This chapter is reproduced from *Capital Markets in Asia: Changing Roles for Economic Development* edited by Donna Vandenbrink and Denis Hew, with the kind permission of the copyright-holder, Tokyo Club Foundation For Global Studies.

CHAPTER 11

THE FUTURE ROLE OF JAPANESE EQUITY INVESTMENTS IN THE INDUSTRIAL DEVELOPMENT OF EAST ASIA

Seiichi Masuyama and Donna Vandenbrink

INTRODUCTION

East Asian economies have achieved a remarkable catch-up industrialization by effectively using foreign direct investment centred on the key export sector. Many of these economies now seem to be at a critical stage in which domestic corporations need to play a larger role in order to drive economic development more endogenously. To support the development of domestic corporations, the East Asian financial system, which has been heavily bank-oriented, needs to diversify to accommodate capital markets more. Foreign portfolio investment should contribute to developing domestic capital markets. Japan, the regional economic giant, which has been a major provider of foreign direct investment to Asia, has been a marginal provider of foreign portfolio investment in the region. At the end of 2002, Japan's outstanding portfolio investment in Asia was ¥5,565 billion. This represented only 5% of Japan's total foreign portfolio investment outstanding and it was only 41% as large as Japan's direct investment outstanding in Asia.

This chapter looks at the scope for increasing the flow of portfolio capital, in particular stock investment, from Japan to East Asia to facilitate the industrialization of those economies. The focus is on stock investment because it is mainly through stock markets that economies develop the requisite infrastructure for robust capital markets, such as corporate disclosure and governance practices. The main question this paper asks is whether there is a role for Japanese investment in East Asian stocks to support the endogenous development of East Asian economies.

To answer this question we consider factors both on the receiving end and on the investing end of equity investment from Japan to East Asia. The first section discusses how foreign investment from Japan, which centred on FDI, benefited the East Asian economies and how the pattern of investment

© 2005 Tokyo Club Foundation for Global Studies

now needs to include more portfolio investment in order to generate development endogenously. The second section describes the framework of Japanese stock investment in East Asian economies, focusing on the channels for investment flows of distinct groups of investors. The third section discusses the conditions on both the Japanese and the East Asian sides that constrained past purchases of East Asian stocks by Japanese investors and considers some recent trends and developments. The final section proposes a path for East Asia's future development supported by investors in Japan purchasing the stocks of local companies.

JAPANESE INVESTMENT AND EAST ASIAN ECONOMIC DEVELOPMENT

FDI-Centred Japanese Investment in East Asia

In the past, private capital flowed from Japan to East Asian economies primarily as foreign direct investment (FDI) and as bank loans, and not as portfolio investment (FPI). At the end of 2002, outstanding Japanese FDI in Asia amounted to ¥7.0 trillion, which was 19.1% of Japan's total outward direct investment (Table 11.1)[1]. In contrast, only 1.5% of total Japanese FPI outstanding, or ¥2.4 trillion, was in Asia. Japanese foreign investment in advanced economies is more balanced between FDI and FPI. For example, at the end of 2002 North America accounted for 46.1% of Japan's outstanding FDI and 39.3% of outstanding FPI, and Western Europe accounted for 23.7% of FDI and 39.1% of FPI outstanding.

[1] Although the investment figures for Asia include India, they mostly represent investment in East Asia because India's share is very small. Japan's outstanding investment in Asia fell from ¥9.2 trillion at the end of 1996 because of write-downs connected with the 1997-98 Asia financial crisis.

© 2005 Tokyo Club Foundation for Global Studies

TABLE 11.1
Japanese FDI and FPI Outstanding, End of 1996 and 2002

	Direct Investment		Portfolio Investment: Total FPI		Stocks		Bonds	
	1996	2002	1996	2002	1996	2002	1996	2002
	Amount (billion yen)							
Asia	9,180.0	6,973.7	5,565.3	2,428.4	2,564.2	815.9	3,031.1	1,612.5
North America	11,352.2	16,829.0	40,633.6	62,572.8	7,026.6	13,361.4	3,3607.0	49,211.4
Cent. & South America	1,389.3	2,168.6	9,433.6	24,463.4	933.7	2,290.1	8,499.9	22,173.3
Oceania	1,217.9	1,414.7	6,239.6	2,870.4	1,623.4	451.0	4,616.1	2,419.4
Western Europe	5,511.7	8,642.8	41,401.1	65,349.6	5,586.0	8,267.6	3,5815.1	57,081.9
E. Europe & Russia	22.8	87.4	1,128.9	150.4	210.3	6.7	918.6	143.7
Middle East	112.1	106.6	1.2	117.6	0.9	2.5	0.3	115.1
Africa	51.1	147.1	23.4	267.5	32.9	15.6	200.7	251.9
International organizations	-	-	4,053.4	7,438.7	2.1	-	4,051.4	7,438.7
Total	29,998.6	36,477.6	108,710.8	167,203.1	17,967.5	25,277.1	90,743.3	147,926.0
	Composition (%)							
Asia	30.6	19.1	5.1	1.5	14.1	3.2	3.3	1.1
North America	37.8	46.1	37.4	39.3	39.1	52.9	37.0	34.7
Cent. & South America	4.6	5.9	8.7	14.6	5.2	9.1	9.4	15.6
Oceania	4.1	3.9	5.7	1.7	9.0	1.8	5.1	1.7
Western Europe	18.4	23.7	38.1	39.1	31.1	32.7	39.5	40.2
E. Europe & Russia	0.1	0.2	1.0	0.1	1.2	0.0	1.0	0.1
Middle East	0.4	0.3	0.0	0.1	0.0	0.0	0.0	0.1
Africa	0.2	0.4	0.0	0.2	0.2	0.1	0.2	0.2
International organizations	-	-	3.7	4.4	0.0	-	4.5	5.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: Investment in Central and South American is mostly investment in the Cayman Islands.
Source: Bank of Japan.

In East Asia, corporate stocks make up a larger portion of Japanese FPI than they do in other regions. In 1996 stocks comprised almost half of Japanese FPI in Asia (46%) but only 17% of Japan's FPI in North America and 13 % in Western Europe. Stocks' share of FPI in Asia decreased after 1996, because bond investment did not decline as severely in the Asian Crisis. Japan's outstanding investment in Asian stocks declined from ¥2.5 trillion at the end of 1996 to ¥0.8 trillion at the end of 2002, while the outstanding Japanese investment in Asian bonds declined from ¥3.0 trillion to ¥1.6 trillion during the same period (Table 11.1).

Other data also reveal Japan's limited presence in East Asian capital markets compared to the presence of other advanced economies. For example, Japan accounted for only 4% of overseas investor cash trading on the Hong Kong Exchange from October 2002 to September 2003, trailing far behind the UK (25%), the rest of Europe (24%), the U.S. (22%), Singapore (9%), and Mainland China (8%)[2]. Japan accounted for only 3% of total funds under management in Singapore at the end of 1998,

[2] Hong Kong Exchange Cash Market Transaction Survey 2002/2003.

© 2005 Tokyo Club Foundation for Global Studies

compared to Singapore's 21%, Europe's 20%, America's 14%, Hong Kong's 9%, and other ASEAN's 8%.[3] Japan's 1% share of foreign investment in Korean stocks in 2001 was insignificant compared to the U.S. share of 37% and the U.K. share of 18%.[4]

Direct investment from Japan is believed to have served the industrialisation of Asian economies well during the 1980s and 1990s for a number of reasons. First, along with FDI comes technological and managerial expertise that developing economies generally lack and that neither FPI nor bank loans can provide. Second, FDI is a stable source of capital inflow because it consists primarily of equity capital, takes longer to invest and divest than FPI, and is not subject to the market volatility of FPI. And third, FDI circumvents developing economies' usual lack of capacity to absorb FPI since multinational corporations can finance their investments in the capital markets of their home countries. Indeed, because of such advantages of FDI and disadvantages of other forms of investment for developing economies, FDI is the one form of capital flow consistently found by several empirical studies to be associated positively with domestic investment and growth (Prasad et al.). Arguably, the capacity-building aspect of FDI was as beneficial to the development of the East Asian economies as the financing itself, given their generally high savings rates and high levels of foreign reserves.

Foreign Investment and Endogenous Industrial Development in Asia

FDI will continue to be important for all the East Asian economies, but many economies in the region need to refocus their development strategy toward endogenously driven development led by a broad base of domestic corporations. For example, the newly industrialized economies (NIEs) have reached a stage in which they need to reduce their dependence on FDI and to increase their capacity to stimulate industrial development from within through robust industrial clusters where domestic corporations participate in synergy with foreign-owned corporations (Masuyama and Vandenbrink 2001). Indeed, most economies in the region need to create more knowledge-based and service-oriented firms and to enhance industrial clusters with greater participation of domestic firms in order to sustain their future economic growth under the continuing press of globalization and technological

[3] The Monetary Authority of Singapore (MAS) has not published Japan's proportion since 1999. The composition of sources of discretionary funds managed in Singapore is 30% from domestic sources, 25% from Europe, 14% from North America and 13% from the rest of Asia Pacific, of which Japan must be a very small percentage.

© 2005 Tokyo Club Foundation for Global Studies

development.

To support such domestic corporations, East Asian economies need to provide not only debt financing, which is readily available under their bank-centered financial systems, but also equity financing in the capital market. Capital markets—equity markets, in particular—are important to the development of dynamic, efficient domestic corporations not only as a source of financing but also as a platform for corporate governance.

The Role of Foreign Portfolio Equity Investment

Foreign investment through a country's domestic stock market can contribute to establishing the conditions for long-run, endogenously generated growth. Foreigners' stock purchases on the primary market inject funds to domestic corporations and their purchases on the secondary market increase the market's liquidity, which in turn makes it easier for domestic corporations to issue new equity. Active participation by foreign investors from economies with advanced capital markets also stimulates the modernisation of local stock markets and encourages better corporate governance in local firms. Moreover, in transition economies such as China, where state-owned enterprises are being privatised or corporatised on a massive scale, participation by foreigners complements purchases by domestic investors to help absorb the increasing supply of stocks.

The greatest downside of FPI for developing economies is its volatility. Massive inflows of FPI may overheat the economy; sudden withdrawals can affect the availability and cost of financing for domestic firms, with concomitant effects on corporate profits and liquidity, and also adversely affect financial and currency markets as well as the real economy. The negative impact of FPI was witnessed clearly with the Asian financial crisis of 1997-98.

Diversifying foreign capital inflows to include more foreign portfolio equity investment (FPEI) adds a measure of financial stability to developing economies. While FPEI may be more volatile than FDI, as a source of equity capital it enhances the financial stability of domestic corporations by reducing debt-equity ratios. Moreover, by building up the capital market as an alternative to bank-based financing, FPEI can increase the overall stability of domestic financial systems in an

[4] Nihon Keizai Shimbun, 26 August 2002.

© 2005 Tokyo Club Foundation for Global Studies

environment of globalizing capital markets. Sudden changes in risk and return in global markets can throw a narrowly bank-based system into crisis because banks tend to carry systemic risks within themselves for a long time. Capital markets, on the other hand, distribute risk rapidly and widely among many investors (T5 Policy Statement 2003). In order to limit the risks of FPEI and capture its benefits, Asian economies should encourage domestic investors to participate more actively in local stock markets, because local investors are likely to be better informed about local conditions and less likely to flee from the domestic market.

ROLE OF JAPANESE PORTFOLIO EQUITY INVESTMENT IN EAST ASIA

Benefits to East Asian Economies

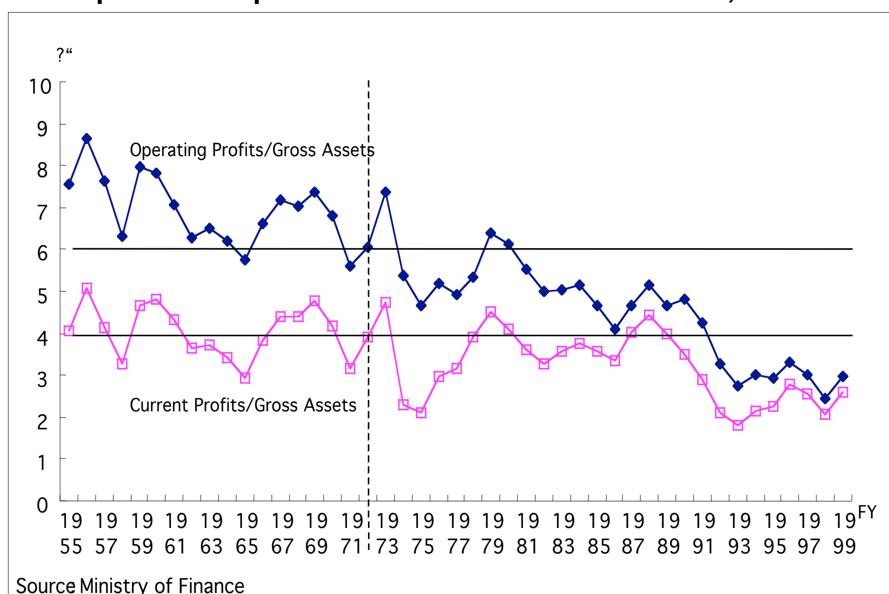
In a number of ways, increasing portfolio equity, or stock, investment from Japan specifically should contribute to the industrial development of East Asian economies. First, it should diversify the overall risk to East Asian economies from foreign portfolio investment, because Japanese investors in corporate stocks have different characteristics and motivations from their North American and European counterparts, who are currently the main sources of FPEI to East Asia. Second, participation of Japanese investors will broaden the knowledge base of equity investment in East Asian markets. Since East Asia has become the global manufacturing base—with extensive linkages with Japan—and since East Asian stock markets list an increasing number of manufacturing companies, the analysis of manufacturing firms is crucial. Japanese investors' knowledge of the manufacturing industry developed at home will augment the store of knowledge about East Asian manufacturing stocks.

Third, more participation by Japanese investors can be expected to deepen the corporate governance structure in recipient countries. Americans and Europeans underestimate Japanese corporate governance in part because its structure is different. The weakness of corporate governance in Japan as a result of the weakened main bank system in the face of increasingly abundant money caused over-investment during the 1980s, which resulted in secular declines in the profitability of Japanese corporations and a bubble economy (Figure 11.1). Japanese investors are becoming aware that in order to generate higher returns from Japanese stocks they need to exercise better governance to

© 2005 Tokyo Club Foundation for Global Studies

force Japanese corporations to become more profitable. Recent improvements in corporate governance put Japanese portfolio investment in East Asia in a better position to influence governance in the region. While Japan's corporate governance structure is becoming more Americanized in the process of reform, it will retain its unique characteristics. As the Enron scandal and other incidents have revealed, the American system is not a panacea. The unique aspects of Japan's system should contribute to the governance of East Asian corporations by enhancing necessary diversity.

FIGURE 11.1
Japanese Corporations' Return on Gross Assets, 1955-99



Finally, increased portfolio investment from Japan will benefit East Asian economies by building up a platform of expertise to support all foreign portfolio investment in the region. At present, since Japan's stock market dominates the market capitalization of East Asian stock markets as a whole, the managers of East Asian portfolios in American and European investment firms tend to manage the regional portfolios by focusing on the Japanese stock market with subsidiary responsibility for managing other markets in the region. The expertise that Japanese fund managers develop by more active participation in East Asian capital markets will strengthen the platform for other foreigners purchasing shares in East Asian companies.

Benefits to Japanese Investors

On the other side of the ledger, Japan stands to benefit significantly from directing greater flows of

© 2005 Tokyo Club Foundation for Global Studies

portfolio equity investment to the rest of East Asia. Stocks of East Asian companies offer Japanese the opportunity to diversify risk and generate higher returns. With the rate of return on investment in domestic stocks declining for decades, despite recent signs of recovery, Japanese investors need to find ways to earn higher returns (Table 11.2). This need promises to build as Japan's population continues to age rapidly, expanding the assets of pension funds and limiting investing opportunities in domestic markets. Investment in foreign stocks in general should provide an opportunity to improve the risk-return trade-off of investment portfolios; in particular, it is generally believed that pension portfolios should be diversified internationally.

TABLE 11.2
Long Term Return on Investment in Japanese Stocks and Bonds
Percent

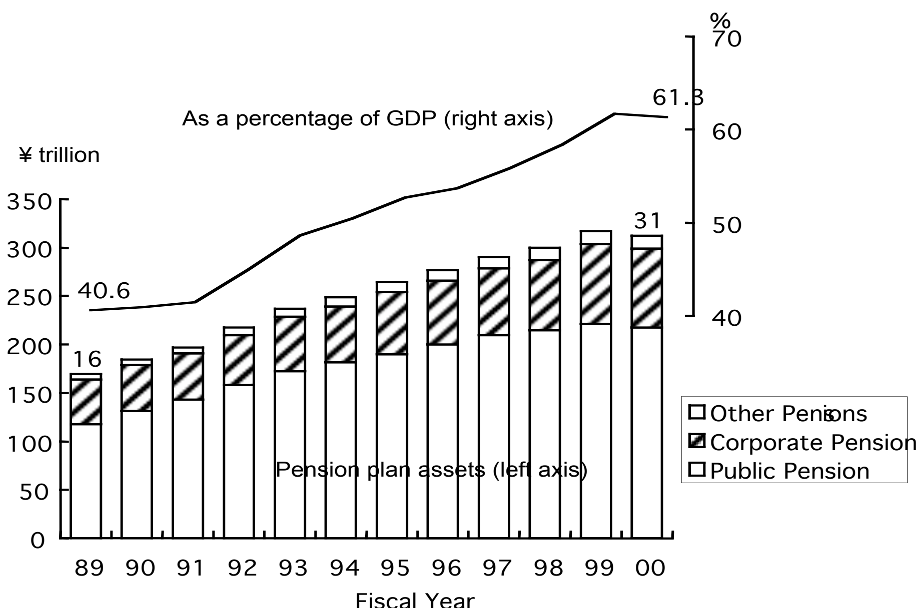
	Nominal Return			Real Return		
	Stocks	Bonds	CPI	Stocks	Bonds	GDP Growth
End 1960 to end 1970	8.21	8.79	5.92	2.16	2.71	10.2
End 1970 to end 1980	15.87	8.24	8.91	6.39	-0.62	4.5
End 1980 to end 1990	13.86	7.43	1.92	11.72	0.54	4.1
End 1990 to end 2000	-6.08	6.28	0.57	-6.12	5.68	1.3

Note: The return on stock investment is the annual compound rate based on the Nikkei225 including dividends. The return on bond investment is the annual compound rate based on the Nomura BPI.
Source: Junichi Ujiie ed. *Japanese Financial Markets*. Tokyo Keizai Shimposha. Calculated by Financial Research Centre, Nomura Securities.

After 2010, Japan will have the highest share of elderly in the world, with 22% of its population over age 65. With a smaller proportion of the population working, Japanese will need to depend more on the income generated from accumulated financial assets and to increase the return on those assets in order to sustain their standard of living. So far, the aging of Japan's population during the 1990s has translated into rapid growth of pension fund assets and this trend should continue for the foreseeable future (**Figure 11.2**). In general, stocks are a suitable place to invest pension assets since their long-run returns tend to be higher than for bonds. While the prolonged phase of deflation in Japan has reversed this relationship since the 1990s (Table 11.2), the normalization of this situation would generate a need for Japanese to diversify out of deposits at banks and postal savings and bonds, where they now keep most of their assets, into higher risk investments such as stocks.

© 2005 Tokyo Club Foundation for Global Studies

FIGURE 11.2
Public and Private Pension Assets in Japan



Source: Bank of Japan

East Asian stocks can be expected to offer returns that are attractive to Japanese investors, and particularly to the growing pool of pension funds. The developing economies in the region should post high growth rates as they recover fully from the Asian Financial Crisis and as emergence of the Chinese economy has its impact. If such economic growth—albeit not as high as in the late 1980s and early 1990s—translates into higher performance of stock investment with necessary development of stock market infrastructure, investments in East Asian stocks should earn quite reasonable returns.

Finally, expanded Japanese investment in East Asian stocks should also benefit Japanese investors and businesses by facilitating the internationalisation of Japan's financial centres. Financial centres in Japan should be advantageous places for trading and managing the stocks of East Asian firms not only because of their size, bur also because of the economic interdependencies and the resulting dense information flows between Japan and the other parts of the region. As trading in East Asian stocks increases, the number of Japanese financial analysts covering East Asian corporations and economies will increase and a network of related services will develop. This would serve as an information infrastructure for business activities in East Asia.

© 2005 Tokyo Club Foundation for Global Studies

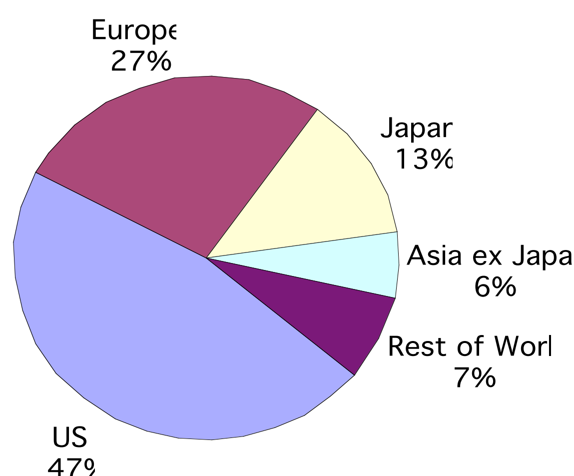
CONSTRAINTS ON JAPANESE INVESTMENT IN EAST ASIAN STOCKS

Despite these substantial benefits to both Japan and other Asian economies, actual Japanese investment in East Asian stocks so far has been extremely limited, as we have seen. In addition to the seemingly inherent disadvantages of FPI vis á vis FDI, other factors on both the recipient and the investment sides constrain Japan's portfolio investment in East Asia.

The Recipient Side

Deficiencies in pull factors—such as the availability of investible large firms, the efficiency of local stock markets, and the functioning of corporate governance[5]—constrain the flow of portfolio equity investment to East Asia by all international investors, not just Japanese investors. At the end of 1999 non-Japan Asia accounted for only about 6.0% of the world's total stock market capitalization compared with the U.S. market's 46.6% share, Europe's 27.3%, and Japan's 12.7% (**Figure 11.3**). In essence, the major constraint on Japanese and other foreign investment in East Asian shares is the incapacity of East Asian stock markets to absorb substantial quantities of investment funds.

FIGURE 11.3
World Stock Market Capitalization by Region



Weak corporate governance in East Asian economies is a serious obstacle to developing dynamic

[5] There is some empirical evidence that portfolio investment from international mutual funds is more likely to go to countries with a higher level of transparency (Prasad et al.).

© 2005 Tokyo Club Foundation for Global Studies

local stock markets. Tight control by family owner-managers creates governance problems in firms throughout the region. In China, the structure of governance inherent in state-owned enterprises even presents a challenge to the concept of a stock market. With a majority of listed firms owned by the state or its agencies, it is extremely difficult to define and protect the ownership rights of minority shareholders from insider dealing among related state enterprises.

Some recent developments in the Asian economies point to improvements in the capacity of local stock markets and local companies. One is the emergence of indigenous firms, particularly IT firms in newly industrialising economies, that are seriously challenging firms in advanced economies such as Japan. Unconstrained by sunk investment in old technologies and organisational structure, these East Asian firms are able to readily adopt the new technological and organisational paradigm of the IT Revolution and "leapfrog" ahead of larger and more established firms in advanced economies. These firms are becoming accustomed to the norms of international capital markets as they rely heavily on venture capital and emerging company stock markets for financing.

A second positive change is the extensive reforms pursued throughout the region after the Asian Crisis in 1997-98 painfully revealed the weakness in corporate governance. The conditionality imposed by the IMF/World Bank for the crisis-hit countries included corporate governance reform, and other non-affected countries also strengthened their reform efforts. In essence, the reform in the region was to Americanize their corporate governance rules and practices. This has resulted in a considerable improvement in corporate governance in many regional economies. However, there is still has a long way to go until such a borrowed framework adapts to local conditions sufficiently to function effectively. An improvement in this area will weaken one of the most serious constraints to developing stock markets in East Asia and also to attracting FPEI to the region.

Another development is the rapid growth of corporations in China. Within the brief period of transition from a planned to a market economy, China has made remarkable progress in corporate development. Already, some Chinese corporations are more competitive than foreign corporations in certain domestic Chinese product market segments of consumer electronics, home appliances, and PCs. Given the size of its domestic market China has the potential to create large, world-class firms suitable to solicit international investment on domestic or foreign stock markets. Certainly, to realise

© 2005 Tokyo Club Foundation for Global Studies

the potential of its stock markets, China needs to address the fundamental problem caused by the listing of state-owned enterprises. The governance reform process, probably by privatization and rapid listing of privately owned companies, will be extensive and take some time to accomplish.

The Japanese Side

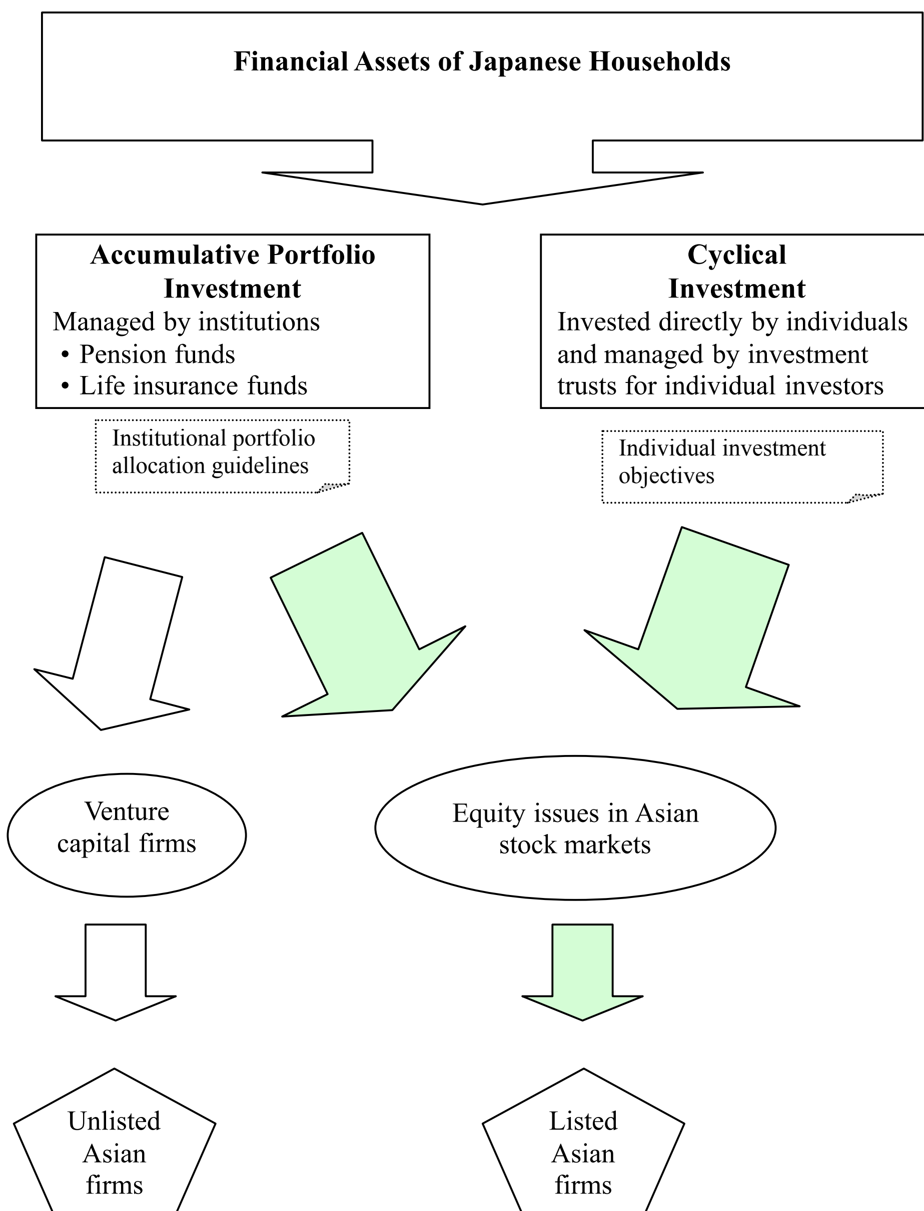
Of course, the total accumulation of household financial assets in Japan is the ultimate source of investment in securities. In order to understand the constraints on Japanese investment in Asian stocks, we start by depicting the various channels for investing Japan's household assets and identifying the key decision-makers, or keepers of the flow, and their motivations (Figure 11.4).

Channels of Japanese Investment in Asian Stocks

First, the mechanisms for Japanese to invest in Asian stocks differ for firms that are listed on exchanges and those that are not. Investment in listed stocks occurs through stock exchanges, while investing in unlisted firms must be done through specialized financial institutions outside of stock exchanges, such as venture capital firms (Figure 11.4). Although investment in unlisted stocks is particularly important in East Asia, we focus on the flow of investment to listed stocks because, so far, the flow through venture capital has been small.

© 2005 Tokyo Club Foundation for Global Studies

FIGURE 11.4
Channels of Japanese Investment in Asian Stocks



Source: Authors.

© 2005 Tokyo Club Foundation for Global Studies

Japanese household assets flow to firms listed on East Asian stock markets primarily in two channels in terms of investment patterns, as indicated by the shaded arrows in Figure 11.4. One channel is through portfolio investments made by institutions such as insurance companies, trust banks, and other large financial institutions, and the other is through stock purchases by individuals and by retail investment trusts owned by individuals. Investments through the second channel are largely determined by the preferences of individual investors since they trade among investment trusts such as country funds based on each one's specific investment objectives. In general, investments through the second channel tend to be short-term and cyclical. The flow of Japanese household assets into East Asian stocks through this channel, then, depends on how individuals allocate their non-institutionalized assets to equity and on the portion of this equity investment they allocate to East Asia in particular, either by purchasing stocks directly or by choosing investment trusts that specialize in East Asian stocks.

The flow of Japanese household assets into East Asian stocks through the first channel, on the other hand, tends to be less cyclical and much more stable. In contrast to individuals and investment trusts, institutional investors managing pension funds and other large portfolios tend to focus on the longer term and the diversification of risk. Usually, those investors manage funds by targeting market indices, which means that the asset allocation of their portfolios cannot deviate too much from market portfolios. Furthermore, investments of institutional investors reflect the asset allocation guidelines mandated by the fund sponsor. Since pension funds comprise the largest part of funds managed by institutional investors in Japan, investment flows through this channel depend significantly on the investment guidelines of pension funds, which often specify the share of foreign stocks in the portfolio.

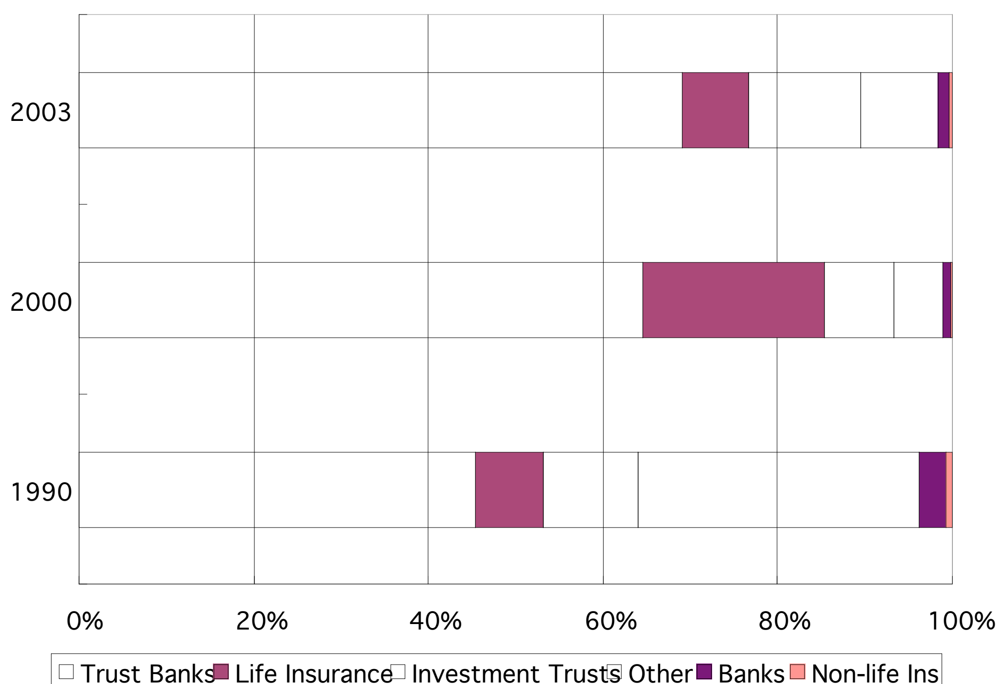
Figure 11.5 gives an idea of which decision-makers control the overall flow of outward equity investment from Japan. Over the 1990s, institutional investors, specifically fund management firms other than investment trusts, became much more prominent in Japan's outward flow of stock investment. In 2003 they accounted for over 75% of total outward investment in stocks (**Figure 11.5**). Trust banks and life insurance firms both manage pension funds, and life insurance firms also manage funds for life insurance policies. Trust banks' share of outward stock investment increased from 45%

© 2005 Tokyo Club Foundation for Global Studies

in 1990 to 65% in 2000 and to 69% in 2003. While the share of life insurance companies more than doubled from 8% in 1990 to 21% in 2000, it fell back to 8% in 2003.

The increasing share of these institutional investors in Japan's outward stock investment came largely at the expense of the share of individuals. The share of outward stock investment by the "other" category, which is primarily individual investors, shrank from 32% at the beginning of the decade to only 6% in 2000. The share of investment trusts also fell from 11% to 8% between 1990 and 2000. Both investment trusts and the Other category increased their shares slightly from 2000 to 2003, with investment trusts surpassing their 1990 share by two percentage points.

FIGURE 11.5
Composition of Japan's Outward Stock Investment by Investor, 1990-2003



Source: Ministry of Finance. http://www.mof.go.jp/english/shoutou/monthstw.htm

Looking at Japanese investment in terms of this framework, we identify four characteristics that have limited the flows to East Asian economies: 1) individuals' bias against risky investments; 2) under-development of the fund management industry, 3) domestic orientation, and 4) non-Asian orientation.

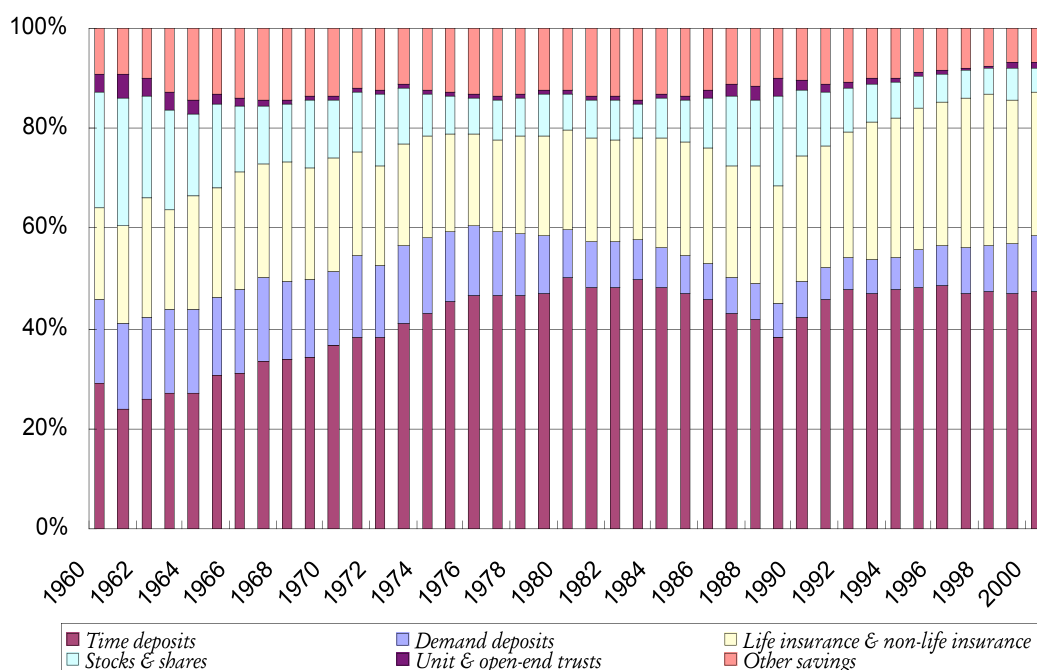
Risk Averseness of Japanese Individuals

First, individual Japanese investors are extremely risk-averse in the allocation of their financial assets,

© 2005 Tokyo Club Foundation for Global Studies

with very limited exposure to equity investment. Japanese households have about ¥1,400 trillion in financial assets, but these are mainly deposited in banks and postal savings accounts rather than invested in stocks or equity-oriented investment trusts. Demand and time deposits reached 58% of household savings in 2000 and their share has been above 50% since 1991, after dipping to 45% during the bubble years of the late 1980s (**Figure 11.6**). Conversely, while the proportion of savings invested in shares and investment trusts increased during the 1980s, it declined sharply during the 1990s; in 2000, stocks and shares comprised a mere 5% of household savings and investment trusts, just 1.1%. (The ratio of life and non-life insurance, which includes pension funds, has steadily increased to over one-quarter of household financial assets, reflecting the aging of Japanese population.)

FIGURE 11.6
Composition of Household Savings, 1960-2000



Source: *Family Savings Survey.* Statistics Bureau, Ministry of Public Management, Home Affairs, Posts and Telecommunications.

This preference for deposits over shares and investment trusts distinguishes Japanese households from their American and European counterparts. Only 11% of financial assets in the United States and 27% in Europe are held as deposits compared to over 50% in Japan. On the other hand, 46_ of American and 31% of European financial assets are held in shares and mutual funds, while less than

© 2005 Tokyo Club Foundation for Global Studies

11% of Japanese are held this way (**Table 11.3**).

TABLE 11.3
Composition of Household Financial Wealth in Japan, Europe, and the United States, end 2000
Percent

	Japan	Europe (6)	United States
Currency and deposits	11.4	10.1	1.1
Time, savings, and other deposits	41.4	17.3	9.9
Money market funds	0.2	0.8	3.1
Securities other than shares	4.5	6.8	6.4
Shares and other equity	8.3	21.3	33.1
Mutual funds	2.4	9.5	12.9
Life insurance	17.7	17.2	7.1
Pension funds	9.7	10.7	23.8
Other	4.4	6.2	2.5
Total	100.0	100.0	100.0

Source: OECD, 2002, *Household Wealth in the National Accounts of Europe, the United States, and Japan*.

The propensity of Japanese individuals to hold the bulk of their assets as deposits is often attributed to risk-averseness. Survey data indicate that security and liquidity of savings are the top priority for 70 to 80% of Japanese households, while only 20% attach great importance to profitability (Nakagawa and Shimizu 2000). Nakamura and Shimizu calculate that Japanese households are several times as risk averse as those in the United States (p 9).

The dominant position of banks and the postal saving system in Japan's financial system probably contributed to this situation. During the 1990s, as private banks weakened due to the collapse of the stock market and bad loan problems, government-run financial institutions, especially the postal savings system continued to attract savers (Hayakawa 1996, p. 142). At the end of fiscal 1999, assets in the postal saving system amounted to ¥260 trillion, or 19% of Japan's total private financial assets. Government backing and tax advantages make the postal saving system attractive compared to private deposit-taking institutions and this attraction, in combination with the dominance of banks, leaves little money to flow to capital markets. In addition, Japan’s tax system favours investment in debt instruments over stock investments.

Underdevelopment of the investment trust industry is yet another factor in the bias against equity investments. Investment trusts offer professional management and an opportunity to diversify risk to individual investors, who usually lack expertise and time to manage their own portfolios. But in Japan, unlike in the United States and some European countries, the industry is not a significant

© 2005 Tokyo Club Foundation for Global Studies

alternative to individuals' managing their own stock investments. The Japanese investment trust industry still has a bad image based on past questionable sales and management practices and unattractive products. Japanese mutual funds captured only 2.4% of household financial wealth in 2000 compared to 9.5% in Europe and 12.9% in the United States (Table 11.3). In 1999, total assets of the entire Japanese investment trust industry stood at roughly US$400 billion, while the assets of U.S. equity-related mutual funds alone stood at US$4 trillion (Brown et al.10 2002, p. 4). Generally speaking, Japanese households regard the quantity and quality of investment information provided by financial institutions as insufficient. This environment naturally favours deposits over stock investment because of the lower information requirements (Nakagawa and Shimizu, p. 11).

Lastly, the sustained deflationary pressure since the beginning of the 1990s, which lowered returns on investment in Japanese stocks and raised returns on investment in fixed-income instruments, reinforced any inherent bias of Japanese against investing in stocks. In the environment of sharply decelerating inflation and stagnant economic growth during the 1990s, bonds yielded historically high real returns while Japanese stocks yielded poor returns (**Table 11.2**). To a large extent, the poor investment return on stocks reflects the long-term decline in the profitability of Japanese corporations (**Figure 11.1**). The most outstanding reasons for the declining profitability are the loss of economic dynamism due to population ageing, the mismanagement of the macro-economy that created the deflationary environment, and the malfunctioning of corporate governance due to inadequate development of capital markets. The persistent bear market in Japan since 1989 discouraged individual Japanese from investing in all stocks, domestic as well as foreign. Analysing portfolio selection by Japanese households, Nakagawa and Shimizu found that "deteriorating return on risky assets and the increase in precautionary demand for safe assets due to uncertainties about income have been the main factors that make households more reluctant to invest in risky assets . . . than they were before the 1990s" (p.ii.).

Underdevelopment of the Fund Management Industry

The underdevelopment of the fund management industry in Japan may have been an obstacle for Japanese institutional investors. The fund management industry in Japan lags behind that in other

© 2005 Tokyo Club Foundation for Global Studies

advanced economies, particularly the U.S. and U.K, in both size and expertise. Inexpert fund management kept institutional investors from accumulating a substantial pool of long-term funds, from allocating the funds rationally to international equities, including East Asian shares, and from exerting corporate governance on East Asian corporations.

After expanding rapidly in the previous decade buoyed by the appreciation of share prices and the expansion of pension fund assets, the fund management industry in Japan lowered its international standing during the 1990s due to a bear market. During the 1980s in response first to rising stock markets and then to population aging, life insurance companies shifted from long-term commercial lending to securities investment and in the early 1990s trust banks shifted dramatically away from long-term commercial lending toward managing corporate pension and public investment funds (Hayakawa 1996, p. 126). By 1992, institutional investors' assets in Japan stood at 78% of GDP, a higher percentage than in Canada or France and double the rate in Germany. During the 1990s, however, the industry shrank with the stagnant stock market and sharp fall in share prices. In 1999 Japan ranked well behind other leading economies in terms of assets of institutional investors, and as a percentage of GDP, assets of the fund management industry in Japan were less than half those in the United Kingdom or the United States (**Table 11.4**).

TABLE 11.4
Financial Assets of Institutional Investors in Selected Economies, 1992 and 1999
Percent of GDP

	1992	1999
Canada	66.8	112.7
France	61.9	125.4
Germany	34.0	76.8
Italy	21.8	96.9
Japan	78.0	100.5
Korea	51.8	88.5
United Kingdom	131.3	226.7
United States	127.7	207.3

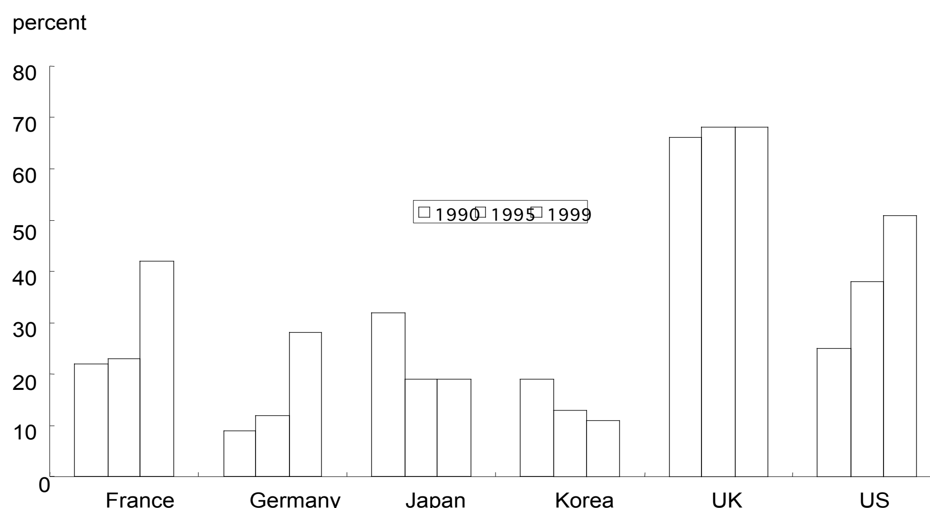
Note: Institutional investors include insurance companies, investment companies, pension funds, and other forms of institutional savings.
Source: OECD, 2001. *Recent Trends in Institutional Investors Statistics*, No. 80 (Sept.).

Moreover, the share of institutionalized financial assets invested in stocks declined during the long market downturn. In 1990 over 30% of Japanese institutional investors' assets were invested in shares, well above the rates in the United States, France, Germany, and Korea although only half the rate in the UK (**Figure 11.7**). At the end of the decade, however, shares had fallen to about 20% of

© 2005 Tokyo Club Foundation for Global Studies

institutional investors' portfolios in Japan, while the rates in the United States, France and Germany increased, and Japan outranked only Korea in the percentage of shares in institutional investors' portfolios.

FIGURE 11.7
Shares as a Percentage of Financial Assets of Institutional Investors in Selected OECD Economies, 1990, 1995, 1999



Note: Institutional investors include insurance companies, investment companies, pension funds, and other forms of institutional savings.
Source: OECD. *Financial Market Trends*. No. 80, Sept. 2001.

Several factors prevented the development of expertise in the Japanese fund management industry. Institutionalisation is a relatively new phenomenon in Japan's financial market and heavy regulation of the fund management industry prevented the industry from acquiring management expertise. For example, until the 1990s only trust banks and insurance companies were allowed to manage corporate pension funds. In addition, under the so-called 5/3/3/2 Rule, corporate pension funds were required to allocate more than 50% of funds to "safe" assets such as government bonds and they could allocate no more than 30% to stocks, 30% to foreign currency-denominated assets, and 20% to real estate.

Besides regulatory constraints, the relationship-oriented characteristic of Japanese corporate culture obviated the need for investment expertise based on economic factors. For example, at life insurance companies and trust banks fund management decisions were heavily influenced by considerations of corporate relationships instead of considerations of financial performance.

© 2005 Tokyo Club Foundation for Global Studies

Traditional job-rotation practices also constrained the development of portfolio management expertise at fund management firms.

Finally, the prolonged bear market of the 1990s substantially weakened the industry's ability to manage equity portfolios including international equity. Pension sponsors increasingly turned to foreign firms and opted for index-based management of their assets. The portion of passively managed assets of commingled accounts of trust banks increased over 8 percentage points from March 2000 to December 2001, and it is particularly high for foreign stocks (**Table 11.5**). As a result, the demand for active fund management capability in Japan as well as for research on international stocks declined.

TABLE 11.5
Weight of Passively Managed Commingled Accounts of Japanese Trust Banks

		Assets under management (billion yen)			Passively Managed Share (%)		
		Mar. 2000	**Mar. 2001**	**Dec. 2001**	**Mar. 2000**	**Mar. 2001**	**Dec. 2001**
Stocks	Domestic	12,842	11,230	9,571	38.6	38.9	45.4
	Foreign	6,192	5,538	5,693	48.3	50.4	56.5
Bonds	Domestic	10,606	9,393	9,428	28.4	31.8	35.5
	Foreign	2,203	2,970	3,101	20.7	31.6	38.0
Total		31,842	29,221	27,793	35.0	38.2	43.5

Note: Domestic bonds include convertible bonds.
Source: Nenkin Joho, No. 228. 4 March 2002.

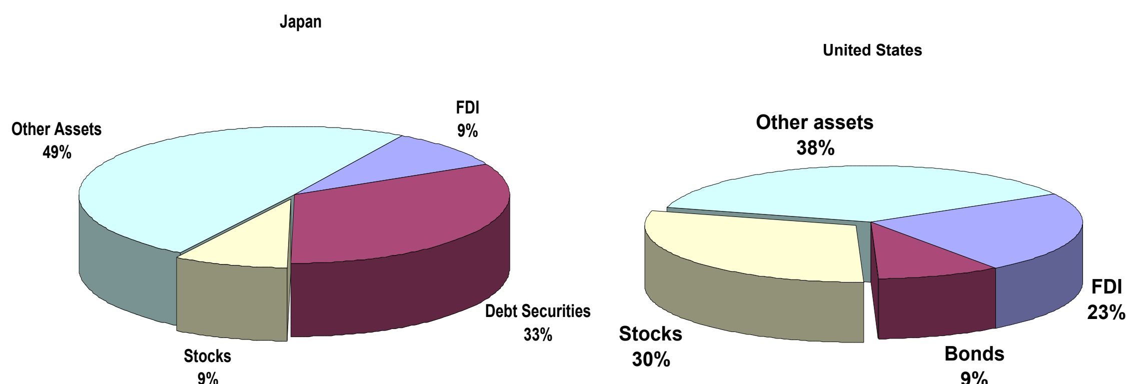
Domestic Orientation of Stock Investment

Stock holdings of Japanese investors are not as internationally diversified as those of investors in other advanced economies. We can infer this by comparing the composition of international asset holdings in Japan and the United States in 2000 (**Figure 11.8**). Stocks made up only 9% of Japan's international assets while debt securities occupied 33%. The situation is just about reverse in the case of the United States, with stocks comprising 30% of international assets and bonds (the equivalent of debt securities in the Japanese statistics) only 9%. The propensity of Japanese to hold foreign assets as debt-instruments and of Americans to hold them as stocks reflects similar tendencies in the composition of personal financial assets in the two economies.[6]

[6] Another characteristic of Japanese international assets is the small share of FDI (9% compared to 23% for the U.S.). This must reflect the difference in the maturity of FDI activities between the two countries.

© 2005 Tokyo Club Foundation for Global Studies

Figure 11.8
Composition of International Assets in Japan and the United States, 2000



Source: Hompo Taigai Shisan Fusai Zandaka. U.S. Department of Commerce, Bureau of Economic Analysis.

Two likely explanations for the comparatively low level of foreign stock investment by Japanese are the preference of individual investors in Japan for domestic over foreign stocks (including in their purchase of investment trusts) and the conservative management of government-controlled public pension funds. Individual investors could compensate for the inherent drawbacks of investing in foreign stocks—their additional currency risk and more limited information—by choosing investment trusts which have professional managers with wide access to financial information and which diversify risk by buying shares in a pool of many stocks. But Japanese investors do not utilize these vehicles for their savings to any great extent, as we have seen, and when they do they choose largely domestic-oriented ones. In October 2002, for example, only 5.3% of the assets of stock-oriented publicly offered investment trusts in Japan were foreign-currency denominated assets.[7]

For pension funds, investing in foreign stocks can reduce the overall risk of a portfolio because returns on foreign stocks are not highly correlated with each other or with returns on domestic assets. Private corporate pension funds in Japan became much more internationally oriented during the 1990s. From 1991 to 2000 while the share of domestic stocks and bonds in their portfolios increased from 36.6% to 56.6%, the share of international stocks and bonds almost tripled from 10.0% to 28.4% (Figure 11.9). Moreover, in 2000, 18.1% of total investment by private corporate pension funds was

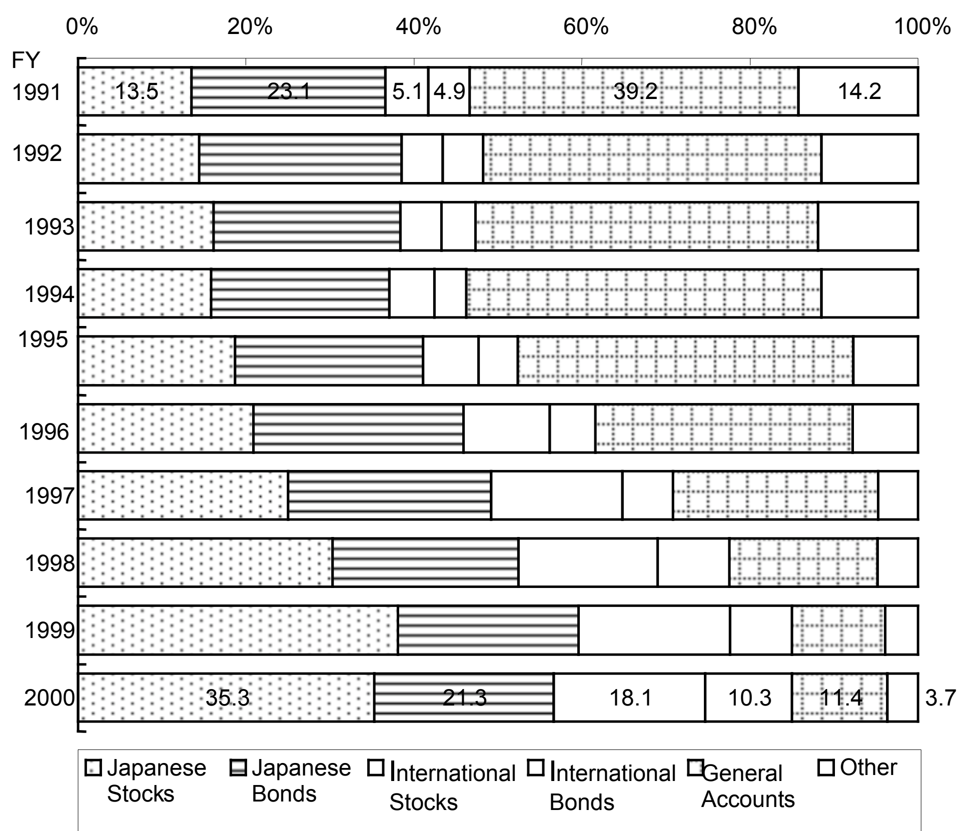
[7]Calculated from www.toushin.or.jp/result/getuji/g1-1.htm, which shows ¥852 billion in foreign currency-denominated assets out of ¥15.9 trillion total assets.

© 2005 Tokyo Club Foundation for Global Studies

allocated to international stocks compared to 35.3% to domestic stocks.

In contrast, the public pension fund system in Japan is still heavily domestically oriented. The portfolio allocation of these assets is relatively conservative, emphasizing not only domestic over foreign investments but also less risky bonds over equities. For example, the basic portfolio strategy published in December 2000 stipulated 68% of public pension assets invested in domestic bonds and 7% in foreign bonds, with only 12% allocated to domestic stocks and 8% to foreign stocks, with certain allowances for deviation. Since the public pension system has several times more assets than private pension funds (Figure 11.2) the conservative allocation strategy for these funds is a big factor in the limited international diversification of Japanese assets overall.

FIGURE 11.9
Composition of Japan's Employee Pension Funds, 1991-2000



Note: Japanese stock category includes convertible bonds.
Source: Pension Fund Association.

Low Allocation of Japanese Stock Investment to East Asia

Finally, East Asia captures a very small portion of Japanese investment in foreign shares. In 2002

© 2005 Tokyo Club Foundation for Global Studies

only 3% of Japan's aggregate outward investment in stocks went to Asia, mostly to East Asia, while over half (53%) went to the United States and almost a quarter (23%) went to Western Europe (**Table 11.1**). Japan's allocation to Asia is much lower than Asia's share (excluding Japan) of global market capitalization, which is roughly 7% (**Figure 11.3**). Even though Japanese investment trusts are not very active in international equity investment, their allocation to East Asian stocks is higher than the proportion of total outward investment from Japan that goes to East Asia. At the end of 2002, 22.2% of the ¥832 billion total foreign currency-denominated assets of publicly offered investment trusts was in stocks of East Asian economies (Table 11.6). Most of this amount (¥160 billion) was denominated in Hong Kong dollars (Table 11.7). Hong Kong captured such a large share because of the opportunity its market provided for Japanese to invest in the shares of Chinese companies by buying H-shares and red chips.

TABLE 11.6
Foreign Stocks, by Area, in Assets Managed by Japanese Investment Trusts, 1995-2002
(year-end market value)

	East Asia	North America	Europe	Other	Total
	Amount (billion yen)				
1995	820.3	175.6	46.8	52.5	1,095.2
1996	496.6	240.2	56.4	111.0	904.2
1997	193.4	269.2	196.5	54.8	713.9
1998	189.7	359.3	499.7	14.7	1,063.4
1999	205.2	561.6	338.5	63.6	1,168.9
2000	185.4	597.8	301.4	17.0	1,101.6
2001	211.5	636.7	253.6	39.4	1,141.2
2002	184.8	398.5	141.1	107.4	831.8
	Share of total (%)				
1995	74.9	16.0	4.3	4.8	100.0
1996	54.9	26.6	6.2	12.3	100.0
1997	27.1	37.7	27.5	7.7	100.0
1998	17.8	33.8	47.0	1.4	100.0
1999	17.6	48.0	29.0	5.4	100.0
2000	16.8	54.3	27.4	1.5	100.0
2001	18.5	55.8	22.2	3.5	100.0
2002	22.2	47.9	17.0	12.9	100.0

Source: Calculated from *Toshin Geppo*, Nihon Toshi Shintaku Kyokai.

© 2005 Tokyo Club Foundation for Global Studies

TABLE 11.7
East Asian Stocks in the Assets Managed by Japanese Investment Trusts by Country
(year-end market value)

	Hong Kong	Thailand	Singapore	Malaysia	Korea	Taiwan	Others	East Asia Total
				Amount (billion yen)				
1995	391.0	118.9	122.1	149.7	0.8	--	45.3	827.8
1996	226.1	80.0	57.8	109.0	1.4	--	45.9	520.2
1997	122.7	17.6	21.7	12.7	0.7	--	8.4	183.8
1998	76.7	20.8	21.7	8.6	6.9	5.3	5.2	145.2
1999	96.9	33.1	29.1	5.5	29.8	24.7	7.1	226.2
2000	94.6	12.2	25.5	3.2	15.1	20.6	2.9	174.1
2001	144.4	11.6	14.4	4.0	22.1	25.4	1.5	223.4
2002	160.4	11.1	9.7	3.2	19.8	15.6	1.4	221.2
				Share of total (%)				
1995	47.2	14.4	14.7	18.1	0.1	-	5.5	100.0
1996	43.5	15.4	11.1	21.0	0.3	-	8.8	100.0
1997	66.8	9.6	11.8	6.9	0.4	-	4.6	100.0
1998	52.8	14.3	14.9	5.9	4.8	3.7	3.6	100.0
1999	42.8	14.6	12.9	2.4	13.2	10.9	3.1	100.0
2000	54.3	7.0	14.6	1.8	8.7	11.8	1.7	100.0
2001	64.6	5.2	6.4	1.8	9.9	11.4	0.7	100.0
2002	72.5	5.0	4.4	1.4	9.0	7.1	0.6	100.0

Source: Calculated from *Toshin Geppo*, Nihon Toshi Shintaku Kyokai.

One reason for the limited exposure of Japanese pension funds to Asian stocks is their misguided benchmarking of international equity portfolios. The Pension Fund Association advises fund managers to monitor their performance against the stock market indices of Morgan Stanley Capital International (MSCI), and according to industry sources, most institutional investors managing Japanese pension funds use MSCI's *Kokudai Index* (World excluding Japan) as the benchmark for their investment in foreign stocks. Companies managing pension fund assets aim their investments to track the benchmark within a range of 5 to 10%. Moreover, the tracking error must be close to zero on the more than half of pension fund assets that are passively managed. Thus, this index has a significant influence over the choices of East Asian stock investments by pension fund managers in Japan. But this index is a skewed measure of actual stock market performance in the region, because it includes only Singapore and Hong Kong stocks. Together Hong Kong and Singapore make up slightly over half of the total market for stocks in East Asia not counting Japan (Table 11.7). Korea and Taiwan, which are omitted from the MSCI index, represent another 30% of the Asian market, and Malaysia's market is roughly two-thirds the size of Singapore's. Moreover, listings in the Singapore and Hong Kong markets are predominately lower-tech service sector companies, while South Korea and Taiwan markets include many manufacturing stocks with significant technological resources.

© 2005 Tokyo Club Foundation for Global Studies

Thus, the performance of the index does not reflect the underlying market portfolio of East Asia.

It is not difficult to see that the choice of this benchmark is likely to have constrained the flow of institutionally managed investment from Japan to East Asian markets other than Hong Kong and Singapore, particularly to the Korean and Taiwanese markets. Japanese managers of pension funds are reluctant to include Korean or Taiwanese stocks in their portfolios because that would increase the risk that their portfolio performance deviates from the benchmark. American and European investors do not face the same disincentive because they use an index that includes Japanese stocks as a benchmark for their investment in international markets. As Japan accounts for the lion's share of their benchmark index, investment in non-Japanese Asian markets, which are not included in the index, will not have a very large effect on the overall performance of the portfolio.

Positive Developments in Japan

Conditions in Japan's financial markets have changed substantially in recent years. From late 1997 the Japanese government initiated efforts to restore the financial system and adopted a series of Big Bang reforms intended to make the financial system more capital-market based. Almost all of the planned measures were implemented by May 2001, but their full impact on the financial system has not yet been felt because of the continuing stock market slump. Once the prolonged economic malaise and stock market slump are overcome, these new financial market conditions should make for significant changes in the way Japanese allocate their assets and should increase the supply of investible funds from Japanese savers. Some of these changes also have direct implications for the flow of Japanese investment into foreign, and specifically East Asian, stocks. For example, the anticipated relaxation of investment guidelines on public pension funds will increase the pool of funds available for investment in foreign stocks.

Several regulatory developments may stimulate individual Japanese investors' appetite for riskier, equity investments. One is the lifting of restrictions on the sale of investment trusts by financial institutions which began in December 1997. The outstanding amount of such funds sold by banks and other financial institutions reached \6 trillion in June 2000 and, importantly, the equity fund proportion of the funds sold by banks and financial institutions increased steadily, reaching almost 50% by November 2000 (Iwatani 2001, p. 36.). Moreover, this liberalisation likely contributed to the

© 2005 Tokyo Club Foundation for Global Studies

accumulation of investment trust accounts in Japan since investment trusts sold by banks have a much lower redemption rate than ones sold by securities companies (Ujiie 2002, p.62). Another is the introduction of a defined contribution pension program during fiscal 2001. The defined contribution system allows individuals to allocate their pension savings among investment options offered by private investment management companies. This option is expected to encourage individuals to become more knowledgeable investors, since the size of their pension benefit will depend on the success of their investments. In seeking higher returns, individuals may allocate some of their pension assets to stock purchases through investment trusts, for example (Ujiie 2002, pp.69, 122). Finally, the liberalization of stock commission fees together with the emergence of on-line stockbroking may also make it easier and more attractive for Japanese to invest in stocks. In September 2000, private investors carried out 26% of their transactions (by value) on-line, up from 3% in October 1999 when commission rates were fully deregulated (Iwatani 2001).

Big Bang reforms and financial market deregulation—such as opening pension fund management to investment advisory firms, allowing foreign firms to enter the fund management industry, and lifting the 5/3/3/2 Rule on the allocation of corporate pension funds—should also stimulate development of the fund management and investment trust industries. Liberalising entry into the corporate pension fund management business increased the share of investment advisory firms in the fund management industry. Competition has also intensified in the investment trust industry. Allowing asset management subsidiaries to conduct both investment trust and discretionary investment management has brought mergers between investment trust companies and investment advisory companies. Inroads by foreign companies have also intensified competition in the fund management industry. Until deregulation, the cost of setting up a separate company to do discretionary asset management discouraged foreign firms from entering the investment trust business.[8] Observers expect that these changes eventually will have an extremely positive impact on the investment capabilities and sophistication of Japanese fund managers and increase the industry's capacity to serve investors. Already, they are forcing domestic institutional investors to focus more on economic than on relationship criteria and leading to specialization among fund managers.

© 2005 Tokyo Club Foundation for Global Studies

The trend among institutional investors such as pension funds to shift from country allocation to industry allocation bears mentioning as a factor that is likely to affect Japanese portfolio investment in East Asian stocks. Economic globalisation has created industries that span the planet without regard for national borders, a phenomenon that is particularly evident in the IT industry. With the emergence of such global industries, institutional investors are putting more weight in their investment decisions on sector or industry factors at the expense of country factors. In this environment, the issue of appropriate regional benchmark indices will lose significance. More importantly, companies in such global industries may begin to shun local stock markets as they seek listing in stock markets that have a global scope, such as the New York Stock Exchange, in order to benefit from recognition of global investors. In that case, institutional investors are likely to channel investment in global industries, such as IT, in multinational companies through markets in major global financial centres and not in local East Asian companies through local East Asian stock markets. Then, the absorptive capacity of local stock markets will become less constraining. However, the reality is that local markets will continue to be important even though global financial centres will take some share.

Finally, the gradual shift beginning in April 2001 to self-management of deposits by Japan's postal savings and postal insurance systems should increase the supply of funds to the Japanese fund management industry, some of which may be allocated to foreign stocks. Under the Trust Fund Bureau of the Ministry of Finance, postal savings deposits and postal insurance funds were entirely invested in domestic projects or used to make policy-based loans; under the new management the initial target is to allocate 5% of the funds to foreign stock investment. Since the combined assets of the postal saving and postal insurance systems amounted to ¥375.6 trillion at the end of fiscal 1999, even this relatively low allocation will generate a sizeable pool of new funds aimed at foreign stocks. For example, about ¥10 to ¥13 trillion of new money is expected to flow from the postal savings system into foreign stocks during the next 7 to 10 years as a result of the policy shift (Ujiie 2002, p. 77).

At the same time, profound changes taking place in corporate governance in Japan should greatly improve the profitability of Japanese corporations in the long run. Co-shareholding among Japanese corporations is being dissolved and corporate governance is improving as various legal measures are

[8] Bill Wilder interviewed in Finance Asia.com

© 2005 Tokyo Club Foundation for Global Studies

implemented. The increased competition in the fund management industry will also serve to improve governance of Japanese corporations.

AGENDA FOR INCREASED JAPANESE INVESTMENT IN ASIAN STOCKS

Our analysis points to the following agenda of items to be addressed by Japan and by Asian economies to realise an increased flow of investment in Asian stocks from Japan for the mutual benefit of both sides.

Non-Japanese Asian Side

The recipient economies should further improve the infrastructure on which their local stock markets depend, including corporate governance, and they should pursue policies to increase the pool of investible domestic corporations. Creating modern corporations is key to increasing the supply of stocks attractive to international investors. Encouraging venture capital businesses and establishing stock markets for small and emerging companies will serve this purpose. To institute effective corporate governance and develop dynamic capital markets, East Asian economies need to reduce family control over local firms. Moreover, they must secure a healthy banking sector since this is a prerequisite for developing capital markets and since firms in developing economies that have weak information infrastructure must continue to rely on bank financing.

Japanese Side

In order for Japan to expand its equity portfolio investment in East Asia and play a constructive role in indigenous industrial development in the region, it is necessary to address the constraints on the individual investors and investment trusts on the one hand and on pension fund and institutional investors, on the other hand.

With regard to the former, it is necessary increase the risk appetite of Japanese individual investors. Winding down the prolonged deflation will help to some extent, but basic educational efforts to promote sound personal finance are also called for. A joint effort between the financial and educational sectors is necessary. Some policy biases such as excessive guaranteeing of deposits in both the banking and postal saving systems should be corrected. Investment trusts should become a

© 2005 Tokyo Club Foundation for Global Studies

basic instrument for individuals to invest in East Asian shares to overcome the asymmetry of information involving stocks, especially foreign stocks. Stronger educational efforts are needed to promote investment trusts among Japanese savers, and the investment trust industry needs to upgrade its management capability as well as its reputation by providing more and better public information about the products it offers and the potential risks and returns.

With regard to other institutional investors, the most fundamental factor to increasing the flow of investment in East Asian stocks is to raise the sophistication of the fund management industry in Japan. With deregulation of the industry largely accomplished, further improvement now depends on private-sector efforts. The fundamental weakness in governance among East Asian corporations means that Japanese fund managers need to monitor investments in East Asia particularly carefully and they may need to engage in dialogues on improving governance practices with market-related organizations and officials in the region. Finally, corporate pension funds in Japan should adopt a more appropriate index to measure the performance of their stock portfolios to remove the artificial constraint on Japanese investment in East Asian stocks.

© 2005 Tokyo Club Foundation for Global Studies

References

Brown, Stephen J., William Goetzmann, Takato Hiraki, Noriyoshi Shiraishi, and Masahiro Watanabe. 2002. Investor Sentiment in Japanese and U.S. Daily Mutual Fund Flows. http://www.nber.org/papers/w9470.pdf.

Hayakawa Shigenobu ed. 1996. *Japanese Financial Markets.* Cambridge: Gresham Books.

International Monetary Fund (IMF). 1998. *International Capital Markets: Developments, Prospects, and Key Policy Issues.*

Iwatani Masanobu. 2001. "The Composition of Personal Financial Assets in the Wake of Japan's 'Big Bang'". *Capital Research Journal* (Nomura Research Institute) 4(1, Spring): 30-45.

Masuyama, Seiichi, and Donna Vandenbrink. 2001. "Industrial Restructuring in East Asian Economies for the Twenty-First Century, " in S. Masuyama and D. Vandenbrink ed., *Industrial Restructuring in East Asia towards the 21st Century,* Singapore: Nomura Research Institute and Institute of Southeast Asia.

Nakagawa, Shinobu, and Tomio Shimizu. 2000. "Portfolio Selection of Financial Assets by Japan's Households." Tokyo: Bank of Japan. http://www.boj.or.jp/en/ronbun/00/data/ron0009a/pdf.

Prasad, Eswar, Kenneth Rogoff, Shang-Jin Wei, and M. Ayhan Kose. 2003. "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence." International Monetary Fund, 17 March. http://www.imf.org/external/np/res/docs/2003/031703.pdf.

T5 Policy Statement. 2003. *The Development of Capital Markets and their Governance: A Shift to Markets in Diverse National Context*s. Tokyo: Tokyo Club Foundation for Global Studies and http://www.tcf.or.jp.

Ujiie, Junichi, ed. 2002. *Nihon no Shihonsijou* (Japanese Financial Markets). Tokyo: Toyo Keizai Shimposha.

World Bank. 2001. *Global Development Finance. Country Tables.* Washington, DC: World Bank.

____________. 2003. *Global Development Finance 2003.* Washington, DC: World Bank.

____________. 1996. *Managing Capital Flows in East Asia.* Washington, DC: World Bank.

© 2005 Tokyo Club Foundation for Global Studies