</td>
</tr>
<tr>
<td>India</td>
<td>6.4</td>
</tr>
<tr>
<td>ASEAN-5</td>
<td>4.7</td>
</tr>
</tbody>
</table>
Preparation on the Receiving Side

- Lessons from the Asian Financial Crisis
  - Excessive dependence on foreign short-term borrowings can make the financial sector vulnerable and can cause economic instability.
  - Asia must be prepared to use financing productively

- Items Necessary
  - Regional arrangements as financial safety nets
    → Chiang Mai Initiative (CMI)
  - Mobilizing domestic savings and receiving finance from secure fund sources
    → Asian Bond Market Initiative (ABMI)
Developing bond markets in Asia through ABMI and ABMF

<table>
<thead>
<tr>
<th>Asian Bond Markets Initiative (ABMI)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Aims to:</strong></td>
</tr>
<tr>
<td>- Develop robust bond markets;</td>
</tr>
<tr>
<td>- Avoid the double mismatch of maturity and currency; and</td>
</tr>
<tr>
<td>- Re-channel more Asian savings into the Asian economies.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASEAN+3 Bond Market Forum (ABMF) (launched in 2010)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Aims to:</strong></td>
</tr>
<tr>
<td>- Assess the existing regulatory frameworks, as identified by the participants, and their recommendations on how to foster harmonization of regulations and market practices that facilitate cross-border bond transactions in the region;</td>
</tr>
<tr>
<td>- Enhance dialogue between the private sector and ASEAN+3 officials to develop bond markets in the region and improve harmonization, standardization, and integration; and</td>
</tr>
<tr>
<td>- Provide opportunities to exchange knowledge, expertise, and experience among the private and public sector in the region.</td>
</tr>
</tbody>
</table>