

## Chapter 6

### Tokyo's Ultimately Failed Bid for First Tier International Financial Center Status: Why Did It Fall Short and What Are the Lessons for Shanghai?

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#### Introduction

Tokyo may once have had the potential to become a dominant international financial center (hereafter, IFC) to rival New York and London. History tells us that this apparent potential was left unfulfilled, with Tokyo having settled down as a very important but not dominant centre for international financial activity. This chapter will consider why Tokyo's apparent bid to ascend to the very top tier of IFCs was ultimately unsuccessful. The experience of Tokyo, Japan contains many lessons for Shanghai, China.

In the period from the early 1970s to the mid-1980s, Tokyo acquired many of the necessary characteristics for achieving top tier IFC status, but not all of them — and it did not do so quickly enough for them to bear fruit and mature before the underlying support from the spectacular rise of the economy went into reverse. Tokyo had not yet achieved equivalent status to New York or London during Japan's late 1980s zenith. Then, as the Japanese economy, its financial system and real and financial asset markets began to struggle in the early 1990s, the gap widened considerably. By the time of

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the banking crisis of the late 1990s, which occurred simultaneously with the Asian financial crisis and the rise of the euro as a reserve currency competitor for the US dollar, the first tier IFC opportunity was lost.

The fact that establishing Tokyo as a first tier IFC was never a super-ordinate goal of national economic policy until the middle 1990s — in other words, it was never seen as a goal that other national policy objectives should be subordinated to until it was too late, and even then, somewhat ambivalently<sup>1</sup> — prevented a strategic approach to maximizing the obvious potential inherent in its earlier bid. A holistic effort is required to overcome the inherent disadvantages of a “latecomer” with aspirations to join the first tier. With hindsight, we can see that Tokyo was neither a genuine scale competitor for New York (Japan was never going to be able to double US output per head levels to overcome the population differential and become the world’s largest economy) or a genuine competitor for London in terms of the concentration of expertise and support services, with the associated economies of scale and scope available to financial services firms operating out of that location. Even so, there is more that could have been done, and earlier, to maximize Tokyo’s chances before the economy slowed, if the “bid” was “active” rather than “passive.” Shanghai’s chances are better, when one takes the long view, as it will be the financial hub of the world’s largest economy for most of the time between 2016 and the final third of the century.<sup>2</sup>

Besides these top level judgments, more specifically this chapter concludes that the most important fundamental elements that

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<sup>1</sup>I am indebted to Chalongsob Sussangkarn, a seminar participant at the Asian Economic Panel meeting in Penang, Malaysia, commenting on a previous version of this research, who poignantly noted that bureaucracies express their ambivalence for an initiative by deferring decisions through the establishment of committees, working groups, expert panels and so forth. On this measure, Japan’s ambivalence to the IFC goal can be read through the succession of official studies on yen internationalization, trade invoicing, the financial system’s international competitiveness and the like, that spanned more than two decades of “further discussion.”

<sup>2</sup>For a discussion of a number of scenarios on global growth and world output shares between the present and 2100, see McKay (2012).

prevented Tokyo from ascending to the top tier of IFCs were as follows:

- (a) The failure of the Japanese yen to become a genuine competitor for the US dollar as an international vehicle currency prior to the introduction of the euro.
- (b) The relative and absolute decline of the performance of the Japanese economy and its financial markets from the early 1990s, which prevented the gains of the 1970s and 1980s from continuing to compound positively.
- (c) Various accidents of timing in the global economic landscape that worked to amplify the power of incumbency for London and New York and to limit the degree of relevance attached to Japan. Most fundamentally, the time between Japan operating as a closed, financially repressed system with weak internal competitive dynamics (up to the Bretton Woods breakdown) and its late 1980s window of opportunity was just too short for it to realistically compete in terms of maturity, depth and sophistication with the incumbents.

These conclusions are reached following a systematic examination of Tokyo's absolute and relative IFC *bona fides* against rigorous criteria. The continual emphasis on absolute and relative positions is due to the acknowledged persistence (path dependency) associated with first tier IFC (and vehicle currency) status. It is not enough to merely meet the criteria oneself. One must be strong enough to also displace incumbents and take market share away from them. History shows that Tokyo was unable to meet the relative challenge in the long run.

The initial task is to define the vital traits of top tier IFCs that are critical to that status. The second is to assess Tokyo's first tier IFC candidacy through time against this framework. The third task is to integrate this assessment with a discussion of the global macroeconomic and macro-financial developments that defined the last three decades of the 20th century.

Finally, we apply the lessons of the Tokyo, Japan experience to the future challenges of Shanghai, China in the IFC arena, with a modest aside on the South Korean model. In considering the import

of these conclusions for Shanghai, I am at pains to place the IFC goal in the broader context of China's ultimate macroeconomic objectives, its current growth model and the structural legacies that derive from it, alongside an assessment of desirable alterations to that model as its industrialization drive matures.

The intermediate policy actions required of China to accommodate an ultimate objective of achieving first tier IFC status will be a challenge to many internal interests that benefit from the parameters of the current system. However, such moves are inherently complementary with China's acknowledged need for transition towards a new growth model that sustains growth in aggregate living standards in an environmentally conscious way while simultaneously promoting equality of income and opportunity (McKay and Song, 2013). The new model that arises must emphasize domestic absorption and efficient capital and resource allocation, at the expense of over-expansion of productive capacity and the pursuit of foreign market share. Establishing a super-ordinate national objective to raise Shanghai to first tier IFC status would highlight that the Chinese authorities believe that an open, internationally competitive and sophisticated financial system can play a prime role in channeling resources to their most efficient uses, alongside requisite efforts to reduce the factor market distortions that have created the internal and external imbalances that the new leadership is seeking to redress.

The conclusion is that Shanghai will be advantaged *vis-a-vis* Tokyo due to the likely future scale of China's economic and financial footprint which indicates that the renminbi has an excellent chance to become a genuine international vehicle currency at some point. On the other hand, Shanghai at present is extremely disadvantaged by a lack of indigenous expertise and experience in international finance, and some pronounced shortcomings across the vast majority of the soft infrastructure demanded of first tier IFCs. China, of course, has time on its side to build such expertise, as it will be the world's largest economy for at least the next two generations. Even so, the imperative for a new growth model is more urgent than that, and the IFC goal may usefully serve as a galvanizing force in the overall reform process, assisting policymakers to move forward with focus and resolve.

### *Characteristics of first tier IFCs*

The features of first tier IFCs that are considered critical are the following:

1. Unrestricted capital and financial accounts, including flows of portfolio equity, portfolio debt and derivatives, loans and other finance. While this criterion can be softened if the global financial architecture is not consistent with it (such as at the height of the Bretton Woods era), it is not negotiable at times of free flowing capital, such as today or in the final third of the “long” 19th century.
2. A convertible, internationalized currency that is acceptable as a store of value, unit of account, a denominator for unrelated third party real economy and financial transactions (especially debt, Thimann, 2010) and is readily able to be hedged in liquid markets. In other words, the local money must serve as an international vehicle currency. London’s current status may only weakly meet this definition, but as the world’s major centre for foreign exchange trading with a 40% market share, the supply of vehicle currencies other than the pound available in London is more than ample. Even in the Bretton Woods era, when the pound was deposed by the dollar, the euro–dollar market centered on London, because the global banks were already there and so was the international expertise (Baker and Collins, 2005; Schenk, 2005). Further, with many more euro changing hands in foreign exchange deals in London than on the continent, it has once again shown an ability to leverage its IFC advantages into concrete market share gains.
3. A liquid market for anchor risk free assets in the home currency: for example, British Consols, French Rentes, UK Gilts, US Treasury securities. This blends with the characteristics of the home currency in criterion 2 to achieve reserve currency status. A highly regarded<sup>3</sup> sovereign issuer is therefore essential. Note

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<sup>3</sup>The term “regarded” is used here in preference to “rated,” as mature markets for sovereign debt existed well before ratings agencies became embedded in the global financial system, and formal ratings actions tend to lag well behind investor sentiment toward a troubled issuer — or one who has improved its balance sheet sufficiently to warrant a

that Japan's foreign long-term credit rating first reached AAA in February 1975 (Standard and Poor's Financial Services, LLC 2012). It lost that status in February 2002 and is presently rated AA minus, three notches below the risk free rating.

The combination of characteristics 2 and 3 is powerful. This combination ensures that the minimum level of foreign interest required to become a dominant center for the conduct of international financial business is present.

Additional characteristics that aid the competitive advantage of first tier IFCs are:

4. A market making central bank-primary dealer complex in the key financing vehicles of the day — whether the discounting of bills of exchange, government securities on repo/reverse repo or commercial paper. This was one factor in London's continued dominance over New York as an IFC in the late 1900s, despite the US economy becoming the world's largest in 1870. Prior to the creation of the US Federal Reserve System in 1913, following the 1907 financial crisis, there was no equivalent to the Bank of England's willingness to discount sterling bills in London or the liquidity of the markets it bestrode (Eichengreen, 2011).
5. A broad variety of financial assets to cater for the appetites of a diverse domestic and international investor base. This tends to prioritize the development of non-bank, arm's length financing channels (direct equity and debt raisings principally). London long held an advantage over its competitors in this space, with public and private issuers alike favoring its highly developed capital markets.<sup>4</sup> Even today, British Law is used for a large proportion of international bond issuance.<sup>5</sup> However, fiscal dominance

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re-valuing of its debt. For a similar reason, the presence of rating agencies is excluded from the criteria for IFCs above. They are an implicit element of the support services outlined in criterion 7.

<sup>4</sup>Recent evidence shows that Paris was an impressive international financial center that was not as far behind London as one might have supposed during the *belle époque* (Esteves, 2011; Flandreau and Gallice, 2005). At the very least, it was a very creditable number two to London at a time when New York was yet to find its feet.

<sup>5</sup>This was recently highlighted in the negotiations over the Greek sovereign debt restructuring, where some of its bonds were issued under local law and some under British law, with the latter disallowing re-denomination of the security from the original issue currency if Greece had left the euro.

can undermine an IFC's status in this field. For instance, major wars have generally left combatant sovereigns seriously indebted. Financially repressive and/or inflationary policies are then pursued to deal with the sovereign debt problem. This has obvious negative implications for IFC status.

6. A broad variety of financial institutions to cater for diverse intermediation functions. These institutions will also have a global footprint. At the very least, an internationally competitive cluster of banking, insurance and funds management firms must be present. Depending upon the regulatory situation, banks may be universal in scope (the early 20th century New York model), or deposit gathering and securities business may be separated (the US from the 1930s until the late 1990s, the UK's savings versus merchant banking model). What is important is that global demands are met and pre-empted, not that one particular institutional model is in place.
7. A legal framework that is transparent and predictable. This goes hand-in-hand with an independent judiciary and political stability. Other support services such as accounting, IT, and specialist higher education offer economies of scale and scope to financial institutions that choose to base their activities in IFCs. In the 19th century, London offered further benefits of agglomeration through its position as the center for maritime logistics and commodity trading (insuring cargoes, the Baltic exchange for the brokering of freight, the London Bullion Market and the London Metals Exchange).
8. A regulatory framework that is seen as a credible check on excesses without stifling innovation. While this may seem to be an ambiguous factor — given the tendency of private institutions to gravitate to the lightest touch jurisdictions — it is lower tier IFCs that must compete for business through a regulatory race to the bottom, not first tier IFCs.
9. A demonstrated ability to consistently and transparently allocate large amounts of capital to productive uses. It is in this “perception” that the advantages of a large scale and globally recognized funds management industry become very clear. Not even immense scale (think of Japan Post's massive deposit

pool for instance) can overcome a perception of backwardness or opacity.

10. A dynamic and cosmopolitan living environment that will be attractive to the world's leading financial professionals.<sup>6</sup>

### *Vehicle currencies, IFCs & the yen*

The most important shortfalls in Tokyo's first tier IFC bid were arguably those pertaining to criteria 2 and 3. Japan failed to reach critical mass in terms of non-resident demand for the yen as it was unable to denominate the majority of its own trade in its own currency, which meant it was not able to assume a full role as an international "vehicle currency" and instead remained dependent on the US dollar for a large proportion of its international transactions. Non-residents were therefore not lured to Japanese financial markets in significant numbers. Japan was somewhat late to the game in providing foreign investors with a "risk free" yen denominated fixed income asset — it first allowed non-resident access to AAA rated sovereign bonds under "modern" conditions in the mid 1970s, and these bonds ceased to be perceived "risk free" sometime in the mid to late 1990s.<sup>7</sup> That is a narrow window. The combination of these failures left the yen short of achieving true inner circle reserve currency status. That is despite its well acknowledged "safe haven" status due to Japan's position as a large international creditor and its role as an IMF special drawing rights currency since the basket's inception in July 1974 (International Monetary Fund, 2001, Table 18.4, p. 951).<sup>8</sup>

<sup>6</sup>I am indebted to Dr. Lin See-Yan, a discussant of a previous version of this research, for highlighting the importance of this qualitative factor in IFC competition.

<sup>7</sup>There are many aspects here. The liberalization of inflow, the move away from balanced budgets to build a sizeable bond stock, liberalizing the sales of bonds outside the original "syndicate" of domestic financial institutions, the allowance of secondary market sales and the upgrade to AAA by the global rating agencies.

<sup>8</sup>Not all nations with the ability to achieve inner circle reserve status desire to do so. The Germans in particular have displayed an historical ambivalence towards reserve currency status, acknowledging that embracing the implications of the "Triffin Dilemma" (Triffin, 1978) — that a global reserve currency must be prepared to run current account deficits to furnish international monetary liquidity — was inconsistent with the anti-inflationary ethos that was deeply ingrained in the national psyche by the damage done in the 1920s hyperinflations.

Beginning with the 1984 report of the bilateral US–Japan “Yen–Dollar Committee,” there have been a number of official and academic studies on the matter of internationalizing the yen, internationalizing Japanese financial markets and the use of the yen as an invoicing currency in trade (see for example, Japanese Ministry of Finance, 1998, 1999, 2003; Oi *et al.*, 2003; Sato, 1999; Aramaki, 2006; Ito *et al.*, 2011). The literature on international currencies, choice of invoice currency, and the currency denomination of bond issuance has also flourished with the introduction of the euro, the weakness of the US dollar since 2002 and China’s evolving exchange arrangements and financial liberalization program (Siegfried *et al.*, 2007; Goldberg and Tille, 2008; Auboin, 2012; Aramaki, 2006; Cui *et al.*, 2009; Yun, 2005; Camps, 2006; Cohen, 2005; McKay, 2007; Dobson and Masson, 2009; Flandreau and Jobst, 2009; Thimann, 2010; Peng and Shu, 2010; Eichengreen, 2011, 2012; Maziad and Kang, 2012).

Nobel Laureate Paul Krugman’s classic article on vehicle currency choice in international exchange (1980), is central to any discussion in this field. Krugman illustrated that in the presence of transactions costs that are negatively related to scale, there will be room for only a very small number of vehicle currencies in the global economy. The zero sum nature of the vehicle currency domain means that the advantages of size will compound and leave just a few currencies able to offer the low transaction costs required: scale will beget scale. That predicts that incumbency is very powerful in the vehicle currency arena and that consequently a high level of persistence in the choice of vehicle currencies will be evident in international exchange. That echoes the thesis put forward in 1967 by financial historian Charles Kindleberger that “For better or worse — and opinions differ on this — the choice of which language and which currency is made not on merit, or moral worth, but on size” (Flandreau and Jobst, 2009, p. 1).

Importantly for the prospective challenger in the vehicle currency domain, Krugman’s dynamics are symmetric. The theory predicts that once a process of market share loss for an incumbent is in train, for whatever reason, its market share can unravel quickly and potentially irreversibly. Any momentum in favor of a greater proportion of transactions being undertaken in the currency of a rising power can

be an accelerant to yet more transactions, as costs decline. A policy focus on encouraging own currency denomination in trade can assist to set these wheels in motion.

It appears that Japan certainly once had some momentum in its favor on this front. The proportion of Japanese exports invoiced in the yen rose rapidly between 1970 and 1985, moving from trivial levels at the outset of the period to two-fifths of all sales in 1985 (Sato, 1999; Oi *et al.*, 2003, Figure 1). Noting that Japan's share of global exports of goods and services had been rising strongly since 1960 (from 3% in 1960 to 5.7% in 1970 to 8.4% in 1985, Figure 2), with an even more pronounced increase in the area of trade most likely to be denominated in the currency of the exporter — manufactures (Grassman, 1973; McKinnon, 1979, Figure 3). Between 1980 and 1985, Japan surpassed Germany and the United States to become the world's largest exporter of manufactured goods.

The impact of the Plaza Accord and the associated reorientation of traded and non-traded activity among the G3 economies saw Japan fall back behind Germany and the United States by 1990. It should not be a surprise therefore that 1985 was the high point for yen denomination of Japanese exports. A 35% to 40% home currency share in export invoicing, as experienced by Japan between 1985 and 2002, is relatively low for advanced countries. Other major

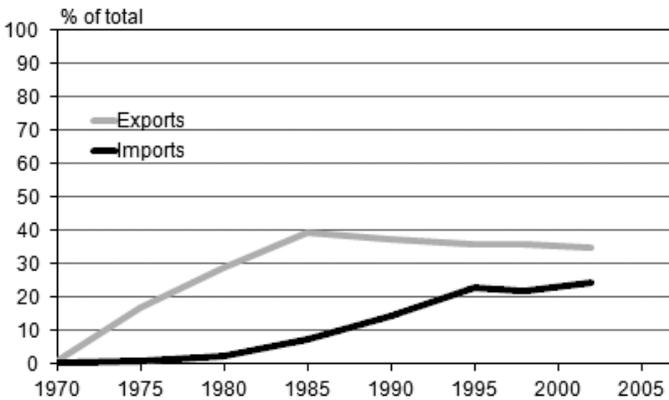


Figure 1. Share of Japanese trade invoiced in the yen.

Source: Sato (1999) and Oi *et al.* (2003).

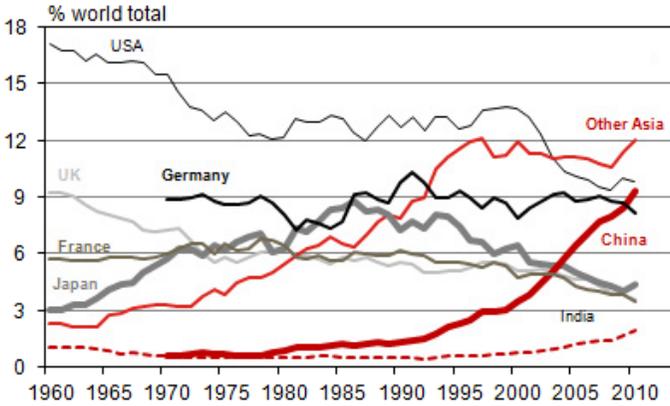


Figure 2. World export shares: Goods and services.

Source: WDI, Westpac.

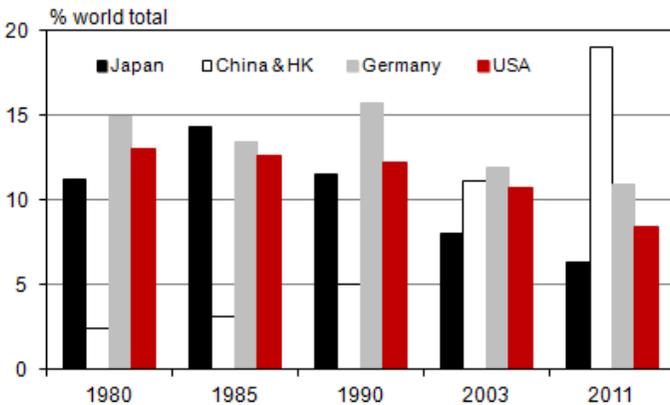


Figure 3. Manufacturing export shares.

Source: WDI, WTO.

economies range from one half (the United Kingdom), two-thirds to four-fifths (Germany, France and Italy) to almost 100% in the United States. An advanced, medium sized commodity exporter, Australia, denominates roughly one third of its exports in its own currency.

On the import side of the equation, yen denomination was much slower to move, and while it peaked later, it was at a lower level than for exports. The proportion of imports that were yen denominated remained trivial through the entirety of the 1970s before rising

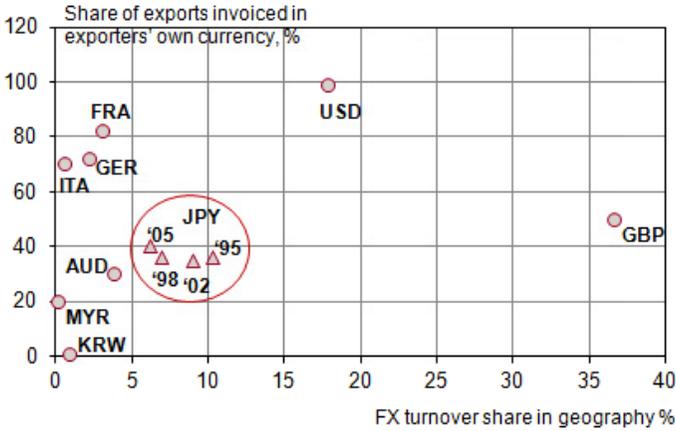


Figure 4. Trade invoicing and FX turnover.

Note: FX turnover data for 2010 except for Japan as specified.

Source: HKMA, Westpac Economics, BIS. Yun (2005).

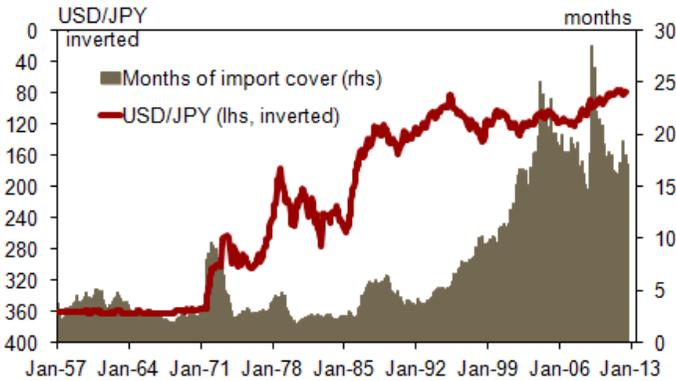


Figure 5. The exchange rate and FX reserve adequacy.

Source: IMF (2001).

steadily through to the mid-1990s to a little under one quarter of the total (Sato, 1999; Oi, 2003, Figure 1). The imprint of the substantial yen appreciation between 1985 and 1995 (Figure 5) can be read in the relative pathways for export and import denomination.

The literature on the underwhelming levels of yen trade invoicing and on the modest internationalization of the yen more generally has

focused on the following arguments:

1. US dollar denominated commodities form a major proportion of Japan's import basket.
2. The nature of intra-firm trade between Japanese based firms and their offshore subsidiaries, and the presence of large trading companies in the resources space, both served to concentrate foreign exchange risk in the firms most equipped to handle it.
3. The immature state of foreign exchange markets in Asia, where Japanese firms are very prominent, and the "original sin" of its trading partners in the region (Eichengreen and Hausmann, 1999) which pushes them towards the US dollar.
4. The lack of non-resident holdings of yen and a low demand for non-resident borrowings in the yen.<sup>9</sup>
5. The wide use of "pricing to market" strategies among Japanese and Asian exporters.

These factors lead to a bias towards the use of a vehicle currency — the US dollar — for much of Japan's trade, rather than its own currency. The official committee on yen internationalization (Japanese Ministry of Finance, 1998) focused its recommendations on the availability of trade finance in Asia; deepening the corporate understanding of the risks inherent in foreign exchange and the advantage of home currency denomination; and using trade invoicing as a "door opener" to drive greater demand for yen financial transactions. These points all relate to what the committee noted was a "vicious cycle" of under-developed markets for yen leading to low transaction volumes and ongoing under-development. This indicates a sophisticated understanding of the dynamics of vehicle currencies outline above, which work to limit entry and sponsor incumbency.

Based on their reading of the situation, these are all sensible suggestions, but they lacked the required game changing jolt to turn the "vicious cycle" virtuous. Where might this jolt have emanated from?

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<sup>9</sup>This point is made with reference to the non-financial sector in the 1990s and before. The famed "yen carry trade," whereby financial institutions funded themselves very cheaply in Tokyo and bought higher yielding assets elsewhere, which reached its heights during the Bank of Japan's original quantitative easing experiment in the early 2000s, is a special case.

There was one clear avenue of opportunity that was open to Japan to further the intermediate objective of establishing the yen as an international vehicle currency as a means of achieving the super-ordinate objective of establishing Tokyo as a first tier IFC. The official committee on yen internationalization states that “The currency used in invoices for trade transactions is determined by such factors as *relative market power*, the currencies in which *international commodities* are invoiced, and trade structures (*ibid.*, author’s italics).”

Japan’s strategists need not have looked far to find commodity markets where they had considerable market power, thereby taking advantage of one aspect of the currency invoicing outcome and breaking a legacy mindset that was holding back progress towards the IFC goal. The argument here is that Japan was too timid in working towards denominating its major commodity imports in yen, particularly where benchmark prices were negotiated rather than traded on an exchange. After all, just as it was the world’s largest exporter of manufactures in 1985, it was the largest steel producer with almost one quarter of global output, and it was also the largest importer of fuel and mining products in the same year, narrowly surpassing the United States (Figure 6). While with hindsight we see that this was a temporary situation, we can be certain that many contemporary observers would have expected that ranking to persist having been caught up in the “Japan as number 1” euphoria of the times.

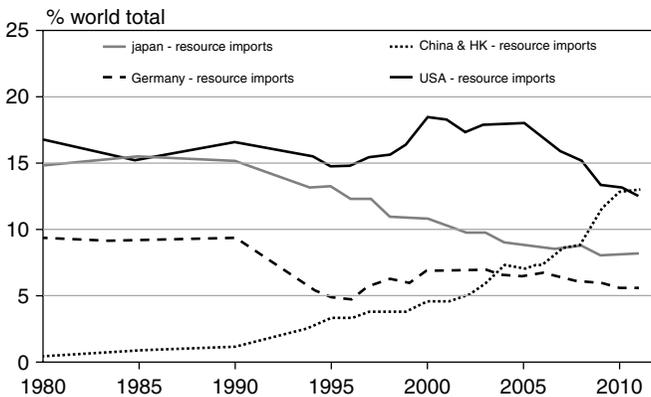


Figure 6. Resource import shares.

Note: Resource imports defined as “fuel and mining” products.

Source: WDI, WTO.

Japan was able to shape the trade in specific non-exchange traded commodities related to steel making to its liking in almost all ways but currency of denomination. Consider the international trade in iron ore and metallurgical (or coking) coal, the two major primary inputs for crude steel production. Until a few years ago, the price of these commodities was set at annual contract negotiations between the Japanese steel mills (the JSMs, often represented by the giant Nippon Steel as lead negotiator) and the major resources companies, principally the Australian headquartered global titans, BHP Billiton and Rio Tinto<sup>10</sup>, and their forerunners. The contract period reflected the *Japanese fiscal year*, beginning on April 1st. *Japanese trading companies* had *substantial equity stakes* in joint ventures to develop the assets. The price negotiations were based on long term considerations, with statistical and anecdotal evidence arguing that neither side pushed for dramatic short run concessions based on cyclical shifts in negotiating power, even though the Japanese clearly had the benefit of inside information based upon their equity stakes in many major projects (Oczkowski, 1993).

The US Geological survey estimated that 82% of Australian iron ore exports went to Japan and the rest of Asia in 1985, with the remainder going to Western Europe (Kuck, 1985, p. 526). Even as late as 2002, Japanese imports of Australian iron ore exceeded those of China, who today dominates the trade.<sup>11</sup> If the various interested parties had been focused on internationalizing the yen as an overarching national goal (the Ministry of International Trade and Industry, the Ministry of Finance, the JSMs themselves, the major trading companies involved in the commodity trade, especially Mitsui and Mitsubishi, the major banks, the domestic consumers of steel and steel products, the various industry associations plus the influential peak business association *Keidranren*) then the JSMs would surely have been requested to negotiate hard for yen denomination of the iron ore and metallurgical coal contracts and would have

<sup>10</sup>The Brazilian company Vale, nee CVRD, was the largest producer of iron then as now, but Australia's proximity (lower freight costs) and stability (noting the unstable policy and economic environment in Latin America in the 1980s and 1990s) made Australia unambiguously the best contract partner.

<sup>11</sup>Customs data accessed via the CEIC database. The primary source for China is the General Administration of Customs and for Japan it is the Ministry of Finance.

been provided with whatever support was deemed necessary. An Australian dollar–Japanese yen foreign exchange swap line between the Bank of Japan and the Reserve Bank of Australia perhaps?

There would certainly have been some reluctance on behalf of the Australian sellers of the resource. An issue for Asian economies that have soft levels of foreign competition in their home markets is that there is little two-way trade conducted by foreign firms outside of the vertical production networks. Two-way transactions are vital as they create the incentive to invoice in the home currency of the trading partner as the firm has both revenues and costs in that unit. One-way transactions only — closed end importing or exporting by the foreign party — argues for either home invoicing by the foreign party or the use of a vehicle currency. For the major resource companies, it would have been costly to convert yen revenues to a currency in which they had obligations — wages, debt servicing, capital goods investment — to meet. Their yen cost bases would have been negligible — essentially running representative offices. However, if Japan simultaneously made great efforts to raise the level of yen invoicing of its exports, the conversion costs for the firm paid in yen would fall as the global market for the currency deepened. Another issue is that, when a currency is expected to appreciate in the longer run, as the yen certainly was in the 1980s, non-residents will be reluctant to accrue obligations in that currency, as they will either need to hedge, which is expensive, or run valuation risk, which is also potentially very costly.

### *Reform of international financial arrangements and the domestic financial system*

At the time of US President Nixon's decision to cease US dollar convertibility to gold, thereby effectively ending the Bretton Woods fixed exchange rate system, the Japanese yen was fixed at ¥360 to the US dollar, exchange arrangements were still highly restrictive, a Glass–Steagall like separation between banking and securities business was in place, interest rates were regulated at repressive low rates and the economy ran small trade surpluses and small current account deficits. From the early 1970s forward, Japan progressively moved towards a more flexible exchange rate and a more open capital account.

Its domestic financial markets deepened appreciably as high household savings and high corporate profits generated virtuous circles of wealth creation. The economy began to produce consistent current account surpluses from the immediate aftermath of the first oil shock. The country's traditional post-war shortage of foreign exchange was reversed and foreign assets begun to build quite rapidly. Japan was a net international creditor in 1980 and it would become the world's largest international creditor in the decades to come. A great deal was achieved in a relatively short space of time. However, the sum of these achievements — added to the documented failure to establish the yen as a major vehicle currency — was not sufficient to establish Tokyo as a first tier IFC ahead of the nation's 1990s decline, which ultimately prevented further advance.

The yen appreciated against the US dollar (and in broad effective terms) in fits and starts in the 1970s. From the Bretton Woods fixed rate of ¥360 to the dollar that held through the 1950s and 1960s, it appreciated to ¥308 after the Smithsonian Agreement of December 1971; it was trading at ¥270 at the end of February 1973 after it was officially floated on the 14th of that month; it appreciated to ¥176 by October 1978. From that point the contractionary monetary policies of the Volcker-led US Federal Reserve sponsored US dollar strength deep in to the 1980s. The yen averaged ¥236 in the five and a half years of the 1980s leading up to the Plaza Accord of September 1985. Following this compact between the G5 nations to depreciate the US dollar, the yen appreciated rapidly, given the existence of a by now very large current account surplus.

The Japanese authorities attempted to manage the rate of currency appreciation throughout this period, which saw foreign exchange reserves rise from two months worth of import cover ahead of the Plaza Accord to five months worth of import cover in December 1987 (Figure 5). The G6 Louvre Accord of February 1987 (noting that Canada attended the Louvre but not the Plaza) temporarily stabilized the US dollar, but the yen kept rising after a slight pause, ending the year at ¥123. All told, by the end of 1987 USD/JPY had moved 66% in the yen's favor since the collapse of Bretton Woods.

While the yen was appreciating, the Japanese authorities were performing a sequenced and gradual opening of their capital account

while moving more cautiously on financial deregulation (Aramaki, 2006, Table 1, pp. 186–191). The reform sequence pursued by the Japanese began with trade liberalization and the allowance of foreign direct investment inflows. The initial moves in these fields go back to the first days of independence from the administration imposed by the Allies.<sup>12</sup> That framework persisted through the 1960s, with some selective forms of portfolio capital inflow allowed from 1964, with general support for the progressive pursuit of capital account convertibility formalized in 1967 (Table 1).

Deregulation of cross border capital flow proceeded through the 1970s and was made both more complicated and more urgent by the demise of the fixed exchange rate system and the oil and financial crises of 1973–1974. However, reforms were not symmetric. They sought to increase capital inflows in the first instance, reflecting the

Table 1. Various reforms relevant for the IFC criteria.

	First post-war reform	Criterion fully met
Capital account convertibility	1967	1984
Unrestricted inward portfolio equity	1964	1973
Unrestricted inward portfolio debt	1964	1980
Unrestricted outward portfolio equity	1970	1980
Unrestricted outward portfolio debt	1970	1980
Floating currency	1971	1973
AAA status	1975 (gained status)	2001 (lost status)
Deregulated interest rates	1979	1993
Active central bank market making	1985	1996
Bond issuance by all forms of financial institutions	NA	1999
Banking/securities business separation	1992	1999
Foreign borrowing by local firms	1960	1964
Yen borrowing by non-residents	1970	1977
Outward direct investment	1969	1972

*Sources:* Aramaki (2006), McKay (1999), Standard and Poor's Financial Services LLC (2012).

<sup>12</sup>A fascinating insider account of some of the domestic economic reform conducted by the Allied administration can be found in Hadley (1970).

needs of the time, and were slower to liberalize outflows. There was even a period of temporary regression towards stronger regulation of capital outflow in times of stress (Aramaki, 2006). Reforms of the domestic financial system itself lagged behind those relating to exchange arrangements and exchange restrictions (Table 1). This strategy appears to describe a textbook path for a middle income economy looking to modernize while simultaneously maintaining domestic stability. *What it is not is the description of an economy with a super-ordinate goal to enter the top tier of IFCs within a decade or two.* This path of policy betrays the key point highlighted at the outset: Japan did not behave in the 1970s and first half of the 1980s as if it had a super-ordinate national goal of establishing Tokyo as a competitor for New York and London. And history shows that moving to do so later missed the window of opportunity.

Returning to Table 1 and considering the subsidiary IFC criteria outlined, it is easy to see that at the time when Japan's economic momentum and share of global aggregates was at its peak between 1985 and 1990, those related to the domestic financial system were not particularly competitive. Consider these criteria in turn against the Japanese experience:

“A market making central bank-primary dealer complex in the key financing vehicles of the day — whether the discounting of bills of exchange, government securities on repo/reverse repo or commercial paper.”

There was a flurry of activity on this front in the mid 1980s, with a yen denominated bankers acceptance market and money market certificates established and introduced respectively in 1985 and the introduction of commercial paper (CP) in 1987. However, a repo market was not established until 1996, well after the slowdown of the economy, declining asset prices and much publicized trading scandals<sup>13</sup> had begun to sap international confidence in Japanese financial markets.

<sup>13</sup>The “loss compensation scandal” involved the revelation that 17 securities firms had been making their best clients whole on equity trading losses (a scandal that engulfed the heights of politics and the bureaucracy) was particularly damaging for the reputation of the financial markets. For further details see Char (1993).

*“A broad variety of financial assets to cater for the appetites of a diverse domestic and international investor base. This tends to prioritize the development of non-bank, arm’s length financing channels (direct equity and debt raisings principally). A broad variety of financial institutions to cater for diverse intermediation functions. These institutions will also have a global footprint. At the very least, an internationally competitive cluster of banking, insurance and funds managements firms must be present.”*

Japan certainly had an active capital market through the 1980s, highlighted by the “*zaiteku*” (literally “financial technology”) era (McKay, 1999), although it operated within an oligopoly structure. Japan inherited a strict separation between securities and banking business from the Allied occupation. This was both an “off the shelf” policy from the United States (the Glass–Steagall Act of 1933) and an attempt to limit the power of the *zaibatsu* banks in postwar Japan. The securities business grew to be dominated by a “big four” with a direct market share of Tokyo Stock Exchange turnover of around 40% and an indirect share close to 60% in the late 1980s (Char, 1993, p. 180). These firms enjoyed a very lucrative, protected underwriting business in the 1980s as the equity market boomed and large firms increasingly moved to raise funds directly.

On the banking side, the industry was also highly concentrated, but it was also strictly fragmented by activity, with distinctions between “long term credit banks,” “city banks,” “regional banks,” “trust banks,” “shinkin banks” and other deposit taking institutions. There was also a group of large but staid insurers and funds management firms. The strict separation between securities and banking business was abolished in 1992 and the banking compartments were progressively removed through the 1990s as well, leading up to the “big bang” financial system reforms of 1998 (of which more below).

Japanese banks did achieve a reasonable footprint in global finance by the end of the 1980s. Indeed, the market capitalization of Japan’s major banks was world leading, courtesy of inflated balance sheet valuations from their cross shareholdings of equity and their exposure to the real estate bubble, and the equity bubble itself. Japan’s share of the gross international financial exposures of the G4 (international assets plus international liabilities, Figure 7) grew sharply in the second half of the 1980s to be equal to the United

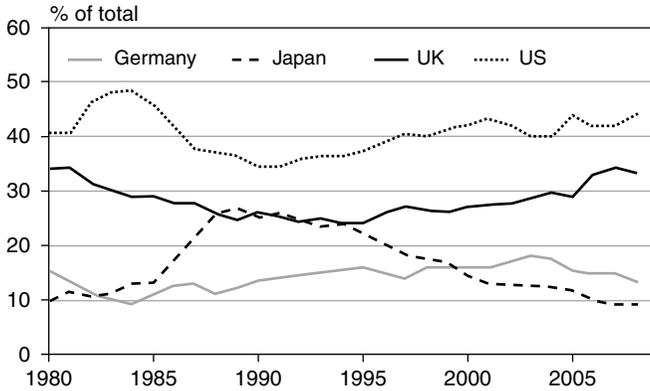


Figure 7. Shares of the G4 international financial position.

*Note:* Sum of each country's gross international assests and liabilities as a proportion of the G-4 total.

*Source:* IMF, Westpac.

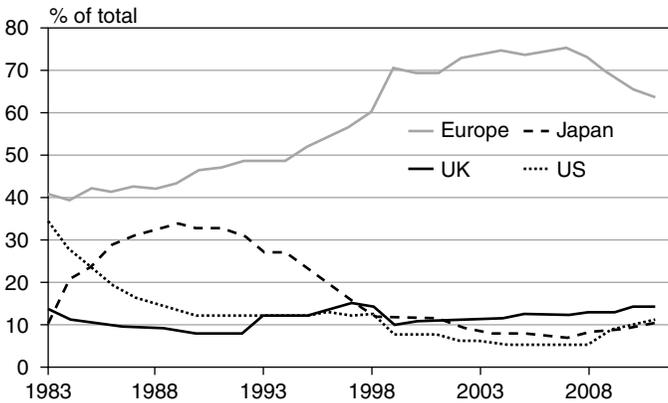


Figure 8. Shares of foreign bank claims: Total.

*Source:* BIS, Westpac.

Kingdom and well ahead of Germany. Japan's share of total cross border banking claims surpassed that of either the US or the UK in the 1980s, to be second only to the combined position of the Europeans, whose home economies would soon enter into a monetary union and provide the first genuine alternative to the US dollar as a global vehicle currency since the interwar period (Figure 8). Japan's

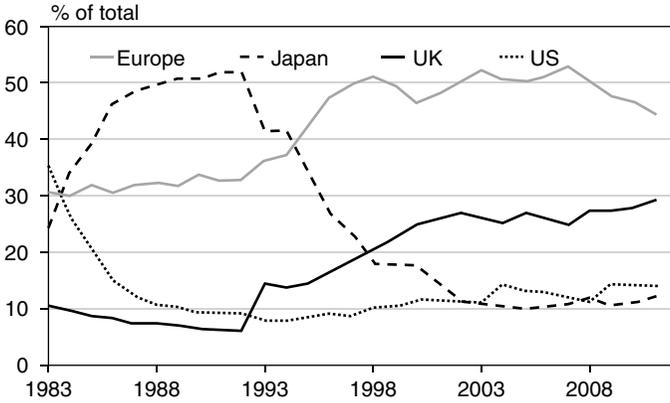


Figure 9. Shares of foreign banking claims on Asia.

Source: BIS, Westpac.

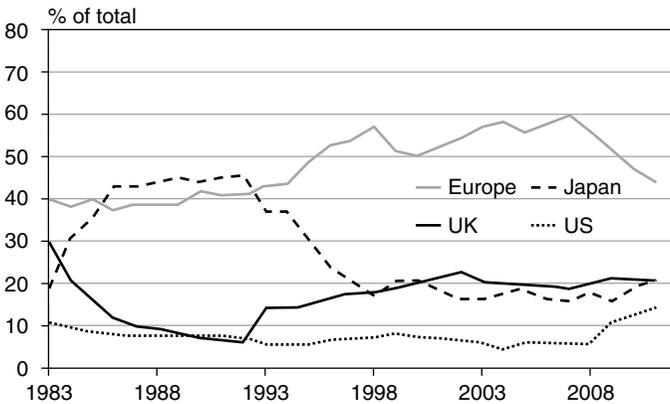


Figure 10. Shares of foreign banking claims: Offshore financial centers.

Source: BIS, Westpac.

international position was even more positive in two subsets of this data: claims on Asia and claims on offshore financial centers (hereafter OFCs, noting Singapore and Hong Kong are in both of these two categories, Figures 9 and 10). Note that the Asian crisis was not the peak for Japan’s share of banking claims on Asia or on OFCs. The peak was early in the 1990s when Japan’s domestic bubble burst and asset quality began to decline at home. So even as Japanese non-financial firms, particularly manufacturers, rapidly increased their

direct investment in emerging Asian countries through the middle 1990s, Japanese banks were in retreat.

“A regulatory framework that is seen as a credible check on excesses without stifling innovation. A legal framework that is transparent and predictable. Other support services such as accounting, IT, and specialist higher education offer economies of scale and scope to financial institutions that choose to base their activities in IFCs.”

The “big bang” was an explicit effort to address Tokyo’s shortcomings relative to London and New York. The reforms liberalized equity trading commissions and over-the-counter business; sought to accelerate competition across the institutional compartments previously kept separate; a new exchange for the listing of small, high growth companies was devised (MOTHERS) and a NASDAQ affiliated exchange was planned; and a new regulatory framework modeled on the United States’ Securities and Exchange Commission was instituted. Later, the cross shareholdings of banks were forced to be divested, increasing the proportion of freely floating shares used for the purpose of calculating the composite market capitalization indices against which global fund managers benchmarked their performance.

“A demonstrated ability to consistently and transparently allocate large amounts of capital to productive uses. A liquid market for anchor risk free assets in the home currency.”

All these moves were positive but they were overshadowed by the dramatic rise in non-performing loans of the banking system as asset prices collapsed from their peak levels. The system entered a full blown solvency crisis ahead of the “big bang,” amplified by the onset of the Asian Financial Crisis. The Japanese government’s own large debt and the contingent liabilities emanating from the banking system served to undermine its status as a risk free issuer around this time. While the formal downgrade from AAA would not come until 2001 (Figure 11), foreign investors had seen enough well beforehand. These reputational losses were irreparable in terms of the first tier IFC criteria, noting that New York looked more formidable than ever at this time, while the introduction of the euro pushed the yen down

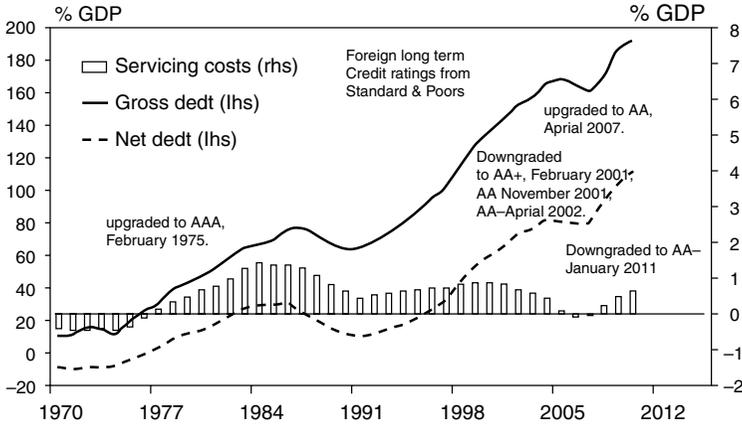


Figure 11. Japan's public debt and its credit rating.

Note: Author calculations.

Source: OECD (2013).

the pecking order from the moment of its formal arrival on January 1, 1999.

### Conclusions on Tokyo's Ultimately Unsuccessful Bid for First Tier IFC Status

This chapter has argued that establishing Tokyo as a first tier IFC was never a super-ordinate goal of national economic policy until the middle 1990s, by which time the window of opportunity had truly closed. This late recognition prevented a strategic approach to maximizing the obvious potential inherent in its earlier bid. The reform decisions of policymakers in the 1970s and 1980s were too gradual, particularly in relation to financial system deregulation, and were thus ultimately ineffective in boosting the competitiveness and attractiveness of Tokyo to first tier levels before the weakness of the economy and the banking system prevailed over all else.

The inability to establish the yen as a competitive international vehicle currency, which was and is reflected in the low proportion of yen invoicing in Japan's own trade, is the mascot for Tokyo's *second tier* IFC status. Yet, perhaps it is unfair to criticize too much. Japanese policymakers could not have had perfect foresight of either a) what Japan would look like in 1985 from the perspective of 1973 or

b) what Japan would look like in 1998 from the perspective of 1985. Decisions were made at each time based upon visions of the future that were in the first instance both too cautious and too humble and in the second instance both too cautious and too proud.

With hindsight it can be shown that greater aggression towards the expansion of yen trade invoicing, if successful, might have instigated virtuous dynamics in the vehicle currency arena with the associated positive spillovers for Tokyo's IFC status. Even so, Japan's economy was never going to be larger than that of the United States, and thus, New York would have always retained the edge in scale over Tokyo. Furthermore, London had two centuries of experience as a first tier IFC. Tokyo sat at the center of a financially repressed, closed system in the 1950s and 1960s, and a system in transition in the 1970s and 1980s. That was not really a fair fight either. Tokyo would have moved closer to first tier IFC status in the late 1980s if Japan had prioritized the goal earlier and acted accordingly; but it would not have changed the ultimate result that Tokyo has settled down as a very important but not dominant centre for international financial activity.

### **Implications for Shanghai's Potential First Tier IFC Status**

When Japan first had international financial openness thrust upon it by the demise of the Bretton Woods system, it had recently achieved the \$8,000 GDP per head level (1990 international dollars). Conveniently, China achieved the same per capita living standard in 2011. Both economies experienced very strong rates of per capita economic growth leading up to the \$8,000 GDP per head landmark. Japan quadrupled its GDP per head from \$2,000 to \$8,000 in 17 years, while China took one year less, beginning in 1995 (McKay and Song, 2013, Table 5.1). Figure 12 depicts some key relative fundamentals for the two economies at the \$8,000 GDP per head level, with Japan serving as numeraire and South Korea included as a further point of comparison.

The figure shows that China's current structure and overall development characteristics differ in some fundamental ways from Japan's when it was an \$8,000 per head economy. Japanese average education

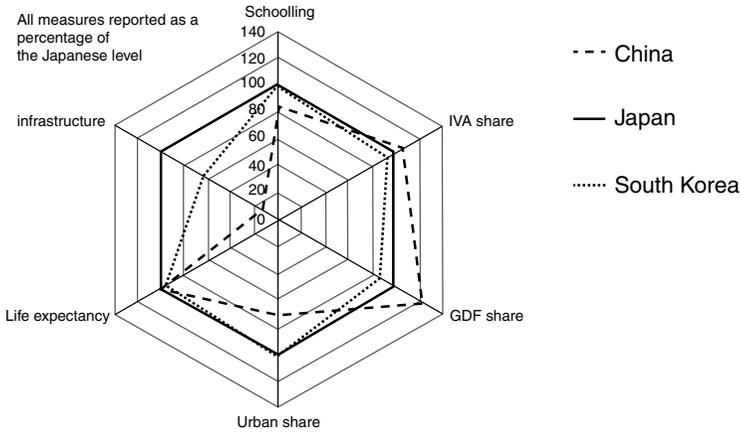


Figure 12. Selected economies at \$8,000 GDP per head.

*Note:* All measures reported as percentage of the Japanese level. “Schooling” refers to average years of schooling per adult. “IVA share” and “GCF share” refers to the percentage of GDP accounted for by industrial production and gross investment respectively. “Life expectancy” is at birth. “Infrastructure” is open rail network length scaled by 2010 land area. “Urban share” is the percentage of the population classed as urban by the United Nations in their 2011 revision. All information on post second world war GDP and GDP per capita levels are from the Conference Board (2012), and are in 1990 Geary Khamis dollars.

*Source:* Adapted from Figure 5.2b in McKay and Song, 2013.

levels were greater than China’s; Japanese urbanization was considerably greater and its infrastructure stock considerably deeper; while the share of overall activity in industrial production and investment in Japan was below the equivalent Chinese levels. The comparisons between China and South Korea are similar in absolute terms to the Sino–Japanese relativities, but the divergences are somewhat less pronounced. This implies that China’s industrialization is less mature at the \$8,000 per head level than it was at the same stage for its North Asian neighbors. Noting that China also exhibits a much higher export orientation today than Japan ever did, alongside a much great reliance on inward foreign direct investment in manufacturing; China has the luxury of a large current account surplus, while Japan still ran current account deficits at the \$8,000 per head

level; while China has a substantially higher rate of income inequality than did Japan. Ergo, there are a number of material points of difference between the two real economies at the starting points of their respective financial deregulation eras.

Put simply, Japan had a more balanced economy at the \$8,000 per head level than China does today, which implies Japanese policymakers had fewer structural legacies to be taken into account in designing and adoption a holistic approach to financial reform. The situation in China is replete with structural legacies that must be acknowledged and incorporated into the design of policy.

The recent remarks of the new Premier, Li Keqiang, reported by official news agency Xinhua (2013b), are clearly in sympathy with this assessment. Speaking at a macroeconomic seminar on April 12, 2013, which brought together policymakers, scholars and industry representatives, Li stressed that the deepening of reform was vital to the sustainability of growth and that any counter cyclical efforts would be considered in the context of their longer term structural implications and their impact on the reform path. The exact reporting was as follows:

*“While effectively coping with short-term problems and maintaining reasonable growth, more efforts should be made to improve the quality and benefits of development, with a focus on promoting economic restructuring and upgrading, expanding employment and increasing people’s incomes, . . . the impetus for sustained development lies in deepening reform, urging targeted policies to cure not only ‘symptoms’ but deeply-rooted problems in the Chinese economy. . . If interim measures have to be carried out, they should not set up barriers for promoting market-oriented reform and development in the future (emphasis added).”*

The State Council memorandum on income distribution reform, which cuts across all relevant aspects of macroeconomic decision making, released on February 5, 2013, was also very realistic. It stated that “deepening the income distribution reform is a systematic project that is arduous and complicated and concerns the reallocation of various interests. There is no way to accomplish it overnight.” (*Xinhua News*, 2013a).

When Li urged “targeted policies to cure not only ‘symptoms’ but deeply-rooted problems” it is an acknowledgment that a redesign of the major parameters that describe the current capital allocation system ought to be on the agenda. Arguably, establishing a super-ordinate goal to raise Shanghai to first tier IFC status could play a galvanizing role in the reform process, assisting policymakers to move forward with focus and resolve.

Disentangling the complex web of the many tiers of the banking system, shadow finance, exchange arrangements and the exchange rate-monetary policy regime is no simple matter. It is not just that capital is too cheap for certain large firms. Household savers are poorly remunerated as a consequence of historically regulated deposit rates that often failed to compensate for inflation. A lack of financial market development and exchange arrangements that disallow most forms of private outward portfolio flows provides a limited menu of alternative investment options, leading to a crowded real estate investment market, which causes fundamental socio-economic problems of its own. Small, private firms often pay too much for their capital. Chinese firms are advantaged in foreign markets by the competitive exchange rate, raising export orientation, while importers are disadvantaged by it, lowering domestic absorption. If China addresses each of these shortcomings with a view towards achieving a more balanced and inclusive growth model, a happy consequence will be that Shanghai becomes a more viable candidate as a major IFC.

There has been much activity in the fields of domestic and international financial liberalization already (Huang, 2001; Ma, 2006; McKay, 2007; Hong Kong Monetary Authority, 2010). Greater flexibility in setting deposit and lending rates has been introduced, although they are not yet fully free. The domestic bond market has been encouraged as an alternative source of both private and public financing. Loan securitization and short selling have both been introduced. Exchange rate flexibility has been increased progressively after the peg to the US dollar was abandoned in 2005; foreign exchange reserve accumulation has leveled out; the supply of RMB now available outside the Mainland has increased rapidly as part of the trade settlement program, the centerpiece of the internationalization initiative; the Qualified Foreign

Institutional Investor (QFII) program, the Qualified Domestic Institutional Investor (QDII) program and a new Renminbi QFII program have been revamped or instituted; and outward flows of direct investment have continued to enjoy policy sponsorship. Furthermore, since the middle of 2012, the People's Bank of China (PBoC) has increasingly relied upon its open market operations to manage domestic liquidity and credit conditions, rather than the traditional administrative tools of required reserve ratios, window guidance and lending quotas. And in a further move towards sophistication, rather than issuing or purchasing bills, reverse repurchase agreements dominated open market operations in 2012, when liquidity was being increased, while repurchase agreements have been used in 2013 so far to keep liquidity from expanding too quickly.

All of this activity points in the right direction and improves China's standing on the IFC criteria outlined in the first section of the chapter. Yet moving more swiftly on interest rate liberalization, particularly with regards to deposit rates, would be a welcome move. An unintended consequence of the slow movement towards deregulation of interest rates has been the rapid growth of off balance sheet activity by the banks and a rise in the market share of non-banks in total credit supply. While such developments are desirable as part of an effort to deepen domestic financial markets, extraordinary growth in lightly regulated areas of the financial system unavoidably comes with heightened systemic risks. Japan's decision to move slowly on deregulation was exposed as a flawed approach from an IFC perspective (and any other perspective, to be fair, given the depth of the resultant problems) when accumulated financial risks burst to the surface in the early 1990s, and have served to hamstring the economy since.

Moving on to the monetary policy–foreign exchange nexus, in concert with the moves to increase the power of market forces in setting the domestic cost of capital, exchange rate flexibility has increased in material fashion since 2005, to the extent that the currency is an accepted element of the counter cyclical toolkit. While the daily volatility of the currency within the present band of plus–minus 1% remains low, there have been official statements that a further widening of the band is just a matter of time. To quote PBoC deputy

governor Yi Gang directly, who spoke at an International Monetary Fund meeting in Washington DC on April 18, 2013:

“Last year we increased the band for the exchange rate from 0.5% to one percent. I think in the near future we’ll increase the floating band even further. . . In China, we all do this kind of reform in a gradual manner. The direction is clear.” (*People’s Daily Online*, 2013).

The desire to maintain a gradual approach to exchange rate flexibility emanates from China’s structural legacies, the most obvious of which in this context is its high degree of export orientation, and the psychological difficulty of changing a winning formula. The success of China’s gradual approach to financial reform through its transition era has been rightly celebrated. Yet when a new model is required, rather than a marginal evolution of business as usual, a bolder strategy becomes more appropriate. Given Japan’s failure to establish the yen as a true international vehicle currency has been identified as a prime shortcoming in its first tier IFC bid, if China is serious about Shanghai’s bid, then RMB internationalization should be advanced aggressively and move beyond trade settlement forthwith.

It was noted that Japan was temporarily the world’s largest importer of fuel and mining products in the mid 1980s (Figure 6). The same figure shows that China (including Hong Kong) recently surpassed the United States to ascend to the same position. Given the United States’ diminished expected appetite for imported fuels with the massive exploitation of its domestic unconventional gas and oil reserves (International Energy Agency, 2012: BP, 2013), and the expected upward trajectory in Chinese resource demand per capita as its development proceeds (McKay, Sheng and Song, 2010: UNDP, 2010), China’s time as the number one importer of fuel and mining products will be anything but brief.

Like Japan in its high growth era, China’s growth has taken a very metal intensive path, which in tandem with its great size, has put it in a very powerful market position in the international trade for iron ore (Sheng and Song, 2012). Indeed, China’s abrupt rise to dominance in the market for steel making inputs served to fracture the Japan-centric institutional arrangements that had been developed over the previous decades. It does not take a great stretch of the

imagination to surmise that a proportion of the international trade in commodities will be re-denominated in the RMB once its supply outside of the Mainland reaches a critical mass. Or less abruptly, once portfolio flows are substantially deregulated, China's onshore commodity exchanges (based in Shanghai) where prices will be quoted in RMB and trades settled in RMB, could become the locus of world trade in resources. Similar arguments might be made for the international trade in food staples and shipping contracts, echoing London's agglomeration benefits dating back centuries. Such developments would no doubt ignite the dynamics of "scale begetting scale" in the vehicle currency domain that Krugman has highlighted. Yet before we get too advanced in that direction, we must acknowledge the point made by the Japanese Ministry of Finance (1998): that a "vicious cycle" of under-developed markets for yen led to low transaction volumes and ongoing under-development that served to limit entry into the vehicle currency arena and to sponsor incumbency. This is a "chicken and the egg" problem that despite China's likely future scale advantages may still need a jolt to initiate the desired dynamics for the latecomer and their counterpoint, adverse dynamics for the incumbents.

To tackle the "vicious circle" of under-developed foreign exchange markets and turn the cycle "virtuous," China's exchange arrangements must be liberalized to allow offshore parties to acquire, accumulate, invest and hedge in the RMB in such amounts that transaction costs decline materially. In this regard, Ma and McCauley (2013) note that while China has become progressively more open financially over the last decade, it is significantly less open than India, a much smaller and less developed economy. A major difference between the two countries is that China's current account surplus allows it the luxury of choice in terms of the types of capital inflows it will allow, whereas, India's large external deficits (and the fact that the financing of the fiscal deficit has first call on the finite domestic savings pool) force it to be more open to both portfolio and lending flows. Recalling the discussion with regards to the Japanese sequence of international financial liberalization, as it spent the 1950s and 1960s with a current account deficit and a shortage of foreign exchange, exchange arrangements were oriented toward

the attraction of foreign capital as well as the retention of domestic savings. China is presently seeking to retain private domestic savings and attract only high quality capital, while repelling most “hot money” style flows (McKay, 2007). It was only when Japan began to run consistent current account surpluses from the middle 1970s that it felt more secure in allowing private portfolio outflows (Table 1). In short, Japan’s approach was an asymmetric one regarding inward and outward portfolio flows, with the former allowed first (during its external deficit era) and the latter almost a decade later, in its external surplus era.

China’s current account surplus — diminished from the pre financial crisis peak above 10% of GDP but still significant at 2–3% of GDP in recent years — is thus a source of comfort for policymakers seeking to liberalize exchange arrangements. The counterpoint is of course the prospective vulnerability of the domestic banking system to a more competitive environment for depositor funds. As argued above, domestic interest rate liberalization is required to modernize and commercialize the Chinese financial system. Deposit leakages are a necessary evil in this process. The example of South Korea is instructive. After the Asian crisis, Korea successfully pushed through the middle income phase of its development to achieve high income status. One element of this process was that South Korea successfully transitioned from a repressed to a relatively open financial system over the last decade and a half, with banks replacing some of their deposits with wholesale financing, deepening domestic capital markets along the way, which in turn has accommodated a move towards an inflation targeting monetary policy regime. Furthermore, Korean Treasury bonds have become a highly traded asset by international investors with the liberalization of inward and outward portfolio flows, deepening capital markets further and increasing turnover in onshore foreign exchange markets and offshore trade in non-deliverable forward markets of the Korean won.

It is possible to infer a relationship between macroeconomic stability, GDP per capita and financial reform in developing economies. My abstract conception of this relationship is depicted in Figure 13. I have refrained from using actual values on the GDP per capita axis, as the precise point at which these hypothesized curves cross

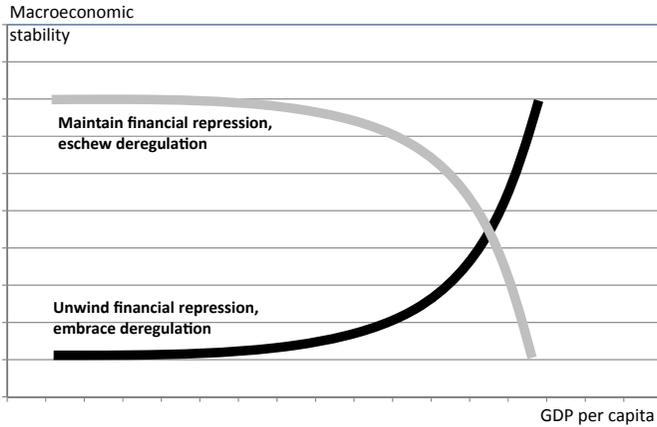


Figure 13. The relationship between macroeconomic stability, GDP per capita and financial reform in developing economies.

*Note:* Authors' own conception.

is unknowable, and may vary considerably based upon the strategy each individual economy has taken towards its financial system in the context of its industrialization. That said, recalling the initial discussion and peer review of China's industrialization path and mode, in this framework it seems entirely reasonable to pursue a gradual approach to financial reforms at a GDP per capita level of \$2,000. However, at \$8,000, the implicit cost-benefit analysis of that strategy, where macroeconomic stability is the ultimate objective, will be less clear cut. Cognizant as I am of the wisdom of the State Council, that "deepening reform is a systematic project that is arduous and complicated. There is no way to accomplish it overnight," (Xinhua News, 2013a) which are especially relevant sentiments regarding financial matters, I respectfully submit that the China of today, in search of a new model, cannot be far from the crossover point in Figure 13, if it is not already there. Korean policymakers perceived that they had persisted too long with the grey (conservative) schedule in Figure 13, and jumped onto the black (reformist) schedule, acknowledging the signal from the financial failures of the 1990s. The decision has been a good one. While Seoul never had a realistic aspiration to reach first tier IFC status, a similar leap from the grey to the black schedule at the opportune moment,

alongside China's prospective dominance of real economy flows in coming decades, would be a powerful combination serving Shanghai's first tier IFC bid.

Deepening financial deregulation assists with the reduction of specific distortions that create rents and skew resource allocation (the low cost of capital for certain firms and industries), it would address asymmetric opportunities that lead to and inflame imbalances (improve entry conditions to boost competition, improve access to finance for private firms and households), and work to minimize macroeconomic risks, and enhance macroeconomic benefits, in a more general way (reducing systemic risk through increasing the proportion of capital allocated on commercial market principles). It brings risks of its own, which have collectively cowed many governments in emerging economies in recent decades (Calvo and Reinhart, 2000), with heightened exposure to foreign exchange and interest rate movements, foreign counterparties, new and complex instruments and greater market discipline for Chinese borrowers and lenders not used to such external oversight among the catalogue of "fears." Of course, successful internationalization of the RMB will reduce systemic foreign exchange risk, although as Cheung, Ma and McCauley (2010) illustrate, China's position as a large international dollar creditor means it is already extremely "long" foreign currency as a nation (primarily via the sovereign balance sheet at this point) and is consequently exposed to major valuation risks on its immense portfolio that cannot be realistically hedged either at the level of the exchange rate or at the underlying instrument level. It is worth recalling the enormous foreign exchange losses imposed on Japanese holdings of US dollar denominated assets in the decade following the Plaza Accord.

It was noted above that China's average schooling levels presently lag behind those seen in Japan and South Korea at the same income level. At the level of higher education, China has no universities in the top 200 social science departments, which is where global finance professionals are usually trained. Human capital is of course the backbone of an IFC once the policy infrastructure is put in place. So a shortfall here could possibly hold Shanghai, China back. However, Marginson (2012, p. 25), reports that Shanghai's schools were the

best performed in the world across the three core disciplines of reading, science and mathematics in the 2009 OECD PISA tests. So while China as a whole is yet to reach the average levels of schooling seen in Japan and South Korea at \$8,000 per head, Shanghai itself is something of a center of excellence in secondary education outcomes. This may translate into a strong next-generation white collar labor force. This dichotomy is noted in the most recent OECD survey of the Chinese economy (OECD, 2013, p. 91), which produces evidence that the quality of education delivery is highly variable by region and hukou status.

The national education figures raise a broader question about the adaptability of the current work force to a new model that is focused less on heavy industry and more on the consumption of services. Being home to a first tier IFC is of course one highly tangible expression of a complete transition to a services driven economy. Perhaps this image will resonate with policymakers as they ponder the optimal timing to enact the necessary steps required to pursue that goal. Or if that is too presumptive a statement, perhaps the establishment of a super-ordinate national goal to establish Shanghai as a first tier IFC by, say, 2030, can be seen to offer a focal point for reforms and to galvanize individual policymakers who may see the present program of rebalancing initiatives as somewhat nebulous and lacking a centre of gravity.

## **Conclusions**

Tokyo never reached the first tier of IFCs. The basic failing in this quest was an inability to establish the yen as an international vehicle currency. Given the likely future scale of China's economic and financial footprint, it seems reasonable to venture that the RMB has an excellent chance to become a genuine international vehicle currency at some point, thus succeeding where Japan fell short. On the other hand, China is in the very early days of international and domestic financial reform, and Shanghai is presently extremely disadvantaged by a lack of indigenous expertise and experience in international finance, and some pronounced shortcomings across the vast majority of the soft infrastructure demanded of first tier IFCs. China,

of course, has time on its side to build such expertise, as it will be the world's largest economy for at least the next two generations, a luxury never afforded to Japan. Even so, the imperative for a new growth model in China is more urgent than that, and the IFC goal may usefully serve as a galvanizing force in the overall reform process, assisting policymakers to move forward with focus and resolve.

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