

Hirohide Yamaguchi: Strengthening growth potential, role of the market, and “production of information”

Remarks by Mr Hirohide Yamaguchi, Deputy Governor of the Bank of Japan, at the Securities Analysts Association of Japan Annual Conference commemorating its 50th anniversary, Tokyo 15 October 2012.

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Introduction

Thank you for having me at the annual conference jointly hosted by the Securities Analysts Association of Japan (SAAJ) and Asian Securities and Investments Federation (ASIF). All the participants here have been striving for the development of securities markets, and, through such efforts, have been contributing to the sound development of Japan’s economy. On behalf of the Bank of Japan, I will pay great respect to your efforts.

Today, under the title “Strengthening Growth Potential, Role of the Market, and ‘Production of Information’,” I will talk about my views on the importance of the financial function that supports economic growth and how securities markets should be, and then I will send cheers to securities analysts while referring to their expected roles.

I. Japan’s economy and securities markets

50 years ago, in 1962 when the SAAJ was established, Japan’s economy was in the midst of a high growth period. Japan’s economy grew by an annual average of 9.7 percent from 1956 up to 1970. It made a transition to stable growth, triggered by the oil shocks, but was on a constant growth path until a bubble burst at the beginning of the 1990s. After the burst of a bubble, things changed completely and the average growth rate declined substantially to around 1.5 percent in the 1990s and around 0.5 percent in the 2000s.

The history of securities markets developed in tandem with such a long-term trend in the real economy. During the high growth period, firms’ buoyant fund demand was mainly supported by indirect finance. However, even during such period, the securities markets gradually came close to people as the phrase “goodbye banks, hello securities firms” began to be heard in the early 1960s when investment trust started to spread among people. Subsequently, the markets continued to grow by weathering trials, including securities markets’ slump after the Tokyo Olympics and, in the 1980s, both the stocks market and the corporate bonds market got into full swing amid financial liberalization and globalization. While equity finance by convertible bonds and warrant bonds rapidly increased during the bubble period on the back of strong expectations for a rise in stock prices, market expansion based on excessive expectations did not last long after all. Since the 1990s, a variety of reforms have taken place mainly to address various events that surfaced in accordance with the emergence and the burst of a bubble, and the markets have steadily improved. However, amid the continued low economic growth, the environment surrounding securities markets has been severe and there has recently been concern over a decline in the competitiveness of Japanese securities markets compared with those overseas.

II. Finance, which holds the key to strengthening growth potential

I have been mentioning repeatedly on various occasions the fundamental background to a declining trend in the growth potential of Japan’s economy. Put it simply, the economy has not sufficiently adapted to major changes of the demographic vortex and globalization. Therefore, to strengthen growth potential, it is essential to tap new potential demand associated with progress in aging and to incorporate expanding global demand, mainly that

of Asian economies. To that end, firms' attempts and an improvement in the environment that supports such attempts are required.

Given that new attempts are always associated with risks, it is not too much to say that the power of finance that evaluates and shoulders such risks will be a key to strengthening the growth potential of Japan's economy. Encouraging firms' attempts and unlocking their growth potential will promote business fixed investment and research and development, expand employment, raise wages, and, through an increase in interest and dividend as well as capital gain, strengthen households' income and asset formation.

In the 2000s, Japan's economy experienced an economic expansion of six years and one month, which was longer than the Izanagi boom during the high growth period, and the Nikkei Stock Average once rose to about 18,000 yen. However, corporate behavior to achieve an improvement in business performance through cutting wages and costs was retained strongly during that period. And, to start with, the economic recovery relied heavily on exports on the back of financial bubbles in the United States and Europe. Therefore, while the economic expansion continued for a long time on the surface, it did not become a sustainable economic recovery backed by an autonomous mechanism. Given such recent experience, it is not an easy task to bring out many firms' incentives to take on the challenge of tapping potential demand and thereby strengthening growth potential amid further progressing aging. However, that is why there are high expectations for the role of financial and capital markets, in which growth money is created. Of course, among eventual fund providers in the financial and capital markets, there are those who want to invest their funds safely by making deposits and there are those who want to increase their investment profits by taking certain risks. It is necessary to enhance the capability of financial and capital markets as a whole to convert a variety of fund management needs into economic growth, while utilizing each characteristic of indirect and direct finance.

III. Three conditions required for securities markets

Based on what I have said, now, I will focus on the securities markets in which analysts are directly involved, and from the viewpoint of strengthening power that creates economic growth and developing securities markets themselves, I will mention three conditions for a desirable form of markets.

First, a high degree of efficiency and fairness. Securities markets can function efficiently only after proper pricing for risks and returns is made. Therefore, it is deemed desirable that many investors who have a variety of evaluation criteria should participate and that the markets should be highly liquid. To that end, first of all, offers of versatile solutions for each fund raiser and fund investor as well as securities trading in the secondary markets have to be made at low costs, namely, the markets need to be a place of efficient financial transactions. In addition, in order for the markets to be a place in which many investors feel safe in participating, the fairness of transactions based on proper governance and high ethical standards has to be guaranteed. In Japanese securities markets, especially after the burst of a bubble, various kinds of system reform have been made in order mainly to achieve a sound competitive environment. However, securities markets have recently been exposed to harsh global competition. In order to maintain the international competitiveness of Japanese securities markets, it is critical to unflaggingly implement efforts to enhance the markets' efficiency and fairness in the future. In that regard, a move to establish Asia's number one stock exchange by merging the Tokyo Stock Exchange and the Osaka Securities Exchange is highly expected as a new start of Japanese securities markets.

Second, the existence of investors who aim at increasing their medium- to long-term returns.

Of course, I do not deny that aiming at short-term trading profits is one of investment strategies or that it enhances market dynamism and liquidity. However, not only to chase short-term profits but, for example, for investment institutions, including pension funds and

insurance companies, to make utmost efforts to raise medium- to long-term returns will enhance securities markets' function of selecting promising firms and projects and eventually contribute to achieving sustainable growth of Japan's economy. In that regard, it is also important that households, which are the eventual fund providers, become highly interested in their own asset management. Given that most of households' financial assets of 1,500 trillion yen have still been in cash or deposits even though long time has passed since "savings to investment" was called for, there seems to be plenty of room for improving the environment which gets growth money out of sleep. For example, to promote initiatives to raise interest in asset management, including the enhancement of financial education that fits each age-group, could encourage investment institutions, which receive households' long-term funds, to compete at a higher level.

Third, the markets need to be a place in which high quality information is created to steadily support investment judgment. What is important, first of all, is disclosure of fund raisers and investors relations. While it goes without saying that honest and fair disclosure is required, in addition to that, it is critical that firms strive to actively and convincingly explain their own management strategies. Firms' information will be analyzed and evaluated from various angles by market participants, and utilized for investors' decision making. In financial theory, a situation in which fund providers do not have sufficient information of fund-raisers is called "information asymmetry" and, if the asymmetry is substantial, even growth of firms with great potential will be constrained from the funding side. Therefore, it is considered that the resolution of "information asymmetry" is the intrinsic function of finance and added-value that finance contributes to economic activity. Added-value is created through "production of information." While the "production of information" is somewhat an abstract expression, simply put its specific meaning, it is nothing less than high-quality analysis and evaluation of the investment asset class. And, those who play an important role in that regard are securities analysts.

IV. "Production of Information" and expectations for securities analysts

Now let me offer three specific expectations for securities analysts.

First, neutral information transmission based on accurate analysis. The standpoint of securities analysts varies according to organizations they belong to, such as the sell-side, the buy-side, and the rating agency. However, for the information they transmit to be trusted and influential, the accuracy of analysis as well as a fair and neutral perspective will be inevitable elements. As for a specific angle of analysis and message to be emphasized, individual securities analysts should devise ways by fully utilizing their respective expertise and knowledge. With securities analysts stimulating each other from different perspectives, "production of information" in the markets as a whole will be elevated both in terms of quality and quantity. What I especially expect is the "production of information" that contributes to exploring growing companies. Although the growth potential of Japan's economy has been declining, if looked at individually, there are many firms with high profits and growth, and there will be further more potentially growing firms. Finding out such promising investment opportunities one by one and nurturing them, while it seems a roundabout approach, will offer a potent breakthrough for eventually increasing growth potential of Japan's economy.

Second, maintaining full communication with firms. While the role of securities analysts is basically to provide investors with analysis on firms, cherishing connection with firms that are the subject of analysis eventually means that securities analysts will ask those firms their unique questions. Namely, securities analysts can contribute to the process, in which firms constantly develop their business strategies while incorporating investors' perspectives. In other words, securities analysts play a valuable role as an interactive connecting point between firms and investors.

Third, playing an active role as global human resources. While currently a slowdown in emerging economies has become somewhat protracted, those economies have high

growth potential in the medium to long term and, on the financial front, it is likely that especially Asian securities markets will expand substantially. Just like today's conference, information exchange and interaction of people at a global level will become increasingly active in the future. In order to improve the attractiveness of Japan's securities markets

and attract overseas investors, and also to utilize expanding overseas investment opportunities in the asset formation of Japanese households, I expect securities analysts to play an active role with the key words "Asia" or "global."

Concluding remarks

From the perspective of strengthening growth potential of Japan's economy, today I have talked about the importance of the role securities markets and securities analysts play. I think the aforementioned term "production of information" illustrates how financial business is a knowledge-intensive industry. In Japan's economy, in which the labor force has been declining in association with aging, increasing the growth rate of added-value per capita is a necessary condition for economic growth. If the typical knowledge-intensive industry of financial business enhances the ability of creating added-value and grows, it will itself contribute to strengthening the growth potential of Japan's economy. I have high hopes that securities analysts, while holding their strong intellectual curiosity and sensibility to read the times, will make a valuable contribution to the development of Japan's securities

markets and eventually to the development of Japan and Asia.