The Internationalisation of the Yen: Essential Issues Overlooked[1]

After years of foot-dragging over the need to internationalise the yen, in 1998 the Japanese government implemented a series of institutional measures to enhance the convenience of using the currency. These have had only modest success. This paper argues that three conditions need to be fulfilled before the yen can become a major international currency: confidence in the Japanese economy and its financial system, stability in the yen exchange rate, and fair and transparent market principles in the Tokyo market. The paper focuses on the importance of the market principles, emphasising the need to address the overpresence of the public sector, especially in postal savings, as this scheme has acted to undermine the proper functioning of the government bond market. When the postal savings scheme comes under self-management in 2001, the market mechanism of the Tokyo capital market might become distorted due to the gargantuan size of its investment, resulting in an oligopoly of the market.

Introduction

Discussions about a future monetary regime in East Asia that would secure stable and sustainable economic growth have been gaining momentum as the regional economy appears to have bottomed out. The yen will play a crucial role in future exchange rate systems, be they individual or collective. The Japanese government has been promoting the internationalisation of the yen over the past two years by taking measures to make yen markets more attractive to international economic agents. These measures have had only modest success.

A currency becomes an international reserve, invoicing and settlement currency when there is confidence in the sound management of the economy and when markets are fair and transparent. The yen has gained significance as a reserve currency, rising from 4.4 per cent of world official foreign reserves at the end of 1980 to 8.4 per cent in 1991, at a time when the Japanese economy was deemed strong relative to that of the United States and Europe, despite the reluctance of authorities to open domestic financial and capital markets. The mismanagement of the Japanese economy resulted in low growth in the 1990s, and the share of the yen in the world's official reserves dropped to 5.1 per cent by the end of 1998 (IMF, various annual reports).

This paper deals mainly with microeconomic reforms in the Japan's capital and financial markets, outlining the main issues that hinder the fair and transparent operation of the market. The authorities have seriously endeavoured to rectify technical deficiencies, but changes at the micro level will not be sufficient to achieve the conditions needed to make the yen a reliable international currency: the recovery of the Japanese economy and macroeconomic fundamentals must happen first.

The history behind the internationalisation of the yen

Recent history

Japan has only seriously addressed the issue of the internationalisation of the yen in the past few years. In May 1998, at the Asia-Pacific Economic Cooperation (APEC) forum's Finance Ministers' Conference, Japan's then Finance Minister, Hikaru Matsunaga, announced the government's intention to internationalise the yen:

> Our government plans to take positive steps to boost the international role of the yen. Japan is currently undertaking reform of the financial system, and as a frontrunner of the reform, we have just implemented the Foreign Exchange Law on April 1 and fully liberalised cross-border transactions. We will continue to take measures to create the market environment in order to enhance the role of the yen as reserve and settlement currency.

The statement was noteworthy on two points. First, there was the absence of conditional phrases such as 'but' or 'however'. In the past, cautionary notes such as 'while taking heed to the financial order of the domestic market' had typically accompanied statements about the yen, reflecting Japan's concern that measures to enhance the convenience of the yen for nonresidents would harm domestic financial and capital markets. The fact that this was a public pronouncement made by a finance minister of a sovereign nation's plan to internationalise its currency was the second noteworthy point – such action has been virtually unheard of. Japan's shift in thinking can be explained by the heightened pressure on the yen to play a more global role. That month the final decision had been reached on which countries would participate in the European Economic and Monetary Union (EMU). The Asian currency crisis had hit the year earlier – the international currency system was still in flux and the global role of the yen was under question.

The first steps: the early 1980s

Japan's monetary authority, the Ministry of Finance, had only began to discuss internationalising the yen at the end of the 1970s. Initially it viewed the likely impact on the economy as negative. The annual report of the International Finance Bureau of the Ministry of Finance (1978) stated, 'Increase in euro-yen bond issues might adversely affect the currency market and may negatively impact the Japanese economy in ways unexpected'.[2]

In December 1980 the Foreign Exchange Control Law was revised, liberalising exchange controls with some exceptions. The US current account deficit had ballooned in response to high interest rates and the strong dollar under the Reagan administration, while the Japanese surplus had mounted. The Yen-Dollar Committee was formed in 1983 to study the issues of financial liberalisation in Japan against heightened US demand for Japan to redress the trade imbalance. The United States blamed the unreasonably weak yen for the imbalance, and attributed the weakness to Japan's closed financial market. The liberalisation of financial markets in Japan, it was argued, would render yen-based assets more accessible for investors, and the higher demand for the yen would strengthen the Japanese currency. In May 1984 the Ministry of Finance published 'The Current Status and Prospects on Financial Liberalisation and the Internationalisation of the Yen' (hereafter called The Current Status and Prospects), along with the report of the Yen-Dollar Committee. The document formed the basis of the Japanese monetary authority's policy on the internationalisation of the yen until Hikaru Matsunaga's statement in 1998.

The Current Status and Prospects stated that if the yen became an international currency, Japan would be able to contribute to the stable development of the world economy and the convenience for nonresidents would be enhanced. The internationalisation of the yen would: (a) eliminate exchange risk and reduce the hedging cost in trade; (b) improve the efficiency of corporate financing; (c) strengthen the positions of Japanese financial institutions in international financial transactions; and (d) build a foundation for Tokyo to become a global financial centre.

Based on this understanding, the government's position on the internationalisation of the yen shifted from negative to neutral:

> In essence, the internationalisation of the yen should evolve naturally through choices made by parties involved in transactions. The monetary authority should take care to remove

> obstacles and create an environment that enables parties involved in transactions to choose the yen freely in a manner most suited to their needs. *Great attention should be paid to the fact that the more the yen is used and held as international currency, the greater its impact would be on the exchange market, domestic monetary policy, and the domestic financial system among others*. (MOF 1984, emphasis added by author)

The government, in other words, believed it should remove constraints in financial and capital markets and create an environment for the yen to evolve naturally into an international currency, rather than to make this a policy objective. This is a valid theory. The warning (in italics) illustrates the government's caution not to encroach on the vested interests of parties involved in the existing markets. Its cautionary approach resulted in delays in taking measures necessary for the internationalisation of the yen and at times emasculated the efforts. The Current Status and Prospects identified specific medium-term to long-term programs for financial liberalisation and the internationalisation of the yen, but, reflecting prevailing domestic arguments, reservations were expressed on crucial points:

> Cross-industry and institutional issues (for financial liberalization): Cross-industry issues among financial institutions as well as institutional issues need to be dealt with in order to respond to the developing needs of the time. In doing so, however, the historical background of the existing institutions and system need to be taken fully into account.[3]
>
> Relaxation of the guideline for issuing euro-yen bonds for residents (for the internationalization of the yen): The guideline for issuing euro-yen bonds (yen-denominated bonds issued overseas) was relaxed. This allowed major private corporations to issue euro-yen bonds under certain issue standards that take into consideration the impact on domestic financial and capital markets.
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> Liberalization of euro-yen lending: This issue is a subject of future study and the impact on the domestic financial system needs to be taken into account in the process of liberalizing mid- to long-term euro-yen lending.
>
> Relaxation of euro-yen CD: Euro-yen CD issues will be liberalised within the year, but in consideration of the impact on domestic financial and capital markets as well as on the domestic financial system, the issue will be limited to a term up to 6 months and sales to residents will not be permitted.
>
> Short-term government security market: Attention should be paid to its close tie to fiscal and treasury institutions.[4] (MOF 1984)

Dual-track policies for Japan's financial and capital markets

The Japanese monetary authority was under external pressure calling for the opening of the Tokyo market and the internationalisation of the yen and domestic pressure from vested interests resisting reform. The government opted for a policy that set two separate paths – both aiming for relaxation and liberalisation of the yen-denominated markets, but at varying speeds. Externally, the policy was that liberalisation would proceed to demonstrate the internationalisation of the yen to the global community, but care would be taken to minimise the impact on the domestic market. Internally, however, except for interest rate liberalisation, the reform and opening up of financial and capital markets, of the scope of businesses financial institutions could enter and of cross-industry issues proceeded at a painstakingly slow pace.

The internationalisation of the yen could have been achieved if obstacles had been removed and institutions reformed to create an environment for the yen to become the currency of choice based on the genuine needs of the parties involved in the transactions. The reality, however, was partial liberalisation on a pretence that was distorted and lacking in even-handedness. Liberalisation of the domestic market, the most critical part, was limited to what vested interests were prepared to mutually concede, although the authorities caved in under external pressure and allowed foreign financial institutions to enter other areas of business.[5]

There are two 'external' yen financial and capital markets: the euro-yen market and the Tokyo offshore market. Euro-yen is yen-denominated credits and liabilities traded outside of Japan, particularly those yen deposits at international financial centres in London or Hong Kong. Euro-yen is traded overseas but the Japanese government has exercised strong power over it. The euro-yen market was successfully liberalised by the mid-1990s. The government, albeit with measures to ameliorate drastic changes, removed restrictions by product category (i.e. mid-term and long-term loans, yen-denominated bonds, CPs [commercial paper] and CDs as well as cross-industry restrictions applied beyond country borders via the guidelines issued by the Finance Ministry).[6]

The establishment of the Tokyo offshore market was included in the program outlined in The Current Status and Prospects and this was achieved by December 1986. Although the JOM (Japan Offshore Market) was not well known to the public, its objective was to bring the euro-yen market to Tokyo, within sight of the Ministry of Finance. The JOM was treated as an offshore account (in effect, an invisible JOM branch) separate and apart from the general account on the books of financial institutions operating in Japan. Deposits in the account enjoyed special privileges such as exemptions from withholding tax, interest rate regulations and reserve requirements. Participants were limited mostly to financial institutions because of strict identification requirements placed on nonresidents participating in transactions.

The size of the JOM grew steadily to 97.1 trillion yen (63.8 trillion yen of yen-denominated assets and 33.3 trillion yen of foreign-currency denominated assets) at the end of 1997. It became one of the most prominent offshore markets in the world, but its assets, particularly yen assets, shrank sharply to 84.0 trillion yen (48.7 trillion yen of yen assets and 35.3 trillion yen of foreign-currency assets) by the end of 1998 (Financial and Economic Statistics Monthly, Bank of Japan). Major Japanese banks had been meeting clients' requests for spread lending (loans with a Libor-based [London inter-banking offered rate] interest rate plus a certain premium, which is the standard lending format in the euro market) in the form of so-called impact loans from overseas. This was done in order to maintain the lucrative prime rate structure in domestic lending and involved transferring domestic yen assets to a JOM account before loans were made to domestic customers via the Hong Kong branch. This manipulation was one of the contributing factors that bloated the JOM balance. In 1998, in an effort to reduce assets on their balance sheets, Japanese banks dropped this unsound practice, causing a drop in the balance of the offshore market.

The Tokyo market lags behind

The policy to split the domestic market from the international yen market allowed the liberalisation of the euro-yen market to precede that of the domestic market and effectively sheltered the domestic market from external pressures. The Tokyo market, encumbered by a labyrinth of vested interests, was left behind in the accelerating global race to develop state-of-the-art financial technology and by the worldwide tide of financial reform. Problems began to surface across the spectrum of the market: the continuation of the administration's policy to protect the financial industry; the lack of progress in breaking down interindustry barriers because of resistance to change; uncontrolled swelling of public financing; slow development of infrastructure for the security settlement system, which was hampered by the bond trustee bank system; tax reform that took little account of international trends; and the never-ending argument about short-term government securities. Many of these features were part of the institutions and practices unique to Japan that had worked effectively in the past but had become riddled with vested interests and were no longer compatible with its status as the world's second largest economy. The Tokyo market lost its international competitiveness as the Japanese economy stagnated in the 1990s and foreign financial institutions moved their Asian headquarters to Hong Kong and Singapore in droves. Securities and mid-term to long-term loan businesses were lost to American, European or Asian financial centres where markets were less regulated and costs lower, and the hollowing out of the Japanese financial industry ensued.

The Japan Centre for International Finance conducted a survey of foreign financial institutions operating in Japan, entitled 'Evaluation and Strategy of Tokyo Financial and Capital Markets'. It found that in 1995 no respondents were 'satisfied' with the market, while 47 per cent said Japanese markets were 'far from liberalisation and internationalisation' (Table 1). The survey report compared the results with the London and New York markets and, in all the years surveyed, these markets both received overwhelmingly higher evaluations than the Tokyo market. Tokyo ranked high in size and for its telecommunication and information network, but low in areas that featured strong Japanese cultural or historical vestiges. The rating was particularly low for such areas as 'trustworthy administrative and supervisory structure for financial institutions', 'low level of regulations over transactions', 'disclosure of financial institutions', 'diversity of financial and capital markets' and 'competent human resources in international finance'.

Prime Minister Ryutaro Hashimoto took the declining status of the Tokyo market seriously and resolved to embark on reform of the financial system – the 'Big Bang'. He commissioned reports from five councils,[7] and these were submitted in June 1997. A clear timetable was set to 'undertake all reforms which are deemed necessary' to achieve the three principles of a free market: one where the market mechanism prevails, which is fair (transparent and trustworthy) and is state-of-the-art and global.

The Ministry of Finance believes reform is essential to develop a financial system that can support the Japanese economy in the 21st century. The Ministry stated:

> In the meantime, there emerged an increasing number of new financial products in the U.S. and European financial markets, due to the rapid progress of globalization and innovation in the information and communication technologies. In addition, euro, a new European currency, is expected to be issued in 1999. In light of these major changes, it is urgently

Table 1 Evaluation of liberalisation and internationalisation of the Tokyo market (per cent)

	1998	1995	1992
Satisfied	10	0	9
Direction is welcome, but insufficient compared with London and New York	22	27	49
Direction is welcome, but speed is too slow	35	22	17
Direction is welcome, but speed is fast and competition too fierce	0	4	2
Good effort but far from liberalisation and internationalisation in reality	33	47	23
Others	0	0	0

Note: Percentage of each response out of the total.
Source: JCIF (1995, 1998).

> required to enhance the functioning of the Japanese financial market to prevent its possible hollowing out. *In doing so, the status of the yen as an international currency would be strengthened.*
>
> In order to meet these objectives, financial systems must be reformed so as to ensure proper return on the 1200 trillion yen of Japanese household financial assets, smooth funding for growing industries for the next generation, and active capital flow with the rest of the world. To create such a system where the market mechanism functions to its full extent and optimal allocation of resources is achieved, it is urgently required for Japan to conduct a comprehensive financial system reform which includes bold deregulation measures and measures to secure transparency and reliability of the market. (MOF 1997, emphasis added by author)

The statement shows a new sense of urgency as the realisation sinks in that the Tokyo market is being left behind and that 1,200 trillion yen of individual assets must be effectively managed otherwise the money will flow out of the country. Bold deregulation measures, at least in comparison with past standards, are now being taken to remove domestic obstacles.

The 'Big Bang' financial reforms began in April 1997 and are scheduled to be completed by March 2002. The reform covers five major areas: products, intermediary services, markets, rules and foreign exchange control. In the product area, securities derivatives were fully derestricted and banks were permitted to sell investment trust instruments and insurance products. Concerning intermediary services, the holding company structure was introduced to group together financial intermediaries. Securities companies were made subject only to registration requirements instead of licensing. In the markets area, the off-exchange trading of securities was allowed. Rules regarding consolidated financial statements, mark-to-market accounting for financial products, the supervision of financial institutions and the protection of bona fide users of financial services have been fundamentally reviewed. Cross-border transactions of foreign exchange were fully liberalised and the system of authorised foreign exchange banks was abolished.

The plan for the internationalisation of the yen, however, has not moved beyond the approach of natural evolution laid out in The Current Status and Prospects. Neither the above statement nor surrounding discussions of specific programs voiced any strong determination to accelerate the process. The tax system is one of the major obstacles blocking the internationalisation of the yen, but references to this issue have been half-hearted. The Plan for Financial System Reform stated: 'Against the background of financial market reform, review on the tax system will be carried out in order to identify the best state for financial activities. Such review will take into account international compatibility of the national tax system'. The only concrete reference was to the security tax system: 'The Securities and Exchange Council requests that efforts should be made to eliminate the securities transaction tax and exchange tax in order to improve the efficiency and international competitiveness of the market'. No reference was made, however, to exempting nonresidents from withholding tax.

On the subject of the need for financing bills (FBs) to expand the short-term government security market, a June 1997 report of the Financial System Research Council (FSRC) stated:

> Some point to the need to expand the TB [treasury bill] market and to review the current system of issuing FBs. The question of the system of issuing FBs, however, needs to be considered from a broader perspective to include consideration of the treasury system and fiscal system. (MOF 1997)

The tone of the report certainly does not reflect a genuine concern nor does it show any improved understanding of the issue since 1984. The council threw in the towel on the problem of swollen postal savings,[8] stating:

> The system of Postal Savings and other public financial institutions must be continuously reexamined to meet economic and social change. Considering the aim of this financial system reform, discussions should proceed from the perspective of having thorough market discipline. However, as this issue goes beyond the sphere of the financial system, it is difficult to discuss only in the FSRC. Rather, the FSRC should concentrate its discussion on resolving the imminent problems in the private sector.

Foot-dragging such as this indicates how strong and tenacious the resistance has been from domestic vested interests against significant financial reform.

Status and issues on the internationalisation of the yen

As an international currency, the yen is used for: (a) foreign exchange transactions or government market interventions (means of exchange); (b) trade contracts or as a peg currency for specific countries (unit of account); and (c) investment or financing financial transactions, or as an official reserve (store of value). Although Japan contributed 14 per cent of the world's GDP in 1997 and 7.7 per cent of world exports (MOF 1999), in all three roles the weight of the yen has been less than could be expected. The yen's role grew from the 1980s to the beginning of the 1990s, but has dropped significantly since the financial crisis in 1997.

Means of exchange

The daily volume of the major foreign exchange markets of the world is approximately US$2 trillion, of which the yen makes up 21 per cent (BIS 1998). The volume includes both sides of transactions (e.g. both the selling of US dollars and the buying of yen), so world's currencies total to 200 per cent.

The volume of foreign exchange transactions in the Tokyo market in 1989 was on a par with New York. The growth has since slowed compared with other markets and in 1998 was negative. As a result Tokyo lagged far behind the London and New York markets while other markets such as Singapore started to catch up. The centre of foreign exchange transactions in Asia shifted from Tokyo to other financial centres in response to the development of electronic broking, concerns about poor Japanese performance on practices such as confidentiality, lower costs elsewhere and, most importantly, the high credit risks of the Japanese banks after the financial crisis (Table 2).

Table 2 Comparison of the world's foreign exchange markets (US$ bn, per cent)

	Foreign exchange daily average volume[a]				
	Tokyo	London	New York	Singapore	Hong Kong
1989 Q4	111	184	115	55	49
1992 Q4	120(8)	290(58)	167(45)	74(35)	60(33)
1995 Q4	161(34)	464(160)	244(46)	105(42)	90(50)
1998 Q4	149(-8)	637(37)	351(44)	139(32)	79(-12)

Notes: a Total of spot, outright forward and foreign exchanges swaps; number in brackets is growth rate compared with previous year.
Source: BIS 1998.

Unit of account

Of total world trade, 5 per cent is denominated in yen, which is below that in US dollars and euros, but also below that in UK pounds (Foreign Exchange Council 1999). The yen is little used even for Japanese export and import transactions, let alone for trade among third countries. In contrast, most US trade is in dollars. As for Germany, Britain and France, 60–80 per cent of their exports and 40–50 per cent of their imports are denominated in their own currencies. About 35 per cent of Japan's exports are denominated in yen, a level that has remained fairly constant. Only 20 per cent of imports are in yen, although this percentage has been rising gradually. Around 50 per cent of exports to Southeast Asia and 45 per cent of imports from the EU are in yen (Table 3). Most imports from Southeast Asia are in dollars.

There are three reasons for the low percentage of yen-denominated trade: (1) Japan's trade structure; (2) characteristics unique to the trading partner regions; and (3) trade finance. Japan's trade has typically been vertical, involving imports of raw materials and exports of finished goods. In response to the strong yen, after 1985 many producers shifted overseas and horizontal trade (trade in similar goods) increased. The import share of finished goods (60 per cent in 1998), however, remains low in comparison with that of the United States and Europe (over 80 per cent). Most trade in finished goods is denominated in the currencies of the exporting industrialised countries while trade in raw materials and energy is overwhelmingly in US dollars (MITI 1999).

Table 3 Currency breakdown of Japan's export-import settlements[1] (per cent)

	World			US			EU			Southeast Asia[2]		
	yen	US$	others	yen	US$	others	yen	US$	others	yen	US$	others
Exports												
Sept.1992	40.1	46.6	13.1	16.6	83.2	0.1	40.3	11.1	48.4	52.3	41.6	5.9
Sept.1993	39.9	48.4	11.7	16.5	83.3	0.2	41.0	7.5	51.5	52.5	44.3	3.2
Sept.1994	39.7	48.3	12.0	19.0	80.8	0.2	36.6	9.0	54.4	49.0	47.9	3.1
Mar. 1995	37.6	51.5	10.9	17.5	82.3	0.2	37.2	11.3	51.5	47.2	49.9	2.9
Sept.1995	36.0	52.5	11.5	17.0	82.9	0.1	34.9	12.2	52.9	44.3	53.4	2.3
Mar. 1996	35.9	53.1	10.9	15.9	83.9	0.2	36.1	12.5	51.3	44.1	53.5	2.3
Sept.1996	35.2	53.3	11.5	14.5	85.4	0.1	33.3	12.4	54.4	46.3	51.5	2.4
Mar. 1997	35.8	52.8	11.3	16.6	83.2	0.2	34.3	13.4	52.3	45.5	51.7	2.7
Sept.1997	35.8	52.1	12.1	15.3	84.5	0.2	34.2	12.3	53.5	47.0	50.2	2.7
Mar. 1998	36.0	51.2	12.9	15.7	84.1	0.1	34.9	13.2	51.9	48.4	48.7	2.9
Imports												
Sept.1992	17.0	74.5	8.5	13.8	86.0	0.2	31.7	17.9	50.4	23.8	73.9	2.3
Sept.1993	20.9	72.4	6.7	13.8	86.1	0.1	45.0	18.2	36.8	25.7	72.0	2.3
Sept.1994	19.2	73.9	6.9	13.3	86.4	0.3	38.6	21.9	39.5	23.6	74.2	2.2
Mar. 1995	24.3	68.9	6.8	18.4	80.9	0.7	40.6	20.2	39.2	34.1	64.2	1.7
Sept.1995	22.7	70.2	7.1	21.5	78.4	0.1	44.8	16.1	39.1	26.2	71.9	1.9
Mar. 1996	20.5	72.2	7.3	17.5	82.7	0.0	40.9	15.3	43.8	23.9	74.1	2.0
Sept.1996	20.6	72.4	7.0	16.4	83.2	0.4	46.1	12.5	41.4	24.0	73.8	2.2
Mar. 1997	18.9	74.0	7.1	14.2	85.6	0.2	41.3	17.0	41.7	23.3	74.9	1.7
Sept.1997	22.6	70.8	6.6	22.0	77.8	0.2	49.3	13.1	37.7	25.0	73.0	1.9
Mar. 1998[3]	21.8	71.7	6.7	16.6	83.3	0.1	44.0	14.4	41.6	26.8	71.5	1.7

Notes: 1 Monthly data compiled using export-import reports mandated by the Foreign Exchange Law.
2 Southeast Asia includes 22 nations: ASEAN, the NIEs, Cambodia, India, Pakistan, Sri Lanka, Maldives, Bangladesh, East Timor, Macao, Afghanistan, Nepal and Bhutan.
3 March 1998 is a flash report.
Source: MITI 1999.

During 1998, Japan sent 30 per cent of its exports to Asia and 30 per cent to North America (MITI 1999). A large part of Japan's trade with Asia is exports of parts and materials to subsidiaries in Asia. The finished goods are either exported to the United States and other countries (these are often products that used to be directly exported from Japan to the United States) or back to Japan. Up until the Asian crisis, regional currencies were mostly linked to the dollar and trading partners paid in dollars to guard against exchange risk. In addition, parent companies in Japan tended to bear the exchange risk because exports were diverted via third countries and because their local affiliates lacked strength in financial markets.

The dollar has been the primary vehicle of trade financing since after World War II. The yen-denominated BA (bankers acceptance) market was established in 1985 as an attempt to expand trade finance in yen, but because of its cumbersome procedures and lack of cost advantage, the market eventually closed down. Until recently there was no interest differential for yen assets based on credit ratings (for instance, yen-denominated BA, a low-risk instrument, should have borne a low interest rate). Now that the interest differential is starting to reflect the low risk and as the relationship between the yen and other Asian currencies continues to grow, there may be more support for a yen-denominated BA market.

Store of value

In 1995 the yen made up 8 per cent of world reserves, but by the end of 1997 its share had fallen to 4.9 per cent, returning to the level of the early 1980s (IMF, various annual reports). Yen-denominated bonds exceeded 20 per cent of cross-border bond issues in 1995, but with the financial crisis plummeted to 6 per cent – back to the level of the early 1980s (Table 4).

Mid-term to long-term overseas lending by Japanese and foreign financial institutions in Japan amounted to US$493.2 billion at the end of 1997 (Foreign Exchange Council 1999), which was around the same level as yen-denominated international bonds. Despite the fact that the loans originated in Japan, the majority (80.9 per cent) were denominated in US dollars and other foreign currencies and only 19.1 per cent were in yen. There is no stipulation that Japanese loans to nonresidents must be in yen; the predominance of dollar-denominated loans reflects the preferences of borrowers. In Asia both private and public borrowers have preferred to transact in US dollars, swapping borrowed funds into dollars even if the loan was denominated in yen. Investors also prefer dollars because sharp fluctuations in the yen exchange rate have meant that the reference rate (the long-term prime rate) did not reflect market interest rates, making it difficult to control the funds after the dollar swap. As Asian countries start to use the yen instead of the US dollar, the imbalance will lessen.

The balance of euro-yen lending (yen-denominated loans executed overseas) reached 36.8 trillion yen in 1995, but over 90 per cent were impact loans for Japanese residents (this declined sharply in 1999) (Arai 1998). Lending to nonresidents was only 2.2 trillion yen – another indication of the lack of popularity of yen loans among overseas borrowers.

Table 4 International bond issues by currencies (US$ bn, per cent)

	1995		1996		1997		1998			
	Amount issued		Amount issued		Amount issued		Amount issued		Amount outstanding	
US$ bonds	118.5	33	391.8	46	517.4	51	534.6	49	1791.3	44
Yen bonds	76.5	21	134.9	16	129.8	13	69.2	6	481.1	12
Euro-participating currency bonds	55.5	16	212.2	25	221.3	22	301.4	28	1114.9	28
Others	107.5	30	122.6	14	146.8	14	178.5	17	651.9	16
Total international bonds	357.9	100	861.5	100	1015.3	100	1083.3	100	4039.2	100

Note: Euro-participating currencies for 1995 was the Deutschemark, 1996 was the EMU currencies, and Euro-area currencies for 1997 and 1998.
Source: International Banking and Financial Market Developments, BIS, 1999.

Why is the internationalisation of the yen important?

The internationalisation of the yen is both important and necessary. The advantages an internationally traded currency holds in eliminating exchange risks in trade are well known. More recently, other countries have been calling for Japan to bear more responsibility for contributing to the international monetary system and stability of the Asian economy. In the fierce international competition between the United States and Europe over the leadership position in financial and capital markets, the internationalisation of the yen could make Japan an important player. Advances in telecommunications and information technology have created a truly global economy where capital is highly mobile. Financing is no longer merely about lending money but is a huge knowledge-based industry that is truly global, and advanced nations need to have competitive leading-edge financial industries.

Internationalisation of Germany's finanzplatz

Without doubt, America's investment banks, commercial banks, nonbanks and investment funds, including hedge funds, are world leaders. They are at an advantage because the US dollar is the key international currency. Money from all over the world flows into the United

States and out again as it is changed into other currencies and reinvested overseas. Financial and information technology industries have been attracted to the United States because markets are less regulated. A large number of vigorously competing financial institutions collectively enjoy unrivalled positions in the world. The financial industry has a strategic role in the American economy and has been behind the push to remove controls on capital and financial markets in other countries. At times the United States has been able to strong-arm developing countries into opening up their financial and capital markets.

Germany has been compared to Japan in many respects, and the two countries have had similar policies toward their currencies and their financial and capital markets. It was not until the mid-1980s (around the time The Current Status and Prospects was published in Japan) that Germany began to liberalise capital transactions and to accept the role of the Deutschemark (DM) as an international currency. In a similar approach to Japan, the German government opened up its financial and capital markets and removed restrictions, expecting the strengthened role of the Deutschemark in trade settlements and financial transactions to follow.

Crucial differences in policies on market development, and in the external environments the two currencies were exposed to, put the yen and the Deutschemark on different paths. While Japan focused on liberalisation outside its borders (i.e. the euro-yen market), Germany put its house in order and opened up its markets to the outside world. Germany took a guarded position on issuing DM bonds in the euro market, only allowing DM-denominated foreign bonds (DM-*Auslandsanleihe*) issued by nonresidents in Germany (like Samurai bonds or yen-denominated foreign bonds issued by nonresidents in Japan). The advent of the European Monetary System (EMS) in 1979 and the movement toward European Single Market in the 1990s increased the Deutschemark's role. As the central banks of the member countries increased their DM holdings, the Deutschemark became the key regional currency in the EMS.

Although keen on developing its domestic financial market, Germany had been reluctant or indifferent about becoming an international financial centre. After the European Single Market became a reality in 1993, and as the prospect of monetary union drew closer, the government began to take a series of aggressive measures to internationalise the financial market. The reserve requirement ratio, which had contributed to the high cost of the domestic market, was significantly reduced (from 12.1 per cent in March 1994 to 2 per cent in August 1995 for demand deposits) and Germany embarked on its version of the financial 'Big Bang'

(*Finanzmarktförderungsgesetz*) that had first been instituted by the United Kingdom. Frankfurt's successful bid against London and Paris to become the home of the European Central Bank made it Europe's financial centre.

Recommendations of the Council on Foreign Exchange and Other Transactions

By 1998 the monetary authority had abandoned its 'natural development theory' – the belief that the internationalisation of the yen will naturally ensue if the proper environment exists. The Ministry of Finance now made the internationalisation of the yen a policy objective. From July 1998 the Foreign Exchange Council, an advisory body to the finance minister, had intensive discussions. In April 1999 the following recommendations were made:

(I) The prerequisite for assuring the broad acceptance of the yen as an international currency is to restore and to enhance domestic and international confidence in the Japanese economy by promptly stabilizing the financial system and by achieving economic recovery. This requires the restoration of medium- and long-term macroeconomic balance.

(II) Achieving relative stability in the exchange rates among the dollar, euro, and yen is the responsibility of the United States, euro-zone countries, and Japan.

(III) One of the options for Asian countries would be to establish a system which stabilises Asian currency exchange rates against a currency basket containing the dollar, yen, euro, and other currencies, each being assigned a weight in light of trade and other economic factors. In this system, it would be desirable for the correlation between the Asian currencies and the yen to be strengthened. Japan must become actively involved in discussions concerning future monetary systems in the Asian region.

(IV) To internationalise the yen, infrastructure improvements in the financial and capital markets must be made to provide greater assurance to yen users.

(A) Improvements in Financial and Capital Markets

The revised Foreign Exchange and Foreign Trade Control Law came into effect in April 1998. In December 1998 the Japanese government announced measures to facilitate the internationalization of the yen, and later implemented necessary arrangements in legal and other frameworks. All of these measures were important advances for the internationalization of the yen. The measures announced in December 1998 included the initiation of FB issuance via competitive price auctions, exempting withholding tax on original issue discounts for TBs and FBs, and exempting nonresidents and foreign corporations from tax on the interest from interest-bearing government bonds. Further improvements in the financial and capital markets are important;

(a) In order to promote nonresident participation in Japan's repo market, the transaction scheme should be promptly adjusted to promote transactions based on repurchase agreements adopted in the United States and Europe.
(b) To promote efficient yield-curve formation of government bonds, a five-year interest-bearing government bond should be introduced as a medium-term benchmark issue.
(c) It is important to pursue further diversification of available products in government bond markets to match the various needs of investors. Introduction of the STRIPS (Separate Trading of Registered Interest and Principal of Securities) program, which has already been introduced in government bond markets in the United States and Europe, should be considered.

(B) Improvement of the Settlement Systems

The improvement of Japan's settlement systems constitutes an important issue in the internationalization of the yen and is an essential requirement for nonresidents to procure and manage yen-based assets with confidence and security.

(a) It is highly important that the ongoing restructuring of the Bank of Japan Financial Network System (BOJ-NET) to an RTGS [real time gross settlement] system and the extension of operating hours by the end of the year 2000 be carried out as scheduled.
(b) Considerations are currently underway to refine the settlement systems for CP and CD with the aim of realizing DVP [delivery versus payment] and other improvements. It is hoped that this will lead to early results.
(c) From the medium- and long-term perspectives it is necessary to consider establishing more comprehensive and centralised settlement systems for all securities.

(C) It is necessary to expand yen-denominated facilities offered by the Bank of Japan to foreign central banks, to diversify the commodities traded in Japan's international commodity markets, to review Japanese accounting rules and standards continuously, and to improve bankruptcy laws.

(V) Given the ongoing major changes in domestic and international economic environments, it appears that it is now necessary to review past practices in trade and capital transactions and to examine the use of the yen from a new angle.

(A) Trade Transactions

- There is a growing need to reevaluate the risks and costs associated with the choice of currency, to review past currency choices, and to examine the possibility of expanding the use of the yen in individual transactions.
- The yen holdings of nonresidents must be expanded to promote the internationalization of the yen. To achieve this, it is crucial that Japan expand its yen-invoiced imports.

(B) Capital Transactions

- Supplying yen funds through capital transactions will not only deepen the yen markets and serve to promote the internationalization of the yen, but will also constitute a critical element in the yen-denominated recycling overseas of Japan's excess savings.
- Both lenders and borrowers must review past arrangements for overseas funding, and it is important to utilise yen-denominated funding to promote the restoration and upgrading of the financial intermediation functions of Japanese financial institutions.
- In view of the current economic conditions in Asia and the recent status of Japanese financial institutions, official financial assistance must play an even more important role than it has in the past in providing yen funds to Asia. (Utilizing the sovereign bond guarantee facilities of the Japan Bank for International Cooperation, providing yen funds under the New Miyazawa Initiative, etc.)

(C) The expansion of yen-denominated financing by international financial institutions and Japan's active use of the yen in figures in business and official presentations are also important. (Foreign Exchange Council 1999)

This lengthy section from the council's report is cited to show the discussions on the internationalisation of the yen that have taken place during the past 15 years. The council recommended that confidence be regained in the financial system (and the Japanese economy as a prerequisite), and stated that the government should stabilise the yen exchange rate and that the link between Asian currencies and the (stable) Japanese yen should be strengthened. These are positive and worthy statements. The report made specific recommendations aimed at enhancing the convenience of the yen: to diversify and improve the products and trade formats of Japanese government bonds and to improve the settlement system. It also stressed the importance of the private sector's involvement in reviewing trade practices.

Many of the specific recommendations dealt with problems that had not been resolved because of tax issues (particularly concerning the repo market) and conflicts among special interests (concerning five-year government bonds and the centralised settlement for securities). The delivery of securities is the part of Japan's financial infrastructure that is still at the level of developing countries. This area needs an immediate overhaul to reach American and European standards if the Tokyo market is to become secure for global participants. All the recommendations are relevant and provide, as Professor Takatoshi Itoh of Hitotsubashi University, the chair of the Expert Committee, stated, 'the last opportunity for the yen to remain as one of the major international currencies'.

Would speedy implementation of the Foreign Exchange Council's recommendations assure the yen's status as an international currency in the near future? Because the recommendations are part and parcel of the overall reform of the financial system, the answer partly depends on other programs. The internationalisation of the yen would be a direct outcome of the globalisation of the Tokyo market, which is one of the three principles of Japan's 'Big Bang' reforms. Whether or not the Tokyo market can be the equal of the London and New York markets depends on the realisation of these principles, namely that markets should be free, fair and global. Unfortunately, dark clouds hang over this goal.

What needs to be done for Tokyo to become an international financial centre?

Japan's financial 'Big Bang' aims to put the Japanese market on a par with New York and London by 2001. The current process has little chance of bringing this goal to reality – indeed, the approach needs be reversed. If Tokyo is to become an international financial centre, the internationalisation of the yen needs be pushed to centre stage, with steps taken to strengthen the international competitiveness of the financial industry. Literally all necessary measures (as was said in the five councils report) should be taken to stave off resistance from vested interests and push ahead with reform and the internationalisation of the yen in order to make Tokyo one of the world's three main financial centres.

As the example of Germany shows, the internationalisation of the yen can be achieved if confidence can be developed in the currency and in the financial market. This, however, is easier said than done. To win the confidence of the global community, financial and capital markets need to be truly fair and function according to market principles. It takes courage to confront the real issues that the current reform program and the Foreign Exchange Council's recommendations did not address. Political will and the determination to take action are needed. Exchange rate stability is indispensable for confidence in the yen, but the task cannot be accomplished without regional cooperation – there is a limit to what Japan can do single-handedly.

When the internationalisation of the yen has progressed to the stage where the yen has begun to take on the role of a third reserve or settlement currency, along with the dollar and the euro, the status of the Tokyo market will have been restored in the process. Japanese financial institutions will have regained competitiveness and be armed with individual financial assets in excess of 1,200 trillion yen, which will have been invested and managed in a sophisticated manner. If this does not happen, the yen will remain a substandard currency and the Tokyo market will become a second-class market.

Barriers to the internationalisation of the yen

Japanese government bonds without benchmarking role

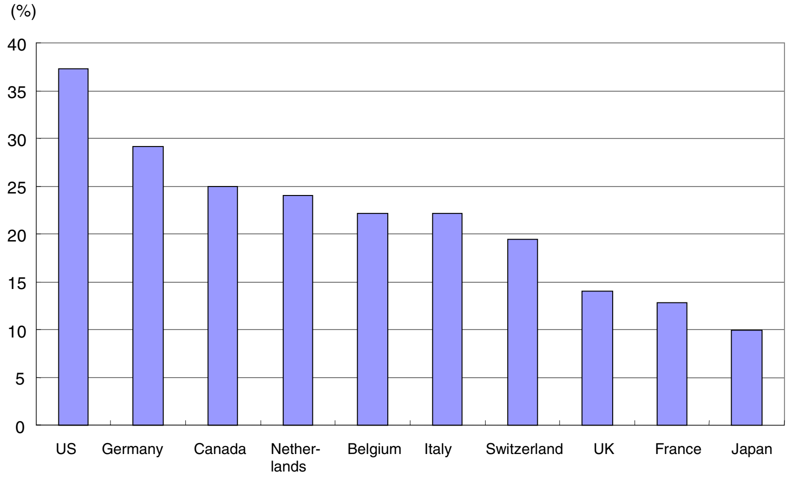
Long-term and short-term government bonds such as US government securities (in US dollars) and German *Bundesanleihe* (in euros) are the main assets held by central banks and institutional investors. Japanese government bonds make up a substantial part of any yen assets held. Government bond yields usually serve as benchmarks of market interest rates because government bonds have a lower risk relative to other bonds and higher liquidity owing to large market size. This is why government bonds are preferred as reserve assets.

Japanese government bonds have a relatively low liquidity. At the end of 1998, the Japanese bond market was 423 trillion yen, of which government bonds made up 280 trillion yen (short-term securities totalled to 15 trillion yen, and government guaranteed securities, local government bonds, bank debentures, corporate bonds and foreign bonds denominated in yen made up the remainder) (BOJ 1999c). The size of government bonds outstanding is second only to US government bonds. In the Japanese market, government bonds have the highest credibility[9] and overwhelmingly have the highest liquidity in terms of turnover ratio (turnover volume/bonds outstanding).

Japan's government bond market, however, has unique characteristics when compared with those of other industrialised countries. Of the government bonds of major markets held by nonresidents, Japanese government bonds are the least popular at 10 per cent (Figure 1). This is a very low percentage considering the yen was the currency of choice after the US dollar and the Deutschemark as a foreign reserve or for holdings of international bonds until 1995.

Another characteristic is that Japanese government bonds lack a benchmarking role. Market interest rates of US dollar bonds are benchmarked against yields of Treasury bills/ bonds and serve as the basis of interest rates of other securities to reflect credit risks. For Aaa-rated World Bank bonds, 20bp (basis points), for example, are added to the Treasury rates as a premium; for A-rated debentures, 150bp might be added. Furthermore, a gently sloping yield curve can be drawn from rates of different maturities (6-month, 2-year, 5-year, 10-year

Figure 1 Ratio of government bonds held by nonresidents in the G10, 1997

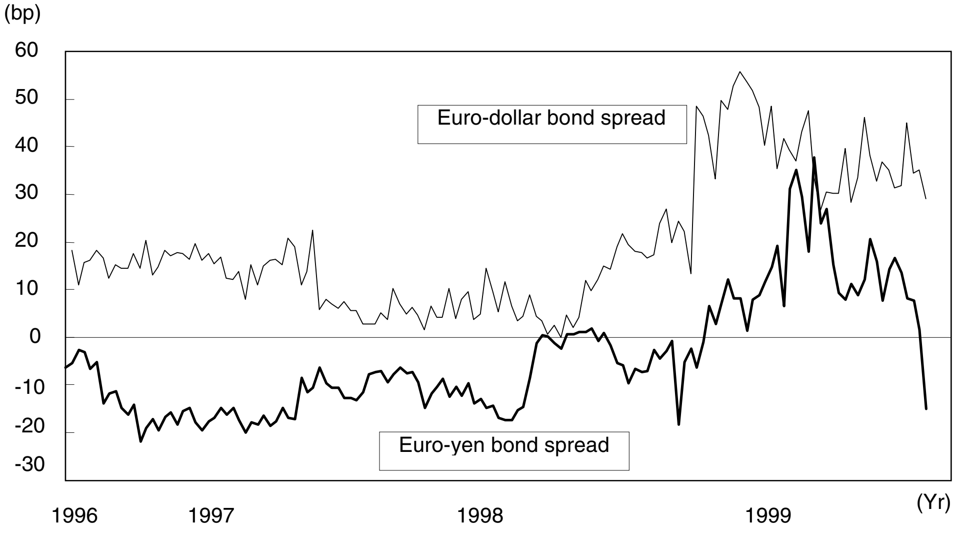


Source: BOJ 1999c.

and 30-year bonds), which forms the criteria for fund management and financing for investors and bond issuers. However, as Figure 2 shows, for yen-bonds, the yield on a Japanese government bond is higher than that of a euro-yen bond (a World Bank bond) of the same maturity. This reverse yield temporarily 'normalised' during the Asian crisis when money flocked to government bonds from the end of 1998 to the first half of 1999, but yields have since reversed again. This means that euro-yen bonds are preferred over Japanese government bonds, which fail to serve as a benchmark. The 10-year bond is the only one that functions as a bellwether issue – the volume of other bonds traded is too small to indicate standard yields.

The low level of liquidity of government securities compared with those of other major countries is the most serious defect of the Japanese bond market. The Financial Markets Department of the Bank of Japan (BOJ) defines high market liquidity as 'a feature of [a] market where instruments can be traded in large volume in a short period of time with little

Figure 2 Comparison of Japanese and US Euro-bond spreads

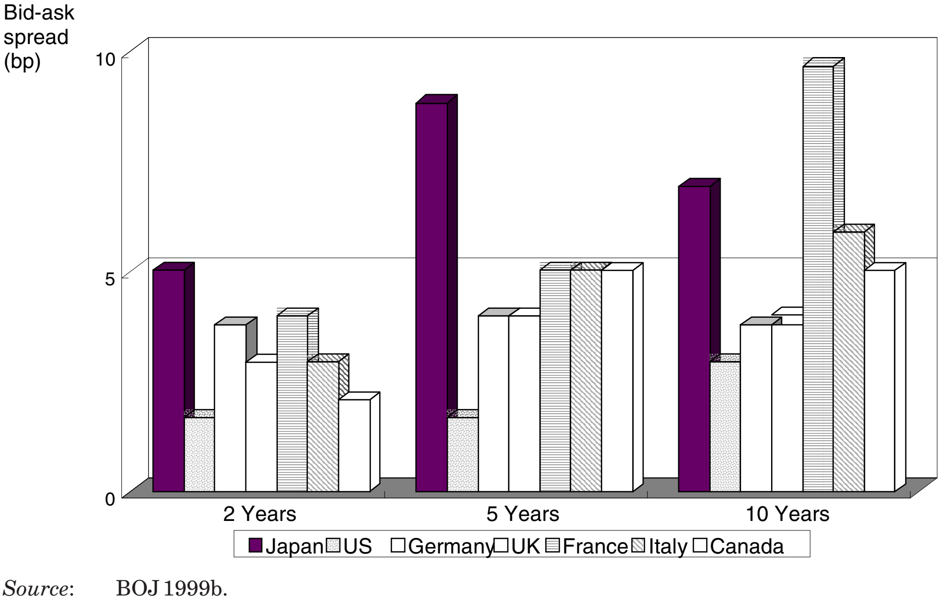


Note: Euro-dollar bond spread = Euro-dollar bond (World Bank 21 August 1996) – US 10-year Treasury bonds (15 July 1996); Euro-yen bond spread = Euro-yen bond (World Bank 20 December 1994) – 174th Japanese government bond (20 September 1994).

Source: Tokyo-Mitsubishi Securities using Bloomberg data.

price fluctuation'. One of the criteria used for market liquidity, in addition to the turnover ratio, is the 'bid-ask spread', which is the difference between the price government bond dealers offer to customers and the asking price. The spread becomes smaller as the number of market participants increases with active trading and expands when there is little trade and market liquidity is low. The bid-ask spreads of Japanese 2-year and 5-year bonds (only the spreads for discount bonds are available) are by far the largest of those of the major industrialised countries. Even for 10-year bonds, which are considered to have relatively high liquidity, Japanese government bonds have the second largest spread after French bonds (Figure 3). Monetary authorities see market liquidity as the most important factor in strengthening the international competitiveness of their countries' financial and capital markets. This lack of liquidity, despite the high level of public debt, is the most serious shortcoming of the Japanese government bond market, and also other financial and capital markets. The Tokyo market cannot hope to regain its international status without addressing this issue.

Figure 3 Bid-ask spread of current issues



Source: BOJ 1999b.

Reasons for failing market principles

The reasons underlying the low liquidity of government bonds (which indicates a market malfunction) are also dragging the pace of the internationalisation of the yen. Japan's financial and capital markets are encumbered with institutions that existed before World War II. These institutions have been preoccupied with dealing with political, administrative and financial special interest groups while avoiding competition through pigeonholing, or separating responsibilities. The administration's policy to protect the financial industry minimised the significance of the credit risk differential until around 1997, and therefore there was little need for government bonds to play a benchmarking role. On the other hand, this repressed the need for a well-developed secondary market because the large volume of government securities issued was taken up by underwriting syndicates or by the Trust Fund Bureau (which is administered by MOF's Financial Bureau), while the bulk of bonds in the market were absorbed by the public sector through the Bank of Japan. The institutions, which were based on indirect financing and mutual reliance, started to crack against internal and external changes. When the bubble burst and the economy plunged into recession, the system finally broke down. The Japanese economy thus stood to experience the financial crisis and the Big Bang simultaneously, and the internationalisation of the yen became an urgent issue.

The cause for the low liquidity of the government bond market lies in the fact that it has been divided through institutional problems and the overpresence of the public sector.[10] The market has not been complete and the price mechanism has not functioned efficiently.

The issue of withholding tax has been the major institutional factor standing in the way of the integration of the government security market. In particular, there are differences in the withholding tax on interest income paid by residents (some financial institutions pay no withholding tax while others, including corporations, are subject to the tax). In September 1999 the interest income of nonresidents was exempted from withholding tax, but for technical reasons some nonresidents still pay the tax. The different tax treatments divided government securities into taxable and nontaxable groups, thus lowering market liquidity. The securities transaction tax and the exchange tax were removed at the end of March 1999.

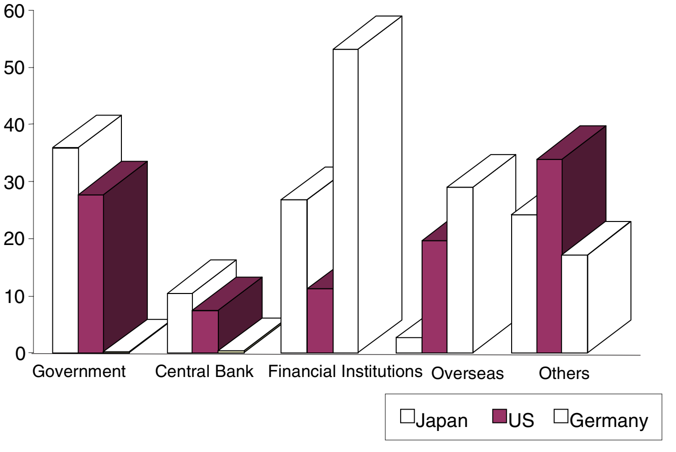
There are problems with all three ways in which government securities can be held: with the two types of settlement system (the transfer settlement system represents 63 per cent securities and the registration system represents 36 per cent) and the possession of effective bonds (1 per cent). Government securities possessed by nonresidents who are exempt from withholding tax come under the transfer settlement system. Nonresidents are not exempt from withholding tax when they hold bonds in the registration system or in the safe. Fund settlement concurrent with the delivery of security (the DVP system) has materialised but problems remain, such as a time lag from contracting to settlement and an inability to execute cross-border settlements, because of problems in connecting with bond markets overseas. Developing a legal framework for paperless transactions is another challenge that needs to be addressed.

Many other institutional issues that need attention, such as diversifying government securities and improving issuing methods, have been thoroughly discussed by the Foreign Exchange Council and are expected to be solved one by one.

The excessive presence of the public sector is another reason for reduced market liquidity in the government bond market. On 12 December 1998, government bond prices dropped sharply and the yield on benchmark issues climbed by 0.4 percentage points from 1.5 per cent to 1.9 per cent. Following this, the yen exchange rate fell from 115 yen to the dollar to 117.5 yen to the dollar. This large fall was caused by the Ministry of Finance's suspension of the Trust Fund Bureau's purchasing of long-term government bonds (the Fund had been buying an average of 200 billion yen a month through the BOJ) as of January 1999, and also its decision not to underwrite bonds scheduled to be issued in fiscal 1999.[11] The market predicted a significant deterioration in the supply and demand of government bonds because of the suspension, while on the other hand the bond issue was expected to surge from 58 trillion yen in fiscal 1998 to 71 trillion yen in fiscal 1999 (*Nihon Keizai Shinbun*, 26 December 1998). This strong market reaction reflects the fact that half the bonds are in the hands of the public sector. At the end of 1997, the government (the Trust Fund Bureau, the Postal Life Insurance Service and the Ministry of Posts and Telecommunications) held government bonds worth 88 trillion yen (36 per cent of the total) and the BOJ held 26 trillion yen (11 per cent of the total), meaning that the public sector held 47 per cent of the total. The rest was held by the private sector, including nonresidents (BOJ 1999a).

The US government holds a quarter of its own bonds, but these are nonmarketable securities issued for social welfare trust funds and have no impact on supply or demand. The Federal Reserve Bank of New York holds only 8 per cent of the total government securities outstanding. The German government holds about 3 per cent of its own bonds (in 1997 the balance held by Bundesbank was nil) and in the UK and France the percentage held by the public sector is also very small (Figure 4).

Figure 4 Percentage of government bonds held: Japan, the US and Germany



Source: Ministry of Finance, as of end of 1996.

Because the Japanese government and the central bank tend to hold bonds until maturity, the bid-ask spread tends to broaden, thereby squeezing the secondary market. Furthermore, government interventions in the long-term bond market, namely in long-term interest rates, are an anomaly in industrialised countries. Regular buying operations by the government are nothing but attempts at price maintenance and lead to the conclusion that the price mechanism is not functioning properly in the market. Consequently, policy changes inevitably have significant impacts not only on the government bond market, but also on related financial, capital and exchange markets and undermine the credibility of these markets.

Non-transparent future

Up until recently, the withholding tax on nonresidents has been regarded as the reason why the yield of Aaa-rated euro-yen bonds was below that of government bonds. Although the yields reversed in the first half of 1999, the situation occurred again just before the withholding tax was to be eliminated in September, suggesting there may be other reasons why the percentage of Japanese government bonds held by nonresidents is low and high-quality euro-yen bonds are preferred overseas. Other more fundamental factors such as the perception by nonresidents that the government bond market lacks transparency may be to blame. The excessive role played by the public sector has distorted the price mechanism in the Japanese government bond market but any future prospects for resolving this problem do not look good. The lack of transparency is closely related to the future direction of the Fiscal Investment and Loan Program (FILP) and the postal savings system. How important are these issues in relation to the internationalisation of the yen?

The FILP raises interest-bearing funds from postal savings, employee and national pension reserves, postal life insurance and other sources. The Trust Fund Bureau manages the most of the FILP funds including postal savings and pension reserves. Funds are lent to public entities such as the Government Housing Loan Corporation and the Japan Highway Public Corporation or invested in such instruments as government bonds. According to its 1998 annual report, the system 'pools public funds and allocates them to public institutions for policy implementation. The program serves as an intermediary, collecting public funds and investing in financial instruments to implement public finance'.

Fiscal investments have steadily risen, as funds under management of the Trust Fund Bureau burgeoned from 167 trillion yen at the end of 1985 to 436 trillion yen at the end of 1998. Postal savings, which constitute the bulk of the fund, increased from 101 trillion to 251 trillion over the same period. At the end of March 1999, the Trust Fund Bureau possessed government bonds amounting to 95 trillion yen (Table 5).

The FILP, in effect the government's major financing arm, is under review and will undergo a major change. From 2001 postal savings and pension reserves will no longer be required to be deposited with the Trust Fund Bureau and can be self-managed. The plan is for FILP financing to come from FILP agency bonds (public-offered bonds issued by each FILP agency with or without a government guarantee) and FILP bonds (a type of Japanese government bond).

Because FILP's funds, including those from accounts other than the Trust Fund Bureau, amount to the size of Japan's GDP and all bear interest, reform in the financing method will have a major impact on the government bond market and related markets. The FILP reform raises questions related to the structure of the government bond market and the balance of supply and demand. For instance, will the issuing of FILP bonds, which are essentially the same as government bonds, divide the government bond market? Will FILP agency bonds be issued solely on their own credibility with an independent rating? Will the postal savings network and other public entities retain the government bond portfolio currently held by the Trust Fund Bureau as funds are released for their own management?

Table 5 The Trust Fund Bureau special account balance sheet (100 mn yen)

Assets	March 1998	March 1999	Liabilities & capital	March 1998	March 1999
Cash	4	9	Deposits	4,171,674	4,332,739
Securities	1,078,948	1,111,982	Postal & postal book transfers Savings	2,387,459	2,509,679
Long-term government bonds	815,118	930,258			
Short-term government bonds	29,725	16,095	Postal life insurance	59,823	52,910
			Employees pension funds	1,239,877	1,291,162
Government agency bonds	193,752	152,637			
Bank debentures	40,358	12,992	National pension funds	99,381	103,810
Loans	3,102,856	3,247,424	Other deposits	385,133	375,178
Loans to general & special accounts	830,522	928,851	Reserves & profits	11,195	27,634
Loans to local public entities	585,254	620,132			
Loans to government-related institutions	1,687,080	1,698,441			
Others		958			
Total	4,182,869	4,360,373	Total	4,182,869	4,360,373

Source: MOF 1998; Monthly Financial and Economic Statistics Report, Bank of Japan.

Armed with sovereign credit and the huge 'Teigaku savings', the postal savings network has grown to be the largest financial institution in the world and looks after 35 per cent of Japan's personal savings. The money is held by the Trust Fund Bureau, with some re-loaned to the Ministry of Posts and Telecommunications and earmarked for the financial liberalisation program (55 trillion yen at the end of 1998, half of which is invested in government bonds) (MPT 1999).

The plan to reform the FILP calls for all postal savings (250 trillion yen) to be placed under the management of the postal authority in April 2001. Because the bulk is expected to be invested in bonds, there is likely to be major turbulence in the 423 trillion yen government bond and corporate debenture markets. Furthermore, a large amount of the Teigaku savings (reportedly 106 trillion yen including accumulated interest for 2000 and 2001) was invested under high interest rates around 1990 and will mature shortly. The Ministry of Posts and Telecommunications formed a study group to examine the issues involved in managing postal savings and postal life insurance funds, and published an interim report in June 1999. The report discussed the impact of FILP reform on the market and optimistically stated:

> Investment of postal savings in the market based on efficient risk and return analysis will result in expanding the size and the depth of financial markets with the inflow of funds from postal savings and may result in improved market efficiency. (MPT 1999)

Will this positive future materialise? If the financial 'Big Bang' is to transform the Tokyo market into a free and transparent market, two main issues need to be addressed. First, postal savings are 3.5 times higher than the funds of the largest private financial institution in Japan (the Bank of Tokyo-Mitsubishi, 70 trillion yen at the end of March 1999) and such a mammoth player might incapacitate the price mechanism of the market. An analogy is that of a whale released into a small pond. The political consensus, as incorporated into Article 17 of the Basic Law for the Reorganisation of Central Government Ministries and Agencies (effected in June 1998) is that the postal savings system should be neither split nor privatised. The plan is for the system to come under the jurisdiction of a newly formed Postal Services Agency, with a Postal Services Public Corporation created to administer it. It is planned that the Postal Services Council, an advisory body to the Minister of Posts and Telecommunications, will publish a yearly investment plan for asset management. Wild market fluctuations are likely to occur as the market tries to anticipate the plan. The interim report acknowledges this possibility and states that 'because of the size of the fund under management, the investment approach should be compatible with the market mechanism and care should be taken not to overly impact the market by becoming a price leader or a market maker'. Even in today's world of free capital movements, it is difficult to expect market principles to work effectively in the Tokyo market with an oligopoly of such gargantuan magnitude.

The second problem is the de facto government subsidies for postal savings (postal savings are exempted from corporation tax, inhabitants tax, property tax, the deposit insurance premium and reserve requirements). In March 1997 the Industrial Fund Committee, a subcommittee of the Industrial Structure Council of the Ministry of International Trade and Industry (MITI), estimated the total value of these exemptions to be 739.1 billion yen (Federation of Bankers Association 1999). The International Monetary Fund regards these as preferential subsidies that prevent the creation of a level playing field for private sector competitors. As well as having leverage from the credibility of being connected to government, the postal savings system is at an advantage in raising money from the public by offering noncommercial products (the Teigaku savings deposit) that private banks cannot afford to offer.[12] This allows the system to invest in bonds at prices out of line with market prices (assuming fair price formation is possible).

Uncertainty as to how FILP reform will impact on the government bond market and confirmation of the continuation of the postal savings system have contributed to raising the risk level and reducing the transparency of the Tokyo market for global investors. In addition, the supply pressure from the accumulation of public debt hovers over the government bond market.

Credibility of the Japanese economy and financial system

The Foreign Exchange Council is correct in pointing out that the prerequisites for the yen to be the third force in the current bipolar monetary system are credibility in the Japanese economy and financial system and a stable yen. The fulfilment of these goals will not only aid Japanese interests but help Japan contribute to the stability of the world economy and the recovery in Asia.

Moody's Investors Services, an American rating agency, downgraded Japanese government bonds (both yen-dominated and foreign currency-denominated) by one notch from the highest rating of Aaa to Aa1 in November 1998.[13] Standard and Poor's, on the other hand, kept the highest rating of Aaa, and this rating remains as of September 2000. The diverging views on the future of the Japanese economy by two internationally renowned companies reflect the structural problems Japan is facing and the absence of a consensus both within and outside Japan on the country's future.

Moody's reasons for the downgrading were the:

> increased long-term uncertainty and risk caused by the economic stagnation and weakness in fiscal policies, significant deterioration in the government's fiscal state, and serious weakening of the financial system which was inherently weak to begin with in comparison to other developed countries. (Moody's, November 1998 press statement)

The rising level of government debt in particular was seen as incompatible with an Aaa rating and as increasing the risk of exchange rate instability in an environment of liberalised capital. Standard and Poor's, on the other hand, decided to maintain its Aaa rating, explaining that

Japan is the world's largest creditor with the highest foreign reserves and is capable of overcoming mid-term to long-term instability since the economy consists of diverse and competitive industries. Standard and Poor's does share the concerns of Moody's over the fiscal deterioration.

Japan's fiscal deficit is the highest of all the 25 countries in the Organisation for Economic Cooperation and Development (OECD). According to the OECD, in 2000 the fiscal deficit as a percentage of GDP is projected to be –9.0 per cent in Japan, +1.8 per cent in the United States and –1.9 per cent in Germany (Table 6). In 2004 Japan's fiscal deficit is projected to be –6.4 per cent of GDP and, consequently, outstanding public debt is expected to climb to 148.3 per cent of GDP (as compared with 42.0 per cent for the United States and 61.6 per cent for Germany). Japan's public debt is 1.5 times its GDP – much higher than Italy's, which has the highest debt in Europe and is rated at Aa3 by Moody's and Aa by Standard and Poor's.

Although there is debate over how appropriate these ratings are, they have been increasingly relied on by investors and banks. The Bank for International Settlements (BIS), for example, proposed to use these ratings in assessing sovereign lending risk in its calculation of national capital adequacy ratios. Many institutional investors and central banks do not include assets below certain ratings in their portfolios. The downgrading of Japanese government bonds is serious since a country's private sector debentures are not generally rated higher than its government bonds. The Japanese rating needs to be on par

Table 6 Fiscal balance projection for major OECD countries (per cent of GDP)

	General fiscal deficits				Public debt balance	
	1998	1999	2000	2004	2000	2004
Japan	-6.0	–8.7	–9.0	–6.4	117.6	148.3
United States	1.7	1.9	1.8	2.5	51.7	42.0
Germany	–2.1	–2.2	–1.9	–1.1	63.0	61.6

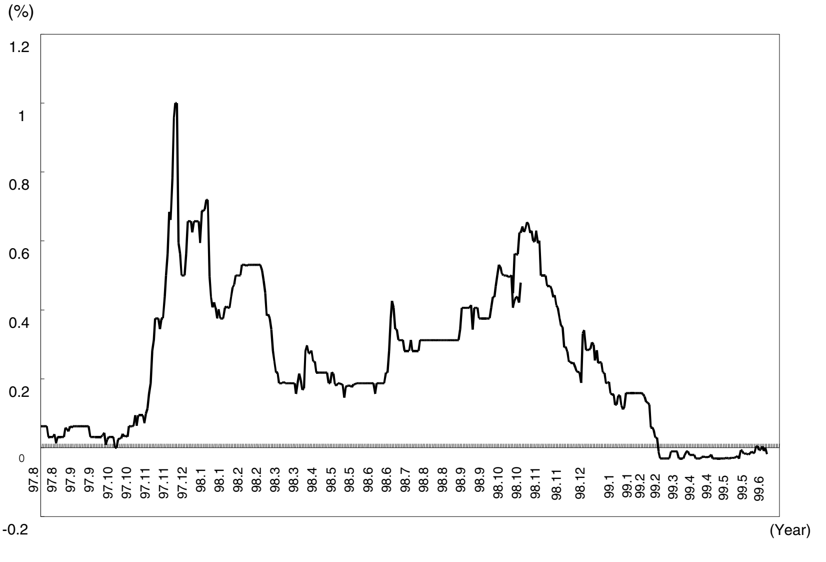
Note: The general fiscal deficit is a total of state, local and social security funds.
Source: OECD Economic Outlook; and European Commission, *European Economy No. 4*, 1999, for Germany 1998 and 1999.

with that of the United States, Germany, France and Britain if the yen is to become internationally credible and a first-class vehicle of investment. When will the Japanese government institute the necessary fiscal restructuring?

The Japan premium

The Japan premium is the interest rate margin that Japanese banks have to pay on top of the interbank rate paid by premier banks in international money markets. The premium jumped after the bank failures in 1997 and the crisis in the Japanese financial system, and remained high for the following 18 months. Top-tier banks ceased to pay the Japan premium in March 1999 when the government announced a 60 trillion yen emergency assistance program and public funds were injected into 15 banks, signalling that the worst of the crisis was over (Figure 5).

Figure 5 The Japan premium 1997 to 1999



Note: Japan Premium=Top-rated Japanese Bank Libor – British Bankers Association Libor (3m/s).
Source: Bank of Tokyo-Mitsubishi.

Two factors were behind the harsh interest rate premium charged to Japanese banks. One was the higher risks that Japan's economy and banks were seen to pose. In 1974, immediately after the first oil crisis, Japanese banks were charged an unreasonably high premium (then called the Japan rate). This was more a warning to a Japanese economy that was overly dependent on petroleum energy than an expression that Japanese banks were a high risk. The premium now signals concern about Japan's banks. A country's banks and economy are not unrelated – banks engaged in international financing maintain separate credit lines for the country and its individual financial institutions. When the country ceiling for Japan (a sovereign risk) is reduced, even Japanese banks that have high credit ratings are forced to pay the Japan premium.

Major Japanese banks scrambled to build up assets in Japan and overseas, offering loans with interest margins as low as 0.25 per cent (often paying the local withholding tax) to major companies in Southeast Asia. The export of Japanese business practices overseas did not involve interest rates that reflected the credit risks. As the Japan premium expanded, not only did overseas lending incur a negative interest margin, but Japanese banks were no longer able to raise dollars and were compelled to reduce their loan assets. While it is true that there was pressure on banks to improve their capital adequacy ratios, such an about-face in behaviour was, as could be expected, criticised heavily.

Another underlying cause for the interest rate premium was that Japan's foreign-currency assets were overwhelmingly in dollars. In addition to providing foreign currency-denominated trade financing, Japanese banks actively expanded overseas after the 1970s, mainly through dollar lending and interbank fund transactions. Lacking a dollar deposit base, Japanese banks had no choice but to rely on funding from foreign banks and were therefore taken advantage of as buyers of dollars in overseas markets. The Japan premium did rise in response to bad news on Japan's economy, but it had been always been present. With the exception of a handful of top banks, Japanese banks have always paid an interest premium that has reduced their profits in international banking.

The Japanese financial industry suffered from a severe shortage of foreign funds from 1997 to 1998 because of the financial crisis and the Japan premium. Trillions of yen were remitted overseas during the crisis. Even then, there was difficulty in swapping yen funds to dollars because foreign banks had reduced the credit limit for Japanese banks. The lesson to be learned here is that there is a risk inherent in a banking practice that is overly dependent on foreign-currency financing. Ultimately, the Bank of Japan, as the financial supervisory authority and lender of last resort, not the Federal Reserve Bank of New York, needs to be able to take care of the cash flow problems of Japanese banks. Banks need to extricate themselves from overdependence on foreign-currency financing and must increase the weight of yen financing in order to prevent the Japan premium from rising again and to strengthen the foundations of their business. Such efforts will promote the internationalisation of the yen.

Stabilisation of the yen exchange rate

Japanese industry has cried out for a stable yen ever since the currency was floated in February 1973. While manufacturers do everything possible to cut costs to the nearest yen, their frugality can be wiped out by exchange rate movements. Major fluctuations in exchange rates expose trading companies to actual and hidden exchange risks and pose difficult problems for banks dealing in foreign exchange; for example, by upsetting their capital adequacy ratios.

Exchange rate fluctuations are inherent in international transactions and are not necessarily problematic unless there is excessive fluctuation (volatility) and extreme overvaluation or undervaluation (misalignment). The Japan Foreign Trade Council plotted the yen-dollar exchange rates since the introduction of floating-rate system, finding that in the eight years between 1973 and 1995, exchange rates fluctuated by over 10 per cent annually (JFTC 1996). The yen appreciated 40.5 per cent from 1985 to 1986. More recently, the yen appreciated 15 per cent against the dollar in the two days between 7 and 9 October 1998, the experience of which renewed concern over the yen exchange risk. The JTFC recommended the internationalisation of the yen and monetary system reform to institute an exchange rate target zone. Orthodox economists stress the need for sound macroeconomic management while others advocate the need for intervention from the monetary authority to secure short-term exchange rate stability. While both these theories may be valid, the attempts over the past 25 years to stabilise the yen exchange rate have fallen short of achieving the desired results.

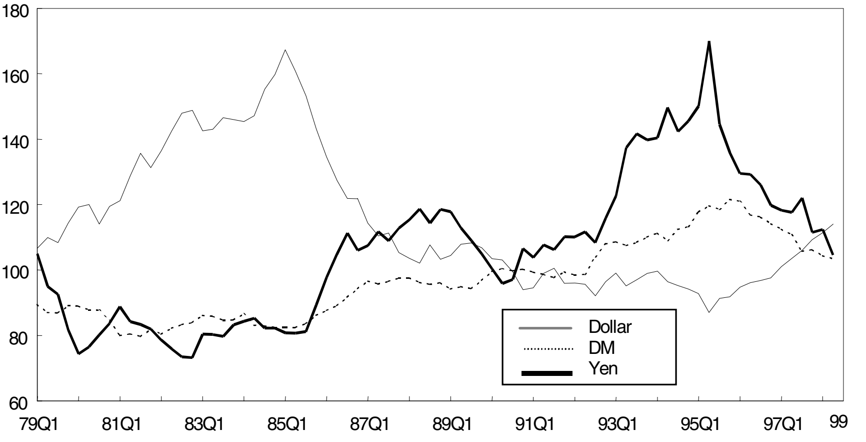
In analysing the extreme yen appreciations and depreciations, it can be seen that major depreciations occurred during the two oil crises, in the early 1980s when interest rates were high in the United States and in 1998 when the concern over the Japanese economy and financial system heightened. Except for the period when interest rates in the United States were in double digits, it has been problems with the Japanese economy that seem to have caused the yen to weaken significantly. The yen had been steadily appreciating until the peak of 1995, and then declined after 1996 as Japan's economic stagnation set in. Major appreciations (overshooting) occurred mainly because of problems and policies of the United States: during stagflation up until 1978, in the dollar confidence crisis that culminated in Black Monday (October 1987) and when US officials talked down the dollar around the time of the Mexican currency crisis.

Sound macroeconomic management to stabilise the exchange rate (i.e. to halt the yen's decline) will play a more important role in the future, although past experience shows that this alone cannot prevent the misalignment.

A comparison of the real effective exchange rate (REER) for the Deutschemark and the yen indicates much greater variability for the yen: from 1986 to 1998, the variances were 265.0 for the yen and 79.2 for the Deutschemark (Figure 6). During this period, the yen and the Deutschemark had completely different monetary regimes: the yen was floating, while the Deutschemark was within the European Monetary System. The Japanese economy had structural weaknesses such as its reliance on imported energy and food. Also, because of its dependence on the United States for security, Japan had to support America's exchange rate policy. A case in point was an administrative pressure to institutional investors by the Japanese government to refrain from sales of Treasury bonds to cooperate with the United States in defending the dollar. Between the Plaza accord in 1985 and the end of 1987, the dollar lost 40 per cent of its value against the yen. Japanese life insurers suffered sizeable exchange losses, but took little action to replace Treasury bonds with instruments of other major currencies to diversify their portfolios. During this period the supervisory authorities exerted pressures on institutional investors through such means as telephone hearings just before bond auction schedules or at the monthly meetings for exchanging information.[14]

On the other hand, European currencies, including the Deutschemark, could defend themselves against arbitrary American interests because they were linked to each other in the European Monetary System. While Germany also had structural weaknesses, the most serious of which was the threat from the Soviet Union and Eastern Europe during the Cold War, it did not deal with the threat single-handedly, but rather within the North Atlantic Treaty Organisation. The subsequent developments in the world dissipated this threat and, in January 1999, the Deutschemark evolved into the euro.

Figure 6 Real effective exchange rates (REER) of yen, dollar and Deutschemark



Note: Variance of the REER: yen – 265.0; US dollar – 92.2; Deutschemark – 79.2.
Source: prepared by Bank of Tokyo-Mitsubishi based on International Financial Statistics, IMF.

Germany's experiences suggest that the yen exchange rate will remain unstable as long as the yen remains a solo player and until Japan secures an equal footing with the United States. The most effective action Japan could take to stabilise the yen is to build a cooperative grouping involving other countries in East Asia and Oceania. The organisation of such a framework will face many practical difficulties, but unless Japan takes up this challenge with a clear political will and starts with what is feasible, the internationalisation of the yen cannot be achieved and Japan's currency will continue to have a lesser role than the dollar and the euro.

Notes

1 This paper is an edited version of an article published in Japanese in *Sekai Keizai Hyoron* (World Economic Review), September and October 1999.

2 Euro-yen bonds are yen-denominated bonds issued overseas.

3 These issues are very well covered in Steiner, Krauss and Flanagan (1988).

4 Full reform, including the abolition of institutional restrictions on business scope, was deferred until the 'Big Bang'.

5 Bidding for public offering in the open market of short-term government securities became a reality in April 1999.

6 Liberalisation lagged behind the most in the elimination of barriers preventing banks, security houses and insurance companies entering each others' businesses. A single administrative agency supervised financial businesses, requiring a license for each part of the industry and that institutions operate exclusively in the area under license. This centralisation was one of the causes for Japan's falling behind in developing leading-edge financial products. Foreign banks operating in Japan were allowed to operate as groups that included banking, trust and security businesses. They also enjoyed preferential treatment in the development of financial products (e.g. approval to market some derivative products was granted to foreign institutions ahead of Japanese banks).

7 The Banking, Securities and International Finance Bureaus of the Ministry of Finance issued a guideline in 1975 that in conducting business in the euro market, Japanese banks and brokers were to observe the rule of separation of business stipulated in Article 65 of the Securities Transaction Law. This guideline was in effect until the mid-1990s.

8 The Council on Foreign Exchange and Other Transactions, the Securities and Exchange Council, the Financial System Research Council, the Insurance Council and the Business Accounting Council. The reports reflected Japan's vertical organisational structure. Each administrative agency was responsible for overseeing one of the industries or categories of businesses separately. This explains why there are limits to what the financial Big Bang can achieve.

9 Public financing, including the postal savings system, has been a concern because it has expanded far beyond its original role, which was to compliment the activities of private financial institutions. The postal savings system had a significant role before and after the war when capital was scarce. Not only has its raison d'etre become questionable, but because of its size and its distortion of the price mechanism in financial and capital markets, the system is now thought to undermined the effectiveness of the financial reforms. In August 1998 the International Monetary Fund made the following recommendation after consultation with Japan:

> Directors welcomed the authorities' commitment to the 'Big Bang' reforms of the financial sector, which are a key element in the necessary restructuring of the Japanese economy ... Indeed, more ambitious measures to scale back the public sector's role in financial intermediation, including by eliminating the preferential treatment of the postal savings system, are needed. (IMF 1998)

10 In Japan high credibility did not necessarily mean low yield until 1996. Because the cost accounting method was used for unlisted debentures such as bank debentures, listed government bonds were sold and bank debentures bought to avoid valuation losses at the end of the year. This caused the abnormal phenomenon of reversed yields.

11 The institutional problems were partially rectified with the abolition in September 1999 of the coupon tax on government bonds held by nonresidents. As the Bundesbank Monthly Report of July 1985 explained:

> With the abolition of the coupon tax on new and old issues, which hitherto existed, of the market for Deutschemark bonds into bonds that were primarily bought by residents and those primarily bought by non-residents came to an end. Now there is a uniform market on which the yields are graded according to creditworthiness of the issuers and other objective bond qualities (price support operation, availability of effective bonds). The unification of the market is tending to create a greater market depth and at the same time to strengthen the secondary market for foreign Deutschemark bonds. (Deutsche Bundesbank 1985)

12 The Ministry of Finance announced the resumption of the purchasing operation on 16 February 1999 as a stopgap measure that managed to temporarily stem the rise of long-term interest rates. The decision to suspend purchasing and underwriting was most likely caused by cash flow problems of the Trust Fund Bureau.

13 Because postal savings deposits have an arbitrary maturity of up to 10 years after an initial six-month fixed period, with interest compounded semiannually at a fixed rate, private banks are not inclined to offer this product.

14 On 7 September 2000, Moody's downgraded its rating of Japan's yen-denominated domestic bonds from Aa1 to Aa2. Foreign currency ratings remain unchanged at Aa1.

15 Mr David Hale of the Zurich Insurance Group considers the Japanese government's support of the dollar as the cost of security (speech made in Tokyo, February 1999).

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