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“ A Vulnerable Power in the World Economy: Japan's Economic Diplomacy and the Yen ”

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Abstract

The volatile yen/dollar exchange rate has largely influenced Japan's business cycles and foreign economic relations from the 1980s. In particular to note is the triangular pattern of trade interdependence which appeared following the rising yen exchange rate and a increased scale of Foreign Direct Investments from Japan. Along with the post-bubble recession, however, the global position of the yen has also declined. The more international use of the currency, although recommended by policy-makers and economists, is limited because of the fact that Japanese economy stands on two pillars, the United States and East Asia, and the latter is more dependent on the former than on Japan.

Key words: post-bubble recession, yen/dollar exchange rate, trade frictions, East Asia, international currency

0. Introduction

In contrast to the 1980s, when the possibility of the tri-polar system of the world economy, composed of the United States, Europe and Japan, was widely discussed, the international reputation of the Japanese economy has largely deteriorated in the 1990s, along with the post-bubble recession. One example is the international position of Japanese financial institutions. Contrary to their share of 31 % in 1988, Japanese banks occupied only 13 % in the external banking business as of 1998[1]. Another example is the share of the yen in the world international reserves, which decreased from the peak of 7.3% in 1990 to 4.8% in 1998 (Table 1).

As a matter of fact, the recession itself, the severest one since the post-war period, was closely connected with the foreign economic relations surrounding this country, and the declining presence of Japan can be characterised as a side effect of a boom and bust cycle from the mid-1980s through the 1990s. Due to the large swing of the cycle, the current state of Japan, as well as the yen, is possibly undervalued. Indeed to what extent of undervaluation is difficult to say, but important to know is the backgrounds against which the global position of the currency is determined. The more international use of the yen, although recommended by policy-makers and economists, is limited because of circumstances in which Japanese economy is located. Knowing that will help us to see the prospect of Japan in the coming century. We try to discuss in the following way.

Section 1 describes how the yen/dollar exchange rate affected the Japanese business cycles and foreign economic relations from the 1980s onwards. In addition, a new pattern of foreign trade and capital flows which appeared is discussed. Section 2 deals with the question of how the international role of the yen has been determined, initially from a viewpoint of the economic background. In short, Japan stands on the two pillars: the United States, on the one hand, and East Asia, on the other, whereas East Asian countries depend more largely on the United Sates than on Japan. This situation explains how Japan has formulated its foreign economic policies. Then, we review the economic diplomacy in the 1990s, in particular during and after the Asian currency crisis. Lastly in Section 3, the conclusion of this paper is summarised.

1. Foreign Economic Relation of Japan

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1 Measured by external assets of banks located in each country, from BIS, *International Banking and Financial Market Developments*, various issues.

1.1 The unstable exchange rate and related policies

From the early 1970s, Japan's foreign economic policy-making has been almost determined by the dollar/yen exchange rate, which caused also a large swing of the business cycles[2]. The yen exchange rate showed an accelerated appreciation after the Plaza Agreement (Figure 1). The international macroeconomic policy co-ordination was designed for soft landing of the dollar, which, however, resulted in the "bubble economy" and the long recession after its burst-out. One of the reasons of this serious side-effect was the lack of prudential policy considerations, in the sense that the Ministry of Finance (MOF) stuck to a balanced budget policy and thus shifted an undue burden onto the monetary policy,

In order to soften the depressing effect of the yen appreciation, the Bank of Japan (BOJ) pursued an easy money policy, keeping the official Bank Rate at the historically low level, in particular at 2.5% from February 1987 to May 1989. With a hindsight, this policy stance obliged by the international considerations stimulated speculation in the stock exchange and the land market. Rising private consumption and investments contributed to unusually high growth rates between 6 and 4% from 1988 to 1991. As the macroeconomic policy turned to a tight stance, in particular, after the BOJ successively raised the interest rate from 2.5 % to 4.75 %, and the new regulations on bank credit on real estates were introduced, the bubble finally burst out. The GDP growth declined to less than 1% from 1992.

From early 1990, the yen began to appreciate, with a record peak of 79.75 yen/dollar in April 1995. Its volatility was also the largest in that year. From the summer of 1995, however, the appreciation of the yen gave way to the depreciation, reaching the level of 140 yen in mid-1998. Although the Japanese growth rate picked up to around 3% in 1995 and 1996, another depression wave commenced in 1997. In consideration of the recovering growth rates, Hashimoto government introduced a policy package of structural reforms, and raised consumption tax from 3% to 5%, and patients' payment of medical care. These fiscal measures resulted in a larger shock than expected, namely minus growth rates for consecutive years. Large financial institutions, security houses and banks, went bankrupt from late 1997 to 1998, further deteriorating public confidence in the government policy. As a result, the 1990s is characterized as "the lost

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2 The relationship between the exchange rate, business cycles in Japan, and the trade frictions is smartly analyzed in McKinnon and Ohno (1997). However, we shall comment on their views in the last section.

decade," which can be attributed to the "boom and bust" cycle from the mid-1980s, being deteriorated further by the change in policy-stance in 1997. Noteworthy is the fact that Hashimoto's reforms, as those under the preceding governments, were partly a response to economic frictions with United States.

The yen depreciation got momentum from late 1996, as international investors began to perceive that economic reforms to cut budget deficits and revitalize the economy would not succeed in Japan, and the stock prices recorded an accelerated decline, led by financial stocks. The BOJ has kept inter-bank rate at 0% from February 1999 in order to stimulate economic recovery from the severest depression, and more importantly to help banks reduce huge amount of bad loans. This policy is also related to considerations on international capital flows to the United States. Yen began to appreciate again from the mid-1999, and this time also, rising yen led politicians to demand for more expansionary money supply. We shall discuss this topic in the last section.

1.2 Economic Frictions and Structural Adjustments[3]

The unstable yen/dollar exchange rate, accompanied by Japanese surplus in current account, caused international economic conflicts. According to US policy-makers and some of the economists, the under-valued yen sustained Japan's growing trade surplus, on the one hand, and US deficits, on the other hand. The word, structural adjustments often appeared in the US-Japan trade talks, implying economic reforms that help to reduce Japanese surplus. While decreased from 4.3% in 1986 to 1.5% in 1990, it increased again until 1994 in terms of the US dollar. Its ratio to GDP gradually declined from the peak of the 1990s, 3.1% in 1993 to 2.2% in 1995, and this tendency continued through the 1990s.

While the current account of the balance of payments is identical with the domestic saving-investment gap, structural problems may cause such a gap, and accordingly lead to international policy debates. Moreover, although the bilateral trade imbalance has little sense, if any, from purely economics' point of view, it has a large political impact, in particular with the United States. How to open the Japanese market has been the focus of trade negotiations with the United States, as well as with European Union and Asian countries.

Whereas economists have not yet agreed on an objective way to measure a degree of protection, the issue was not the tariff level itself, because the tariffs on industrial

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3 Following discussions are based on Iwami (1998).

products stayed lower in Japan than the United States and the EU. In addition, Japanese non-tariff barriers against foreign manufactured products (apart from agricultural imports) are said to remain lower than most of the industrial countries[4]. Despite these facts, there is still a widespread belief that some "unfair" and/or structural factors keep Japanese imports at an artificially low level. The US government proposed Japan to discuss on structural impediments such as governmental procurement, business practices, and distribution system[5].

Often criticized evidence of Japanese trade barrier is the low share of manufactured goods in total imports. However, this ratio has been remarkably rising since the Plaza Agreement, from ca. 30% in 1985 to 59 % in 1995, mainly led by increased imports from East Asian countries that occupied around 40% of the total manufactured imports in 1994[6]. As discussed below, the increased number of Japanese manufacturing subsidiaries in that area contributed to this tendency.

Japan liberalized international capital transactions in the early 1980s, beginning with the amended Foreign Exchange Law of 1980. Now, there are no legal regulations on both inward and outward capital flows. Rather other forms of barriers than restrictions on capital transactions cause the relatively low level of inward Foreign Direct Investment (FDI). According to the opinions of foreign firms, the major hindrance to invest was difficulties in employing staffs, high wage cost and land prices, as well as the closed system symbolized by the word *Keiretsu*. Also criticized by foreign would-be investors were various forms of administrative regulations such as limit on capital participation in telecommunications and transport, regulations for the sake of food safety, industrial standards peculiar in Japan. Most of these barriers have been more or less relaxed and/or reformed, with a result of increased inward FDI flows particularly after the worst stage of the financial turmoil had passed.

Japan often made concessions on the bilateral basis with the United States, not following the multilateral principles of the GATT. The 1991 US-Japan Semiconductor Arrangements, following the similar one in 1986, expected that the US share of semiconductor products would reach 20% in the Japanese market. This expectation was realized in 1992. Such result-oriented approach on the part of the US appeared repeatedly in talks on automobiles (and parts), and cellular telephone. Although Japan reluctantly accepted some of these requests, they did not necessarily lead to cost-

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4 OECD (1991), p.67.

5 For this issue, see, for example, Sato (1991) and Sekiguchi (1993).

6 MITI (1996), pp.149, 151.

reduction and more benefits to consumers, naturally with a disadvantage to damage the principle of non-discriminative multilateralism.

The SII (Structural Impediments Initiative) talks 1990-92 resulted in a report as President Bush persuaded Japanese side to complete it in order to avoid designating Japan as “a country of unfair trading practices” by the “Super 301” provisions added to the 1974 Trade Act. This report recommended Japan to expand public investments for living environments, to improve access of foreign products and investments, and to strengthen the Fair Trade Commission for prohibiting discriminative practices. The Framework for a New Economic Partnership 1994-95 determined that the mid-term objective for Japan is to promote domestic demand and to provide easier access for foreign competitors. Strongly stressed areas were financial services, government procurement of telecommunications, automobiles including parts, and inward direct investment.

Whereas Japan also claimed US problems such as fiscal deficits, the US recommendation on structural reforms stood in the similar line as the deregulation policy stance of the Japanese government from the late 1980s. For example, rice import was finally decided to be liberalized, foreign entries into the telecommunication, and air transport industries became increased. Above all, reforms of the financial system were undertaken, symbolized by the slogan of the “Big Bang” under the Hashimoto government. Under the prolonged recession, pessimistic sentiments that Japan would lose her competitiveness gained popularity. Deregulation and liberalization, as it was stressed, are the last resort for steering the economy out of the recession. The depression induced Japanese policy-makers and business leaders to the recognition that most of the structural characteristics in Japan is rather a cause of the economic weakness than strength, and accept foreign pressures to promote reforms.

1.3 A Triangular Pattern of Interdependence

A new pattern of interdependence emerged in the 1980s as Japanese enterprises accelerated FDI in the region in order to avoid the damaging effects of the yen appreciation on their exports. Although the yen depreciated again thereafter, and it would help to increase exports from Japan, the manufacturing plants once shifted abroad would not easily come back home. Because of this “hysteresis effect”, the fear of de-industrialization once prevailed.

The NIEs (Newly Industrialising Economies) and other ASEAN (Association of Southeast Asian Nations) countries succeeded in industrialising their economies with liberalised capital inflows. They established industrial export zones, associated with tax reductions, relaxing foreign ownership restrictions, thereby promoting inward foreign investments. The open-door policy and market-oriented reforms of China since 1979 have also contributed to the growing intra-regional transactions. China has absorbed the second largest amount of the FDI in the world, after the United States. By the early 1990s, Japan and Asian NIEs became the main investors in the region, where the intra-regional FDI recorded 42% of the total stocks in 1992[7].

The outward FDI from Japan rose from 1.4 trillion yen in 1985 to 7.35 trillion yen in 1990, with a subsequent decline to 1.5 trillion yen in 1993. The ratio to GDP stood at the highest level of 1.7 % in 1990 . Whereas Asia occupied 24 % in overall FDI investments, next to the US share of 42 % in 1994, Asian share recorded 38% in Japanese manufacturing FDI, larger than the US share of 33%[8].

In East Asian foreign trade, the share of intra-regional trade grew from 38% in 1985 to 50% in 1997. This is based upon a triangular pattern of trade created by Japanese multinationals. Electronics, automobile, and other machine manufacturers established production bases for exports not only within Southeast Asia, but also back to Japan and to North America. The Asian countries, on their part, increased imports of capital goods, parts and intermediaries mainly from Japan to build factories and subsequently assemble parts. In 1996, for example, Japanese manufacturing subsidiaries sold more than 70% in East Asia (57% in the host countries, and 21% in Japan), while the export to North America and other industrial countries remained rather quite small.[9]

However, it is important to note that the share of the United States is far larger in exports of all East Asian countries combined (Table 2) than the case of sales by Japanese subsidiaries located in the region. This difference in market orientation can be probably explained by the fact that parts and intermediates produced by Japanese subsidiaries are sold to assemblers in the region, and their final goods are subsequently exported to US markets, possibly with brand-names of the western manufactures[10]. Moreover, the fact that the United States, at least from the mid-1980s, occupies a larger share than Japan in East Asia's overall exports, suggests that imports from Japan are also closely related to final exports to the United States.

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7 Chia (2000). The share of intra-regional FDI is taken from her Table 5.

8 Those data are taken from BOJ, *Economic Statistics Annual*, and JETRO [Japan External Trade Organization], *White Paper of FDI*, various issues.

9 MITI(1999), p. 131. According to Sato (1999) Table 12, 40% of intermediates are procured from the local markets, and another 40% from Japan, as of 1995.

10 See also Sato (2000),Chapter 4.

Japanese imports from East Asia stagnated under the recession, with a share of ca. 35% of the total imports, while the East Asian share in Japanese exports declined from a peak of more than 40% between 1995 and 1997 to less than 35% in 1998. Noteworthy is the fact, however, that the intra-firm trade of Japanese multinationals largely influences the manufacturing trade between East Asia and Japan. As of 1996, 25% of Japanese exports and ca. 40% of imports are undertaken by Japanese subsidiaries[11].

The United States occupied constantly ca. 30% of Japanese exports, and 22-3% of Japanese imports in the 1990s[12]. Thus, although East Asia as a whole occupies larger share than the United States in both export and import sides of Japanese foreign trade, the United States is the single largest trade partner for the country. In this way, the US is situated in the key position of the East Asian triangular trade, which constitutes the basis for the predominant role of the US dollar. In addition, the position of the dollar has been rather strengthened during the last decade, because of the continued boom in the United States, on the one hand, and the depression in Japan, on the other hand.

2. The Role of the Yen

2.1 The stance of Japanese side

The turning point for the internationalisation of the yen was marked by the report of the US-Japan Yen/Dollar Committee of 1984. Japanese government reluctantly accepted opening the domestic financial markets and relaxing regulations on the euro-yen transactions. These measures would lead, as the US side expected, to the increased share of the yen in the international transactions, thereby push the yen exchange rate upwards. The monetary authorities in Japan initially stood firmly against the international use of the yen, which, in their view, would undermine the effect of the monetary policy. They gradually changed its stance, however, along with the recognition that the control on money supply at home is of the primary importance for the stable macro-economy.

Indeed, the yen share in international financial markets did increase in the 1980s, supported by financial liberalization and accelerated cross-border capital transactions. The most peculiar fact on the part of Japanese financial institutions was a rapidly growing investments in the United States, for example purchasing Federal Government Bonds. In particular, life insurance companies increased foreign portfolio investments

11 MITI(1999), pp. 130-1

12 MITI(1999), p.63

by 99.5 billion US dollars (converted with exchange rate at the end of 1990) between 1984 and 1990. Japanese investors, although the largest capital exporter of the world at the time, were not able to invest abroad in their own currency, but in the US dollars. As the yen rapidly appreciated after the Plaza Agreement, they largely suffered from capital-loss due to investments in the US Government Bonds[13]. The large capital-loss of the investors as well as the exchange risk for the foreign traders caused the public opinion to recognize disadvantages of the limited use of the yen. After the Asian currency crisis, Japanese government stepped forward to the internationalisation of the currency, on which we shall discuss later in this Section.

2.2 The Limited Extent of Internationalisation

As discussed above, the major part of Japanese capital abroad has been invested in US dollars. Moreover, yen share in Japanese foreign trade has been traditionally smaller than the proportion of national currencies in not only the US, but also German foreign trade. In addition, yen denominated share in Japanese exports declined from 43% in 1993 to 36% in 1998, while the peak in the case of imports, 24% in 1995, was followed by a slight decline to 22% in 1998. This is another example of the declining international use during the 1990s. The yen share in exports is indeed higher in Asia than elsewhere, but still less than 50%.[14].

The choice of the trade currency reflects at least two factors among others: composition of goods and the trade partner. The limited share of yen in Japanese foreign trade has been traditionally attributed to a large share of the United States in the export market and raw materials and crude oil on the import side, both of which enhance the dollar shares[15]. The latter part of this stylised explanation does not well fit to the recent situation under which the manufactured imports has gained weight, and the yen share has yet shrunk.

In contrast to the real factors like foreign trade, convenience in the financial-and foreign exchange markets has been stressed as a decisive factor for the global selection of the currency. Invoicing in trade is naturally influenced by the convenience in trade finance. The currency selection in trade is at most a secondary factor, as its remarkably low proportion to the daily foreign exchange transactions suggests. In other words, currency selection in financial transactions has gained more weight. Table 3, showing

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13 Iwami (1995), pp.107-12.

14 MITI (1999), p.206-7.

15 Ito (1994), pp.320-1.

the relative position of the yen in the financial markets, reveals also a declining trend in international bank-lending and bond-issues from the early 1990s.

In this context, there has been a number of literature stressing that the further liberalization of the Japanese financial market would be indispensable for the internationally higher status of the yen. In particular, the short-term financial market of the first quality, such as the FB (short-term government bill) market would help foreign monetary authorities to employ their international reserves[16]. Although the declining share of the yen in Table 3 is partly explained by the difficult situation of Japanese firms, the more convenient opportunities in financial markets undoubtedly enhance a preference for yen on the part of foreign investors. Financial reforms since the 1980s have been introduced indeed in the similar direction, but there would surely remain an insurmountable barrier for a currency like the yen to be internationally used.

Iwami (1995, Ch.5) explained the global role of the dollar from the trade aspect, although this explanation is unfortunately not yet widely accepted. We have to stress the causality that foreign exchange markets have developed from the fact that most of the countries had used the US dollar for their foreign trade. The depth of the market (the large volume of transactions) is not necessarily a cause, but a result of a key currency function. Once a currency gains a large amount of transactions, then, because of the scale economy, the transaction cost will decline disproportionally to its demand. Thereby, a virtuous circle between the larger trading volume and decreasing transaction cost of that currency would appear. In the financial market as well, the similar logic holds. Then comes out a crucial question of what was the initial cause that generated a financial- and foreign exchange market based upon a particular currency like the dollar. Here we have to come back to the historical background.

In the postwar years when the international capital movements were restricted, it was the foreign trade that determined a choice of the international currency. "Both exports and imports from countries with a high share of trade are relatively successful at imposing use of their own currencies. The larger a country's trade, the more likely are its currency, and probable movements in it, to be already familiar to trades. Such a currency is also likely to offer a strong forward market, both familiarity and facility to reduce risk encourage its use" stated Page (1981, p.62), explaining the dominant role of the dollar in the world trade. The international financial business was largely liberalized in the 1980s, after the world trade had developed on the basis of the dollar. International financial markets were to develop on the basis of a currency already

16 For example, MITI (1999), p. 203ff.

widely used in foreign trade.

Because the foreign exchange market had already developed on the basis of the dollar, the growing turnover volume accelerated by the liberalized capital mobility strengthened its vehicle currency function. It is rather a recent phenomenon that the convenience in the financial transaction largely determines the selection of the international currency. There has been so far no currency that initially gained a key-position through financial convenience alone.

2.3 Larger Role in East Asia?

In East Asia as well, the US dollar is far more widely used than the yen although the latter plays a larger role than in other regions. As far as the region's official reserves are concerned, the US dollar accounted for almost 60% of total reserves in the early 1990s[17]. Whereas the Asian data have not been published thereafter, the declining share of yen in the world reserves suggests that its role would not have increased in this region as well. Since official reserves are used for intervention in the foreign exchange market, the large share of the US dollar is consistent with the fact that Asian countries tried to keep their currencies stable in terms of the dollar[18].

In denomination of foreign loans to East Asia and Pacific countries, yen share is naturally larger than the case of all developing countries, because of Japanese ODA and bank loans, for example those extended to Japanese subsidiaries in the region. Even in this sphere, yen share shows a decrease from the peak of the early 1990s, while the US dollars remarkably increased its share (Table 4). Japanese banks actually cut loans abroad. Because the adequate capital ratio determined by the BIS (Bank for International Settlements) include capital gains of the stocks held by banks, and as the stock prices in Japan remarkably went down after the bubble-period, they cannot afford to maintain the lending level so far extended.

Another interesting example is the currency selection of the Japanese multinationals in this region. The yen-denominated share in their intra-firm trade might be higher than in the overall trade of the host countries, but not remarkably high as one might expect. As of 1992, 55% of Japanese multinationals' exports to East Asian subsidiaries was invoiced in yen, but 39% in US dollars, whereas their intra-firm

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17 Iwami (1995), Table 5.13.

18For the currency weight in the exchange-rate policy of Asian countries, see estimation by Frankel and Wei (1994).

imports was 45% in yen, and 46% in dollars[19]. As discussed above, Japanese manufacturing subsidiaries sell their products largely in East Asia, where most of the currencies used to be stabilized in terms of the dollar until the currency crisis in 1997. Moreover, when the imported parts from Japan are assembled and finally exported to the United States, trade in the US dollars is naturally convenient.

Since Japanese firms are said to rely on the marketing practice, called "pricing to the market", it is natural that their exports tend to be invoiced in dollars. When the yen appreciates, the Japanese firms try to stabilise their export prices in dollars, thereby maintaining the market shares at the cost of margins in yen. Although these subsidiaries might as well import Japanese parts in yen, the export pricing of their manufactured goods would not be so much different. In other words, whether to import parts in dollars, or in yen leads to a difference in cost accounting, but it would not affect price competitiveness as far as they keep the dollar–price unchanged. In this sense, the currency situation of the export market is a decisive factor for the limited use of the yen. An additional factor is, of course, that these subsidiaries raise and employ funds more easily in the dollar financial market.

The volatile yen/dollar exchange rate has affected business conditions in East Asian countries in various ways. First, export price competitiveness, second, import price from Japan, third, debt-service on yen loans, and fourth, FDI from Japan. Under the yen appreciation, like in the 1990s, East Asian business enters booms through Japanese FDI and growing exports to Japan, despite the increased cost of imported parts from Japan. The yen depreciation tends to depress these economies in an opposite manner, as Kwan (1998) stressed. This relationship naturally depends on the industrial structure of Asian countries, in other words, whether or not their manufacturing industry has arrived at the stage in competition with Japanese products. But the yen depreciation after mid-1995, it was claimed, caused difficulties in these countries at the time of Asian currency crisis of 1997 and 1998. Therefore, the currency crisis may have induced those countries to reconsider pegging to the dollar, and to increase weight of other currencies, like the yen, in their exchange-rate policy. Because their policy of pegging local currencies to the dollar, it is argued, had a detrimental effect on the competitiveness of their exports.

However, yen has lost weight in long-term lending to the regional economy, and these countries would not replace the dollar's share with that of yen in their currency baskets, because the conditions for these countries to depend on the dollar have not yet changed.

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19 Sato (1999), Table A1.

Largely benefited from liberalised flows of goods and capital, at least until the currency crisis, East Asian countries have developed a form of *de facto* economic integration. According to Goto and Hamada (1994), the degree of economic interdependence is, in some respects, higher among East Asian countries than among west Europeans. But these countries are not inclined to form a closed block[20]. Most important for them is to preserve good relations with major trade partners and capital suppliers, namely the United States and Japan.

Asian countries, including Japan, are so dependent on the United States, both economically and politically, that intra-regional trade and capital transactions have developed on the basis of the dollars. Financial integration is one aspect of this large dependence on the United States.

The last question is the future of Chinese currency, yuan. The ever-growing size of the Chinese national economy will indeed enhance the relative position of the currency in East Asia. But the yuan cannot replace yen in the region, much less the dollars, because exchange controls and the closed system, in particular financial market in China constitutes a major hindrance.

2.4 Economic Diplomacy

As for the Japan's policy stance towards East Asian countries, we should take note of the past liabilities, material as well as moral, during the War. Even today, Japan's regional policy is often compared with the old image of the Great East Asian Co-prosperity Zone. Related to this factor, the rival position of China also prevents Japan from taking a leading role in the region. Moreover, Japan's economic difficulties have recently hindered its initiative, not only in economic, but also in political terms.

Another, far larger factor is the United States. The post-war history of Japanese diplomacy has been focused almost entirely on relations with the United States, and political initiatives independent from the latter have been quite rare. A good example is the proposal of the EAEG (East Asian Economic Group) by the Malaysian Prime Minister, Mahathir, in 1990. The initial plan was to build a framework of economic co-operation, with Japan at the central position but excluding United States, Australia and New Zealand. It did not come into existence, because the United States opposed a grouping without its membership, and Japan did not welcome it, following the American opposition.

20 Frankel (1993) found no clear evidence of a bias towards the closed integration. This paper suggests, however, the US anxiety about the Japan's larger presence in East Asia, at the time of his writing.

At the early stage of the Asian currency crisis, the Japanese government proposed an idea of the Asian Monetary Fund that was supposed to extend short-term credit to countries facing currency attacks. It would work as a complementary miniature of the IMF on the regional basis. After a while, however, Japan gave up this idea, mainly because the United States rejected such a monetary scheme that would develop outside its control. In stead, an agreement of regional currency co-operation, called Manila Framework, was reached in November 1997. It includes regional surveillance, technical assistance to strengthen financial sectors, as well as provisions of short-term financing that should be consistent with the IMF adjustment program.

These episodes show that international monetary policy constitutes only a part of the whole diplomacy. The reason why Japan has been almost dependent on the US policy can be attributed to two factors: firstly, the size of the US economy which determines the scale of opportunities for Japanese exports (and investments therein), in other words, anxiety that the US market might be closed, and secondly, the US military capabilities which are indispensable for Japan's security in East Asia, given the latter's constitutional constraints..

It is true that Japan took financial measures, showing a sign of leaving away from the passive stance. Until May 1998, Japan decided to provide 42 US billion dollars to Asian countries in financial trouble. Moreover, Miyazawa Initiative was announced in December 1998, thereby supplying 30 billion US dollars to assist Asian efforts to recover from the crisis and to promote stability of the international financial market. Nevertheless, these policies have not yet implied a clear direction of independence in the international financial strategy.

The capital flows to the United States and their business conditions largely influence East Asia, including Japan. In this respect, the monetary policy of the BOJ has been, at least partly, determined in view of the capital outflows to the US market. Since the low interest rates prevent large scale Japanese savings from being profitably employed at home, on the one hand, and the US stock exchange has experienced historically long boom, on the other hand, there have been continued capital-outflows from Japan to the United States. Thereby, a sort of anti-American feeling has grown at the grass-roots level, that the domestic savings have been misused only to sustain financial gains of American investors, and that Japanese economic difficulties have been caused, or to say the least, worsened by the deregulation policies demanded from abroad.

Nevertheless, if the American boom comes to a sudden end, East Asia is surely to suffer from another recession. In this sense, there is a dilemma for Japanese monetary authorities that cannot change their policy stance so far pursued. From the long-term viewpoint seen, however, it is desirable that they should find a standpoint towards the more internationally independent policy.

3. Concluding Remarks

Having reviewed Japan's foreign economic relations during the last couple of decades, we find that the volatile state of the yen/dollar exchange rate is the most influential factor. It not only led to the economic frictions with the United States, but also generated a new trade pattern with the East Asia. It has been one of the cores of the Japan's macroeconomic policy, that largely affected business cycles in this country as well as in East Asia. Its stabilisation would accordingly reduce trade frictions and large swings of the business cycles. In this respect, the proposal of McKinnon and Ohno (1997) to fix the yen/dollar exchange rate seems to be quite appealing.

However, the crucial point in their proposal is its feasibility. It is hard to imagine that the United States would ever agree to fixing the exchange rate at the cost of its independent macroeconomic policy-making, and even if it is agreed, standing against the currency attack is not an easy task under the current regime of free capital movements. We cannot agree with their views, either, that "the ever-higher yen syndrome" is simply resulted from the talk-up, or pressures of the US government (p.12. for example). The long-term appreciation of the yen actually reflects fundamentals such as increasing Japanese surplus on current account, in other words, the macro-economic IS imbalance between the two countries, which McKinnon and Ohno also discuss in other context.

We have not yet found a sufficient solution to accommodate exchange-rate stabilization with the US predominant position in the world economy. Because of its continued trade deficits, the situation is naturally more complicated. In Japan, due to the current recession, such a feeling that the "globalization" means nothing but Americanization has been strengthened. True that the US government, for its own sake, has pressed other countries to open the market. But economic reforms so far commenced are not necessarily all together disadvantageous to the national economies concerned. Financial liberalization in Japan, for example, was natural outcome of changing fund flows between the private and public sectors, on the one hand, and between private non-financial and financial sectors, on the other hand. It is important to distinguish good policies from the bad.

While the monetary and economic integration like in Europe can be a protection against the unstable state of the globalized economy, Japan has not been equipped with such a condition in East Asia. Although Japan once seemed to have paved a way for the economic integration with neighbouring countries, the depression in the 1990s largely obscured such a prospect. Economic recovery on a sounder basis will surely upgrade Japan's global presence again. Japan would not content with being only a passive player.

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Table 1 International Reserves of the World (%)

Year	1978	1980	1985	1990	1995	1998
US $	72.9	52.9	49.8	43.4	51.4	56.3
DM	10.6	12.5	12.2	15.5	12.5	11.3
Yen	3.1	3.5	6.4	7.3	6.5	4.8
SDR	3.5	3.9	5.0	3.3	2.2	6.5
ECU	---	15.7	10.3	8.5	7.0	0.7

Source: IMF, *Annual Report,* various issues.

Table 2 Share of the United States and Japan in East Asian Foreign Trade (%)

Exports						Imports			
		1980	1985	1991	1997	1980	1985	1991	1997
East Asia	U.S.A	19.9	27	20.6	19.5	17.4	18.4	15.2	14.5
	Japan	21.4	18	14	12	24	31	22.4	19.3
NIEs	U.S.A	24.8	35	24.5	20.2	17.6	23.6	16.4	15.3
	Japan	10.1	10.1	10.5	8.2	23.4	32	22.7	18.1
ASEAN	U.S.A	16.4	19.8	18.6	18.9	15.4	15.2	14.5	15.2
	Japan	29.6	26.1	18.3	13.6	21.9	20.9	24.2	20
Hong Kong	U.S.A	26.1	30.8	22.7	21.8	11.8	9.5	7.6	7.8
	Japan	4.6	4.2	5.4	6.1	23	23.1	16.4	13.7
Korea	U.S.A	26.4	36.2	25.9	15.9	21.9	21.5	23.2	20.7
	Japan	17.4	15.5	17.2	10.9	26.3	25.3	25.9	19.3
Taiwan	U.S.A	34.1	48.1	29.3	24.2	23.7	23.6	22.5	20.3
	Japan	11	11.3	12.1	9.6	27.1	27.6	30	25.4
Singapore	U.S.A	12.5	21.2	19.7	18.5	14.1	15.2	15.8	16.9
	Japan	8.1	9.4	8.7	7.1	18	17.1	21.3	17.6
Indonesia	U.S.A	19.6	22.7	12	14.4	13	14.4	13.1	12.7
	Japan	49.3	49.1	36.9	24.4	31.5	28.1	24.4	21.3
Malaysia	U.S.A	16.4	12.8	16.9	18.6	15.1	15.3	15.3	16.6
	Japan	22.8	24.6	15.9	12.5	22.8	23	26.1	21.7
Philippines	U.S.A	27.5	35.9	35.6	34.4	23.5	25.1	20.2	16.9
	Japan	26.6	19	20	16	19.9	14	19.4	19.7
Thailand	U.S.A	12.7	19.6	21.1	19.4	14.5	11.2	10.5	13.8
	Japan	15.1	13.3	17.8	15.2	21.2	26	29.1	25.7
Brunei	U.S.A	8.6	0.1	1.1	2.2	20	7.4	13.7	5
	Japan	70.9	67.1	62.6	53.9	23.7	13.3	15.8	4.2
Viet Nam	U.S.A	......	......	....	4.3	0.1	3.6	0	2.2
	Japan	28.4	19.6	32.8	22.7	14.1	26.6	6.4	9.9
China	U.S.A	5.4	8.5	8.6	17.9	19.6	12.2	12.5	11.5
	Japan	22.2	22.3	14.3	17.4	26.5	35.7	15.7	20.4

Source: IMF, *Direction of Trade Statistics*, ADB, *Key Indicators of Developing Asia and Pacific Countries.*

Note: East Asia = Hong Kong, Korea ,Taiwan, Singapore, Indonesia, Malaysia, Philippines, Thailand, Brunei, Viet Nam, China. NIEs = Hong Kong, Singapore, Taiwan, Korea. ASEAN = Singapore, Thailand, Malaysia, Philippines, Indonesia, Brunei, including Viet Nam in 1997.

Table 3 Currency share in international financial markets

Year	1977	1980	1984	1988	1991	1993	1995	1997
Eurodeposits								
U.S. dollar	72.6	70.9	76.9	61.4	52.7	50.7	48.5	49.8
DM	15.9	14.1	8.9	12.2	14.7	16.7	17.3	n.a.
Yen	0.6	1.2	2.1	5.3	4.8	4.4	4.9	6.9
International bank-lending								
U.S. dollar	n.a.	89.3*	71.7	64.2	84.5	81.0	76.8	69.8
DM	n.a,	1.8*	2.2	2.8	2.1	3.2	4.1	3.3
Yen	n.a.	1.1*	12.2	6.1	1.1	0.7	0.2	0.2
International bond-issues								
U.S. dollar	54.9	40.7	62.4	36.8	31.1	38.1	38.9	49.2
DM	19.2	21.3	6.0	10.3	6.6	11.4	19.6	17.7
Yen	4.0	4.9	5.4	9.8	13.3	12.4	17.4	3.9

Source：OECD, *Financial Market Trends*, BIS, *International Banking and Financial Market Developments.*

Note: * 1981

Table 4 Currency Share of Long-term Loans to Developing Countries (%)

East Asia and Pacific

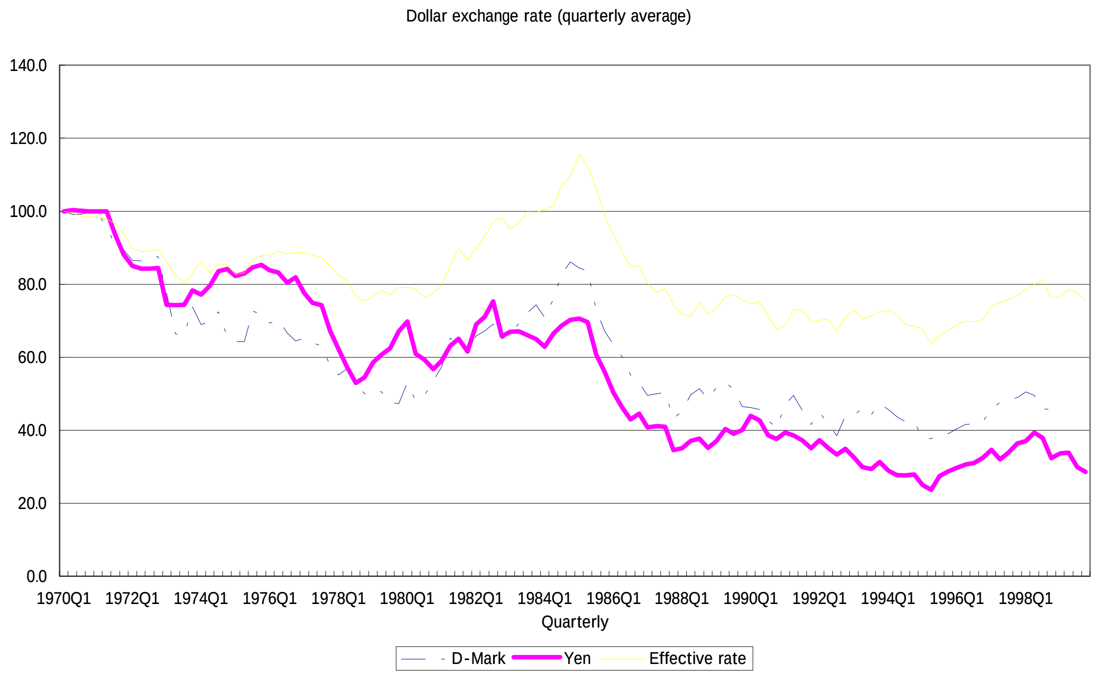
	1970	1980	1991	1995	1997
DM	7.1	5.0	3.5	2.5	1.8
F.Franc	2.6	3.2	2.1	1.5	1.1
Yen	7.3	18.0	29.3	26.4	20.1
U.S. dollars	50.4	40.8	25.8	40.0	57.8
Others	32.6	33	39.3	29.6	19.2

All Developing Countries

	1970	1980	1991	1995	1997
DM	8.6	6.6	9.0	8.1	7.3
F.Franc	5.2	5.5	5.7	4.6	3.7
Yen	2.3	6.9	11.4	12.3	10.0
U.S.dollars	47.1	49.8	39.9	45.9	54.2
Others	36.8	31.2	34	29.1	24.8

Source: World Bank, *Global Development Finance*, 1999.

Figure 1 The Dollar exchange rate (quarterly average, 1970=100)



Source: IMF, *International Financial Statistics.*