Financial Markets Report

— Developments during the Second Half of 2005 —

Bank of Japan
Financial Markets Department

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Executive Summary

I. Financial market developments during the second half of 2005

During the second half of 2005 in Japanese financial markets, (1) stock prices have moved out from their recent trading range and risen strongly relative to overseas markets, (2) long-term interest rates have risen moderately, and (3) the yen has tended to fall against major currencies. Growing confidence in Japan's economic recovery has contributed to the rise in stock prices and active investment in other financial assets.

In the interest rate markets, while the year-on-year change in the consumer price index turned to zero from small negative figures, prospects of an end to the quantitative easing policy and subsequent rise in interest rates have become clearer, leading to a rise in short to medium-term interest rates. On the contrary, the rise in long-term yields has been small and the rate remained below the yearly high of 2004.

In the equity markets, the Nikkei 225 Stock Average rose to 16,000 yen, the highest since October 2000, as the recovery in the economy and solid corporate earnings were confirmed. Stock indexes of newly developing markets were also at historical highs, and both the volume and value of transactions surpassed the level during the bubble in the 1980s to reach historical highs. Overseas investors continued to purchase Japanese stocks actively, and the base of investors expanded as more individual investors utilized internet trading and margin trading. Firms' share buybacks and M&As have increased as well.

Credit spreads have been stable at tight levels on the whole as investors' demand for credit products such as corporate bonds remained strong and their search for yield continued against the background of improved corporate earnings and the low interest rate environment. Under this favorable financing circumstances, signs of firms' accelerating financing activities are observed as the year-on-year change in the amount outstanding of lending by private banks, after adjustment for extraordinary factors, turned positive in the second half of 2005, and the amount of CPs and corporate bonds issued increased. During the period, firms across different sectors started to borrow and new credit channels have steadily broadened as markets for securitized products and syndicated loans continued to develop.

In the foreign exchange markets, the yen fell against major currencies as well as against Asian currencies. The yen had fallen against the U.S. dollar to 121 yen by the beginning of December, the lowest level since March 2003, then rose towards the end of the year, but it remains well below the level in the first half of the year.

The notable factors affecting Japanese financial market developments are as follows: (1) the rise in long-term interest rates was small due to the subdued expectations for inflation in Japan and abroad; (2) investors' search for yield continued under the low interest rate environment, thus affecting the pricing of assets resulting in, for example, the rise of stock prices; (3) the interest rate differential between Japan and abroad widened as the U.S., Euro and other areas raised their interest rates. These changes have encouraged domestic investors, including individual investors, to expand their investments in foreign financial assets.

From a global perspective, Japan's situation was not unique. Stock prices rose in the U.S., Europe, and elsewhere, while long-term interest rates remained relatively stable. Investors' search for yield has been widely observed in the global financial markets. Investors placed their funds actively not only in equity and credit markets but also in hedge funds and commodity markets. Under this trend, overseas investors continued to increase their holdings of Japanese stocks in their portfolios, supporting the vigorous rise in Japan's stock prices. Regarding JGBs, although the share of holdings by overseas investors has been still limited, overseas investors have a growing presence in the JGB futures market and other related markets. Consequently, the correlation between long-term Japanese interest rates and the U.S. rates has strengthened. Outward investments by domestic investors were led by various investors and investment channels, such as foreign bond purchases by institutional investors, foreign assets purchase through mutual funds by financial institutions and individual investors, and foreign exchange margin transactions by individual investors. These capital flows, coupled with the reduced trade surplus associated with the higher crude oil price, drove the yen lower.

II. The issues on functions of financial markets and the Bank's initiatives

With a view to improving the functions and efficiency of financial markets, the Bank conducts market research and takes initiatives to facilitate the market infrastructure. The major issues up to fiscal 2006 are the following.

(1) Short-term money markets

Under the Bank's quantitative easing policy, the amount of transactions in short-term money markets has been reduced drastically. Depending on economic conditions and financial developments in the coming months, the behaviors of market participants could change further, and short-term money markets may well be required to restore more efficient intermediary function accordingly. Meanwhile, various structural changes have occurred in environments surrounding short-term money markets, for example, lenders and borrowers in the markets have changed as financial institutions have been consolidated and their balance sheet structure has changed. Moreover, the fluctuation of intraday fund positions has become greater following the introduction of RTGS (Real-time Gross Settlement). Therefore, there are many issues to be addressed to restore the functions of short-term money markets. The Bank will continue to discuss with market participants issues such as the changing behavior of market participants with respect to funding operations and management of interest rate risk and the resultant effects on money markets. The Bank also seeks joint efforts with market participants to identify further challenges to be addressed in order to attain improved market functioning.

(2) Credit markets

During the period from 2002 to 2003, when the intermediary function of Japanese financial institutions was constrained, the Bank implemented temporary measures, including establishment of outright purchase operations of asset-backed securities (ABS) and asset-backed CPs (ABCPs), with a view to supporting the ABS and ABCP markets that were still in their infancy. Since then, the ABS market has developed steadily, and so the purpose of these temporary measures to support the ABS market is considered to be largely accomplished. In addition, the environment surrounding corporate financing has improved substantially since the temporary measures were implemented. The Bank therefore announced that it would terminate the temporary measures at the end of March 2006, as scheduled. The Bank considers that the development of new credit channels, such as ABS, syndicated loans and credit derivatives remains to be critical to improve the efficiency and stability of the whole financial intermediary system in Japan. The Bank will, therefore, continue to closely monitor the development of credit markets by exchanging views with market participants and search for new tasks to be tackled. It will also continue to take initiatives in addressing outstanding issues such as the development of secondary markets and improvements in disclosure and build-up of market data. Meanwhile, the Bank has embarked on taking actions to facilitate the use of credit market related instruments as collateral in transactions with the Bank.

(3) Business Continuity Plan

The 9.11 terrorist attacks in 2001 drove global market participants and related parties strongly to recognize that it is essential to develop a business continuity plan (BCP) for maintaining market functioning in case of disaster. Indeed, it is now a widely shared notion that BCP is an integral part of market infrastructure that retains minimal market functioning in times of disaster. Not only is the BCP in the interest of each market participant but also contributes to maintaining the stability of financial markets and the economy as a whole. It is necessary to secure networks in markets, including human networks among the related parties and alternative communication tools, in order to continue market transactions. The Bank has participated in discussions in each market and supported their BCP initiatives. The Bank will continue to promote and support concrete actions such as facilitating cooperation between markets, and assisting the building and operation of BCP-designated websites.