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## Removing Capital Controls: Japanese Case

by

Toru Iwami  
The University of Tokyo

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## 1. Introduction

In the 1980s, Japanese financial system underwent a dramatic transformation, symbolized by such slogans as "internationalization and liberalization". Indeed, liberalization of international financial business had already begun during the 1960s; exchange controls on current account was removed when Japan accepted the Article 8 of the IMF Treaty, while the government successively relaxed exchange controls on capital account, for example, the liberalization of inward direct investment from 1967<sup>2</sup>. The changes in the 1980s were far systematic and complete in the sense discussed below. The present framework appeared through the amended Forex Law of 1980 and a series of reforms following the report of the Japan-U.S. Yen/Dollar Committee. While there is a number of literature on this liberalization and its backgrounds<sup>3</sup>, this paper reconsiders the process of removing capital controls in Japan from the following viewpoint.

Strange (1986, Chapter 2) argued that speculative growth of international financial transactions, resembling "Casino", is caused by a policy in the early 1970s that determined "leaving the markets alone". Because the rapid growth of international finance presupposes relaxing or removing capital controls, no one denies that it is a result of a deregulation policy. But opinions would differ on a question whether or not the liberalization was an inevitable policy, and if no, whether or not it should be avoided.

One view to see it inevitable is a stage theory of economic development<sup>4</sup>

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<sup>2</sup>Moreover, short-term capital movements were partly liberalized in the late-1960s, see Iwami (1992).

<sup>3</sup>For example, Kaizuka and Hata (1986), Feldman (1986), Shinkai (1988), Fukao (1990), and Takeda and Turner (1992).

<sup>4</sup>Strange (1986, p.62ff) criticized the arguments which attribute causes of troubled world economy to something inevitable as "determinism". The stage theory, as defined in the text, also belongs to this "determinism".

which regards, roughly speaking, historical changes to be caused by something inevitable from within, being destined to go through different stages. For example, the stage theory of the balance of payments, which has short-comings of not necessarily corresponding with historical facts, but helps to understand economic development theoretically. Though a little bit different, another view of this sort is that Japan is supposed to become a capital exporting country, assuming a long-term trend of rising competitiveness. Is this view supported by actual facts?

To consider these questions, we have to make clear what macroeconomic background actually existed, and whether this circumstance could have been changed. We begin with reviewing the stage theory of balance of payments in section 2, then section 3 deals with macroeconomic background such as changing domestic fund flows, and the relationship between current accounts and the exchange rate. In section 4, we discuss the political economy aspects of the liberalization policy; the amended Forex Law and the Yen/Dollar Committee. In particular, we are concerned with those questions, who demanded liberalization, how advantages and disadvantages of each participant were interrelated. If the policy was actually inevitable, this sort of discussions is not important. But in case the policy was changeable, we should take account of questions who introduced the policy and why. In sum, our reconsideration reaches to the conclusion that the most important political economy element was the U.S.-Japan relation, which is also related to the topic in the section 3, namely relationship between current accounts and the exchange rate.

## 2. Stages of Financial Internationalization

### 2.1 Several Implications of Financial Internationalization

As Kaizuka and Hata (1986, pp.158-165) stressed, the internationalization has

several implications. Summarizing their argument, we point out three elements. Firstly, for financial institutions, the share of international business increases and the branch network extends outward, namely the internationalization of financial institutions. Secondly, in a certain country, the financial transactions of residents as well as non-residents grow across the border, associated with the internationalization of the financial market. The liberalization of capital movements is a prerequisite for this type of internationalization. Thirdly, the development of the second element leads to a formation of an international financial center, which is often accompanied by the internationalization of a currency.

This taxonomy is suggestive to reconsider the implication of financial internationalization for a late-starter like Japan. In the country of a financial center, these three types of internationalization generally coexist. Strictly speaking, an exceptional case for the third element is the London market, in which most of the international transactions are denominated in the foreign currencies. But this phenomenon resulted from the circumstances specific in the 1960s<sup>5</sup>. In the process that a country is forming a financial center, the internationalization of that national currency is accompanied.

Financial institutions of a late-starter have to use the currency and market, including know-how, customs and funds therein, of the leading country in international finance. But later, that country may reach a stage to provide the international financial system for itself. In this rising process, how three elements of internationalization mentioned above are interrelated with each other, whether the order of the first, second and the third stages are due course?

To these questions, Japan's recent experience provides an interesting example. Japan's financial internationalization is unique in the sense that it has

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<sup>5</sup> For this problem, see Iwami (1994b).

taken place so rapidly and that there still remains an obvious gap among these three elements. Table 1 reports the foreign assets and liabilities of the United States, Germany and Japan which indirectly reveal the degree of internationalization, measured by the sum of capital in- and outflows. According to the Sum/GDP ratio, Japanese figure is the lowest in 1972, but grown to 4 times in two decades, overtaking the United States in 1981. Although this measure is merely a rule of thumb, international capital movements over Japanese borders seem to reach the level between the United States and Germany, being accelerated in a relatively short period. Tables 2 through 4 reveal a gap in the sphere of international banking very clearly. Table 2 shows directly the rapid growth of Japanese banks which surpass the American share in the mid-1980s. After a peak in 1988, Japanese share declined slightly, but still maintains nearly a third of the total. The statistics of the international banking share in London<sup>6</sup> tell that the increasing share of Japanese banks began around 1980, its remarkable growth therefore appeared during the 1980s.

Owing to a series of financial deregulations in the 1980s, the share of Japanese market increased, surpassing the American after 1987, and recently came close to the British. The establishment of the Japan Off-Shore Market (JOM) in December 1986 undoubtedly promoted this growth, where the main transactions are among Japanese banks although foreign banks take part. The gap between shares in Table 2 and 3 implies, however, that Japanese banks mainly undertake business abroad. In the eurocurrency market, the yen share shows higher levels than the early 1980s, but does not coincide with the growth of the Japanese market and Japanese banks (Table 4).

In short, the internationalization of banking proceeds most extensively, followed by the growing share of the Japanese market, while the currency is

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<sup>6</sup>Bank of England, *Quarterly Bulletin*, Sept. 1986, Tables D and G.

the least internationalized. Is this gap going to be reduced? While we have to consider internationalization factors for each element, it is also true that financial internationalization is generally linked to the state of balance of payments, as Japan in the post-war years strictly restricted cross-border capital movements due to balance of payments considerations.

International business of financial institutions are related to the balance of payments in the following way. In the economic development of a late-starter, financial institutions, more precisely banks, play crucial roles. Since domestic stock of savings is small as a whole and scattered over, capital market does not exist or underdeveloped, the funds for investment need to be intermediated through banks. But at a certain stage later, as the real and financial stocks increase and their rate of return decreases, domestic fund is apt to flow out across the border. Banks, which formerly intermediated domestic financial flows, now extend their business internationally. This view, stressing the automatic result of capital accumulation, is characterized as a natural development hypothesis. In this case, the elements one and two discussed above appear simultaneously.

The international financial center or the key currency are related to the state of balance of payments, since Britain and the United States rose to the major capital exporter and key-currency country with large surplus in current account<sup>1</sup>. The larger capital export renders large volume of capital transactions in the financial market of that country, the large net foreign assets stabilize the relative value of that currency, which leads to advantages in unit of account, means of payments and store of value.

However, following points are worth noting. The international business of financial institutions take place even before the current account turns to surplus, accompanied by capital export. Financial institutions intermediate

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<sup>1</sup>Iwami (1994b).



not only capital export but import, in particular in the form of trade finance. For the late-starter, the promotion of foreign trade is a primary object of economic policy, despite or because of deficits in trade balance<sup>8</sup>. Even under strict capital controls, trade finance is exceptionally favored.

Generally speaking, international finance other than trade finance expand and the international business increases share in total, as capital controls are deregulated and/or finally lifted. The question is why the late starter restrict and liberalize international capital movements. Even under the deficits in current account, capital controls are not always proper policy option. As the stage theory of the balance of payments predicts, the higher expected rate of return at the initial stage of economic development induces capital import, as the United States in the 19th century.

Japan regulated cross-border capital movements in the postwar years, because of balance of payments restraints. Firstly, since experiences in the interwar years lowered credibility in "equilibrating" effect of private capital movements, global capital transactions did not reach the level of the later period. Against this background, monetary authorities could not expect large capital inflows, even if capital controls would be lifted. Secondly, while the private capital transactions grew during the 1960s, the authority was afraid that capital flows would disturb effects of monetary policy. It was widely admitted that the balance of payments should be "adjusted" through changes in real transaction. Thirdly, last but not least, capital controls were important means of protection for Japanese domestic industries<sup>9</sup>.

To have an international financial center and a key currency, surplus in current account is a necessary condition, but not enough, as Japan, despite

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<sup>8</sup>The Deutsche Bank (in 1871), the Yokohama Specie Bank (in 1880) were established as banks specialized in trade finance, with government support.

<sup>9</sup>For more details, see Iwami (1992).

her large scale surplus, still depends on international financial transactions in dollars.

## 2.2 The Stage Theory of the Balance of Payments

In 1984, when the Japanese current account surplus increased rapidly and foreign countries started to regard it as a global disequilibrium factor, the *White Papers* of both the Ministry for International Trade and Industry (MITI), and the Economic Planning Agency referred to the stage theory of balance of payments<sup>10</sup>. Table 5 shows that the four major countries followed similar paths, as the above theory predicts. Japan, in particular, seems to be a good example, in that the current account deficits gradually decreased, and later increased her surplus<sup>11</sup>. The United States seems to have reached the peak of the current account surplus in the 1920s, and Germany in the 1950s. Britain, on the other hand, shows an abnormally large-scale surplus in the 1950s, but we could also interpret its movement as a wave with a peak in the 1900s and a trough in the 1930s. Whether or not the stage theory actually holds, depends on the option of the period and its length, however.

The stage theory of the balance of payments is often discussed in relation to the rise and decline of an economic power. The economic power is doomed to decline, if the current account surplus necessarily turns to be negative, as the theory predicts. But as Figure 1 shows, a cycle of the balance of payments does not appear so clearly in the history of major countries.

Firstly, the theoretical preposition of free capital movement is not always

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<sup>10</sup>The policy implications was that the current account surplus was historically inevitable and that Japan should not try to reduce her surplus in vain, but to recognize the role of a creditor nation.

<sup>11</sup> We must take into account that, because of U.S. economic aid and the Korean War, the current account surplus expanded more in the 1950s than the 1960s.

satisfied historically. The most liberal phase covered the years under the classic gold standard, while in the inter-war period and under the Bretton Woods System, most of the countries imposed more or less capital controls. In the former period, Britain regulated foreign bond issues in favor of the British Empire from the 1920s onwards and further strengthened its control in the 1930s<sup>12</sup>. In the latter period, since the Bretton Woods Agreement of 1944 excluded capital transactions from the obligation of currency convertibility, only a limited number of countries liberalized capital movements before the early 1980s.

Secondly, the large scale change in international financial positions resulted from the war rather than a regular cyclical pattern. The best examples are the decline of Britain on the one hand, and the rise of the United States, on the other hand, during the first and second World Wars, as fluctuations of the current accounts in Figures 1 illustrate<sup>13</sup>. Japan's surplus in the current account was the largest during the first World War, and the next large surplus was recorded during the Korean War.

In this sense, both the U.S. deficits and Japanese surplus in the 1980s are rather exceptional. The U.S. deficits of 2-3% relative to GDP (the largest figure was 3.6% in 1987) is much smaller than the British deficits of 6-10% during the World War II. It suggests that the U.S. imbalance since the 1980s could be corrected with a relatively minor change in economic policy, not necessarily confined to the fiscal one; an industrial restructuring policy would be important as well. The feasibility of an American industrial policy is naturally influenced by the resistance of the domestic vested interests.

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<sup>12</sup>See, for example, Atkin (1977, p.17ff) and Cairncross and Eichengreen (1983, pp.21-22).

<sup>13</sup> In the United States' case, the balance on goods and services is preferable because it shows the strengthened competitiveness more clearly than the current balance, which includes huge unilateral transfers of the U.S. government during the World War II.

Even though the stage theory does not correspond with historical facts, we can as well interpret it as a theoretical model for financial liberalization. As the real capital stock, coupled with financial assets, accumulates, its rate of return declines, and the capital flows out, pulled by higher return overseas. Another view is that the accumulated financial assets induce demand for portfolio diversification, assuming a risk-avoiding investor. Moreover, the increased scale of assets tends to reduce transaction costs, which are more or less fixed, and enable diversified investments. In a closed system, in which financial assets equal to liabilities, both lenders and borrowers insist on financial liberalization for the sake of more favorable interest rates. Removal of capital controls constitutes a link in the chain of the whole liberalization.

Assuming that the liberalization of international finance is caused by the increased scale of domestic saving, we have to note the following. If international capital movements were totally banned, the equation, net saving = current account surplus = capital export, excludes the possibility of net saving. However, the total ban on capital movements is not feasible, and as above discussed, even the less developed countries have to import capital for financing foreign trade. Japan in the late 1960s partly relaxed regulation on capital transactions, as the current account surplus increased. The partial deregulation led to the overall liberalization later. However, this transformation was not a natural course, but to be mediated by certain shocks.

### 3. Macroeconomic Backgrounds

#### 3.1 Changes in Domestic Fund Flows

Japan's financial reforms in the 1970-80s are often symbolized by two factors, homonyms of "kokusaika"; one is "internationalization" and the other

"increased scale of national debts"<sup>14</sup>. Was the "internationalization" an independent factor which promoted changes in the domestic market, or a result of the third factors which caused reforms in the domestic financial system as well. To answer this question, we have to distinguish mid-or long-term trends from the short-term shock; in particular important is the decelerated economic growth from the mid-1970s.

As the economic growth slowed down, the domestic fund flows transformed itself. Horiuchi (1990, pp.46-47) stressed, for example, "while the personal sector has been continuously in surplus, the surplus of the households corresponded to huge deficits of the corporate business until the early 1960s. From the early 1970s, deficits of the public sector increased, financed by large scale issues of national bonds, while the deficits in corporate business sector declined. In the 1980s, on the other hand, public sector as well as the corporate business decreased deficits. As a result, the surplus in the personal sector is absorbed in deficits overseas, in other words, surplus in Japanese current account". The fund flow account itself resulted from a number of macroeconomic factors, however. What are the independent and dependent factors<sup>15</sup>?

The largest independent factor was the first oil crisis which reduced profitability of firms and kicked their investments down. Comparing 1968-1974 and 1974-1979, fixed capital formation relative to GNP declined 2.8% points (from 34.6% to 31.8%) on yearly average, which is the second largest decrease among the G-7 countries, next to German of 3.8% points. The growth rate of the real gross fixed capital formation declined quite remarkably, between the

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<sup>14</sup>For example, Rohyama (1986, pp.20-23).

<sup>15</sup>For a macroeconomic survey of the 1970s, see Komiya (1990, chapter 8). We do not deny the possibility, as Yoshikawa (1992) stressed, that along with the oil crisis, other long-term factors caused the slowing down of economic growth.

above two periods, from 12.5% to 1.5%<sup>16</sup>. The labor- and energy- saving investments, which replaced extending production capacity, did not demand so much financial resources as formerly, while firms increased liquidity positions<sup>17</sup>. Both of these changes reduced dependence on bank lending.

Another large independent factor was the increased scale of government debts, as a result of growing expenditures in social security, governmental debt service, and public works. During ten years from 1970 and 1980, these three items occupied 58% of the growth in General Account Expenditures of the central government<sup>18</sup>. The growing expenditures in government debt service resulted from the fiscal deficits, while the development of the social security system was not directly related to a slow economic growth. As the year 1973 was called "Fukushi Gan-nen (the new epoch of welfare)", there was a wide consensus on the growth of social security expenditures<sup>19</sup>. The third item, public works, was the largest conventional means of reflationary policy, and its share in General Account Expenditures increased from 13.7% in 1975 to 15.6% in 1980. The public investments reflected partly an international policy coordination, "Three Locomotive Approach" appealed at summits 1977 in London and 1978 in Bonn. Increase in public work expenditures was another side of the decline in private investment, in the sense that both were caused by the global depression after the first oil crisis. But deficits in public sector

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<sup>16</sup>OECD, *Historical Statistics 1960-1989*, pp.57, 69.

<sup>17</sup>The liquidity positions, in terms of deposits, cash, and inter-firm credit over net investments, tended to increase during the 1960s, and reached a peak in the late 1970s. See Yoshikawa (1992, p.219, Figure 5.3).

<sup>18</sup>The increase in expenditure shares was the largest in governmental debt service from 3.7% to 12.5%, and social security from 14.3% to 19.3%, while the public works slightly reduced share from 17.7% to 15.6%. Takeda, Hayashi and Imai (1987, pp.62-63).

<sup>19</sup>Hayashi (1992, p.161) stressed that reforms of 1973 did not establish a new system, but raise the level of social security transfers the aging process requires such as medical care and pensions. The slogan of the "new epoch" was an exaggeration.

need not to have been financed from abroad, like the United States in the 1980s, because the overall domestic fund flows still recorded surplus<sup>20</sup>.

As the deficits of the corporate business sector reduced, the surplus in domestic private sector flowed in public sectors (government debts) and the rest of the world (capital export). Since 1977, the government (MOF) relaxed regulations that had prohibited financial institutions to sell newly issued government bonds, and the secondary market for government bonds (including Gensaki) expanded. Their rate of return began to fluctuate, reflecting the market conditions, and made loopholes in the fixed interest-rate system. In compensation for the regulated deposit rates, banks were allowed to issue CD (negotiable Certificate of Deposits) in May 1979. Moreover, the MOF authorized banks to sell government bonds to individuals, on the one hand, and security houses to issue *de facto* short-term funds (Chukoku Funds), on the other, thus making the boundary between banks and security houses less evident<sup>21</sup>. Although the fixed deposit rate had enabled banks to raise funds at low costs, they were facing difficulties in keeping favorable returns, due to the increased share of funds with higher cost and the tendency of "disintermediation" that firms borrowed directly in the market. Then, banks tried to make ways in the international business, which did not render profitable, though<sup>22</sup>. But expecting good results in the long-run, not merely city banks, but also local banks extended branch networks overseas.

Non-financial firms, on their part, diversified means to raise and employ funds, in order to reduce interest payments and enlarge financial earnings.

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<sup>20</sup>For the supply side of the fund from the personal sector, the high level of the private saving, see Kurosaka and Hamada (1984, chapter 4), Yoshikawa (1992, chapter 4) and the literature therein.

<sup>21</sup>For the influences of large scale government bond issues, see Nakajima (1986) and Matsumoto (1986).

<sup>22</sup>Iwami (1994a, Figure 1) shows the trend of banks' profitability.

The capital controls had restricted opportunities for cheap borrowing and profitable financial investments. Having large amount of external assets, resulted from growing export, firms, in particular big firms engaged in foreign trade were benefitted from the liberalized international finance. Table 5 shows this tendency for big firms. Financial institutions responded to this new trend with expanding international business. While the individual households as well preferred profitable employment of their saving, they usually deposited funds in financial institutions. Accordingly, the behavior of institutional investors was more internationalized, for example, foreign portfolio investments expanded.

How much influence did these domestic factors have on internationalization of financial transactions? The share of international assets in city banks amounted to around a third of the total in the mid-1980s, the foreign portfolio investments occupied 15% of the total assets held by life insurance companies at the end of the 1980s<sup>23</sup>. In view of the years that passed after liberalization, these figures do not suggest that the international transactions constituted main streams of business by above institutions. Considering that the transformation of domestic fund flows resulted from the slower economic growth after the oil crisis, "liberalization" was, roughly speaking, a by-product of an external shock.

### 3.2 Current Account and Exchange Rates

Theoretically and historically, deficits in current account do not necessarily require capital controls. But it is also true that current account surplus facilitates removing capital controls.

As Iwami(1992) showed, declining relative export prices in the 1960s produced

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<sup>23</sup>For assets of city banks, Iwami (1989, Figure 1), and data for life insurance companies, Kawai and Teruyama (1991, Table 1).



surplus in current account, increasing international reserves and capital export. These phenomena were quite remarkable in particular from the late-1960s through the early 1970s. The larger reserves would cause "imported inflation" and appreciation of the yen, therefore the government had to accept, at least partly, liberalization<sup>24</sup>. If the real conditions which rendered rising competitiveness, had not changed thereafter, the partial liberalization would have surely led to the overall open system. The loopholes in the regulated system tend to be enlarged and generate possibilities of increased capital transactions.

Does Japan's experience since the 1970s suggest the tendency to generate surplus sooner or later leads to liberalization of international capital movements?

To note is the fact that floating exchange rates could change relative prices even though conditions in the real economy remained unchanged. Another problem is whether or not the current account shows a long-run trend of growing surplus. The current account (relative to GNP) since the last war illustrates unusual peaks both during the Korean War and in the mid-1980s (Figure 3). The floating exchange rates, coupled with free capital movements, would enlarge current account imbalance and/or its fluctuations, as the United States in the 1980s experienced<sup>25</sup>. But the surplus in Japanese current account increased more remarkably in 1971 and 1972, during the last phase of the fixed exchange rate regime, than in 1977 and 1978 under the floating rates, and the early 1980s after the removal of the capital controls. Moreover, current account continued to show similar fluctuations between surplus and deficits, under both the fixed and floating rates. That the peak in the mid-1980s was followed

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<sup>24</sup>Fukao (1990, pp.117-21).

<sup>25</sup>The United States could not have continued such large scale deficits, if Japan among others had not liberalized capital outflows.

by a sharp decline thereafter, does not suggest a continued rising trend.

The surplus in Japanese current account reflects still larger surplus in trade balance which resulted from a rapid increase in exports. Since the 1970s, machinery and equipments have been leading the export growth. In particular, transport-machines (automobiles among others) and electric machines occupied a half of the total export in the mid-1980s. The increasing trend of these items since the rapid growth period enabled the transformation of export structure towards heavy industrial or high-value-added goods.

If the current account is determined by the relative prices, its surplus implies that the yen exchange rate does not rise enough to compensate for the increasing productivity gap and/or declining prices in yen. This is an argument often stressed by American government and business leaders. On the other hand, larger number of economists regard that the current account reflects a macroeconomic imbalance in saving-investment. The stage theory of the balance of payments is a variant of this approach, and another example is the view which explains the global imbalance in current accounts in the 1980s from the gap in fiscal policy stance between Japan, Germany on the one hand, and the United States on the other hand<sup>26</sup>. More precisely to say, this explanation contributed to this approach gaining ground. In this section, we choose rather an indirect way of examining the influence of the yen exchange rates on Japanese price competitiveness.

Figure 4 illustrates effective exchange rates as nominal and real in terms of several price indicators. The most peculiar is a contrast between the nominal rate and the real rates. The nominal rate continuously followed a rising trend with a peak in 1988, 2.4 times as high as 1975, whereas real rates in terms of both Wholesale Prices (WPI) and Export Prices (EPI) were stabilized from around 1979 to 1985, the year of the Plaza Agreement. There

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<sup>26</sup>The best known example is probably Marris (1985, Ch.1).

seems to exist a strong factor which counteracts rising nominal rate. In addition, during the dollar depreciation phase after 1985, not merely the nominal rate but real rates based on Unit Labor Cost (ULC) and WPI show rising tendency, but the real EPI rate hardly mounted. Surprisingly, the real EPI rate in 1990 stands at a lower level than 1975. Despite a long-term trend of nominal yen appreciation, export prices did not reveal disadvantages.

As Figure 5 shows, the real yen/dollar exchange rates fluctuated more considerably than the effective rates, but the EPI rate stayed the lowest, similarly to the effective rates. Until around 1983, real rate based on CPI stood on the higher level than the nominal rate, and thereafter the rise in the nominal rate was a little bit larger, because the Japanese consumer prices were relatively stabilized from the 1980s onwards<sup>27</sup>.

The fact that a notable rise in nominal effective exchange rate did not hinder the growing surplus in Japanese current account until 1986, apart from a short break after the second oil crisis, casts doubt on the argument that undervalued yen (in terms of nominal rate) caused surplus. The relative prices measured in real EPI effective rate imply neither a decline nor a rise in competitiveness, rather stability on a lower level.

Under the fixed exchange rate system, the CPI real exchange rate demonstrated a rising, whereas the EPI real rate a declining trend, from the early 1950s through the mid-1960s. Iwami (1992) attributes this contrast to both a gap in productivity and low pricing by exporters. Under the floating rate regime, on the other hand, the real EPI rate did not decline, but stayed on a lower level. This difference is caused by a rising trend of nominal rate under the floating regime. However, we find a slight change around 1985. Until then, real exchange rates based on ULC and other index were stabilized on a similar

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<sup>27</sup>Ueda (1992, pp.54-55) stressed also the gap between real effective rates and the real yen/dollar rates and different pattern of movements among real rates based on various price index.

level, implying a large productivity effect that compensated for the rise in nominal rates. Between 1985 and 1988, on the other hand, real rates based ULC and WPI show not a small rise, while the real EPI rate still remained relatively stable. This is possibly because of the pricing to market behavior by exporters.

With regard to the productivity growth, Yoshikawa (1990) concluded that nominal exchange rate moves, in the long-run, along with the level calculated from the gap in productivity. In other words, the productivity growth effects are canceled out by the rise in nominal exchange rate. Another factor to influence the real exchange rate is the behavior to stabilize the dollar export price when yen appreciates, as Ohno (1989) and Marston (1991) analyzed.

That the real exchange rate based on EPI was stabilized almost at a same level, implies that relative prices did not cause surplus in current account. The same efforts of reducing yen-prices by exporters which led to the decline in the real exchange rate under the fixed exchange rate system, succeeded at most in keeping the same relative prices under the floating regime. This difference is worth noting.

The nominal exchange rate is rather determined by international capital movements than by current transactions. In the 1980s when the international capital transactions increased to such an extent, the exchange rate level determined by the capital movements influenced the current account. Since the huge surplus in Japanese current account culminated in the mid-1980s, seems to result from the gap in fiscal policy stance (and its by-product of the depreciated yen), we can conclude that the internationalization of Japanese finance is not an inevitable process of the long-term trend which generates surplus in current account.

The capital outflows to the United States appeared, as described below, during the process of liberalizing international capital movements. Then,

still remains a question why the capital controls had to be lifted, which turns us back to the initial problem.

#### 4. Political Economy Backgrounds

##### 4.1 Basic Framework

The shift to an open economic system (deregulation of international capital movements) was not confined to Japan, but appeared as a global phenomenon, due to peculiar circumstance of the 1970s; firstly, beginning of floating rate regime and secondly, large scale imbalance of current accounts.

Firstly, since the breakdown of the fixed exchange rate system reduced necessity of capital controls, the floating rates facilitated liberalization and internationalization of finance. However, it is to note that under the classical gold standard, when the domestic economic condition hardly influenced macroeconomic policy stance, fixed exchange rates enabled free capital movements as well. Therefore, the above statement presupposes the need of discretionary macroeconomic policy.

Secondly, the increased volatility in both interest and exchange rates requires a risk-avoider to hedge against risks, or generates opportunity for a risk-taker to make profit, through new financial products such as swap, options etc. Their full scale development is indeed enabled by an innovation in information processing, but more importantly, the shift to floating exchange regime enabled and required the expansion of international finance. Against this background, the United States lifted restraints on foreign lending and investments in 1974, and Britain removed foreign exchange controls on

capital transactions in 1979<sup>28</sup>.

However, the authorities did not abandon capital controls completely under the floating exchange rates. For the sake of balance of payments and smoothing out the exchange rates, they often reintroduced controls and intervened in the foreign exchange market, as people called "dirty float" in contrast to the "clean float". The developed countries including Japan intervened in the market, because they were aware that the balance of payments is a crucial macroeconomic factor which affects domestic economic situations, in particular employment. In policy making, such a notion was very important, while it does not so much matter whether or not the government can actually influence the exchange rate. The capital controls were also serious issues. The United States, having lifted capital controls, insisted on extending the freedom of foreign exchange clause to capital transactions during discussions within the C-20 of the International Monetary Fund. European countries resisted to this proposal, because the freedom of capital transactions would influence the level of foreign exchange, thereby trade balance. For the United States, this attitude was nothing but manipulations of the foreign exchange in favor of home export industries<sup>29</sup>. In the 1980s as well, the Japanese competitiveness in export brought about a notion of the "undervalued yen" in foreign countries, which constituted a severe problem in the foreign economic relations. In the domestic politics also, appreciated yen caused serious concern. In this way, the state of the exchange rate generated a political issues domestically as well as internationally.

As for the second point, the current account imbalance, there were two

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<sup>28</sup>Bryant (1987, p.70). In this sense, Strange (1986, chapter 2) is right to argue that the present international financial system and its instability are rooted in the decisions by the monetary authorities to let the exchange rate fluctuate in accordance with the demand and supply in the market.

<sup>29</sup> Dam (1982, pp.247-48).

factors: 1) two oil crises, and 2) the U.S. fiscal deficits which caused the high level of dollar exchange and interest rates. The factor 2) is partly related to the Japanese policy of reducing government debts outstanding, but the U.S. policy and the factor 1) were genuine exogenous and therefore unavoidable factors for Japan.

After the first oil crisis, the need for financing global imbalance in current accounts expanded transactions in those financial markets without regulations. Firms and financial institutions, once experienced cheap and convenient euro-finance, required the similar facilities at home, thereby making potential pressures to financial reforms. Oil-importing countries had to import capital as well, while the surplus countries were in need of capital export. To note, however, is that the surplus and deficits were changeable in a short period, as Japan shortly before and after the both oil crises demonstrated. As a result, the policy concerning capital controls was often modified in a confused fashion, but once the deregulation took place, reintroduced controls did not render effective.

Figure 6 illustrates the relationships between the macroeconomic policy, financial deregulation (internationalization), and policy makers. Needless to stress, the macroeconomic policy is largely affected by the financial internationalization. With frequent capital movements, the exchange and interest rates become volatile, requiring policy response. In an opposite way, the policy mix of fiscal tight and monetary ease heightens pressure for capital outflows, and for removing capital controls. Simultaneously, pressure from outside was also strengthened, as the United States demanded financial liberalization in order to correct "undervaluation" of the yen. Whether or not this logic is right according to the theory of economics, was not crucial in the negotiation between Japan and the United States.

Policy makers for financial matters are the Ministry of Finance and the Bank

of Japan. Although they are not always of the same opinion, the Bank of Japan cannot pursue a policy against the government will, as its independence is far limited compared with other developed countries<sup>30</sup>. Political parties are another players who influence policy making, but the Japanese Diet-Cabinet System, with majority of the Liberal Democratic Party (LDP) until quite recently, makes the opinion gap between the Diet and the government rather small. For these reasons, boundaries in the column B are obscure. It is to be remembered, however, that technocrats at the MOF and BOJ play very important roles in the field as international finance which requires specialized knowledge and experience.

Reviewing the foreign economic policy from the 1970s onwards leads to the general conclusion that the government, the Diet, and the central bank had common object of avoiding yen appreciation (and its outcome of depressed export)<sup>31</sup>, which affected also on the policy towards capital movements. Naturally, this object has been supported by firms and "public opinion". The financial as well as non-financial firms not merely address their views in various advisory councils for the government, for example, the Foreign Exchange Council, but departments of the ministries collect information about those industries concerned. They make discretionary guidance based on these information, through which firms can transmit their will. The line from column B to C indicates this relationship, while consumers express their opinions merely indirectly through voting<sup>32</sup>.

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<sup>30</sup> The Bank of Japan Law was enacted in 1942, in accordance with the war-time mobilization. The Bank, now and then, tried to modify this Law for more independence, without no success so far.

<sup>31</sup> Ueda (1992, chapter 7) argues that this object caused the failure of the monetary policy from the early 1970s through the late-1980s.

<sup>32</sup> This is common in almost every country, but quite evident in Japan. Although representative of consumers have seats in advisory councils, they have limited voices to be heard.



The discussions concerning the "Japan Inc.", although popular in the literature of Japanese studies overseas, are to be reconsidered from this aspect. The Japanese foreign policy is supposed to be mainly oriented towards economic goals, and in this sense, there is no difference from domestic policy, argued an American researcher<sup>33</sup>. The first problem about this view is to suppose a solid consensus between the private sector and the government. Indeed, we regard that avoiding the yen appreciation was a common policy object, but it is hard to believe that there existed any active agreement on economic growth, for example. Secondly, we have to take into account that there remain conflicts of interest even in the private sector; between non-financial firms and financial institutions, and of the latter, between security houses and banks. Thirdly, even if the government pursues policies reflecting the concerted interests of the private sector, it is questionable whether the government can actually succeed in attaining intended goal. These questions constitute touchstones for the notion of the "Japan Inc".

#### 4.2 Amended Forex Law.

The most prominent turning point in the history of Japanese international finance was the amendment of the Forex Law in 1980 (a switch from "embargo" to "freedom" in principle) which, in fact, systematized the ad hoc measures from the 1970s. The most important element for this reform was the expanding demand for international finance under the floating exchange rate. To be questioned is the time-lag between the commence of the floating and the legislation. The key to this question is the sudden shift of Japanese current account from the surplus into deficits during the first oil crisis which forced the government to change the open door policy to the opposite. The

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<sup>33</sup> Spindler (1984, p.116) cites this view, adding that the relationship between the government and banking is the same.

policy toward capital movements was modified in such a zigzag way as follows<sup>34</sup>.

As for "In-Out" transactions, the huge trade deficits during the first oil crisis turned the government's attitude from the partial liberalization in the early 1970s to the opposite direction, the principle of which was to promote capital inflows and restrict outflows, for the sake of financing trade deficits. To promote capital inflows, restrictions on security purchases by non-residents were lifted, and the reserve requirements for non-residents' yen-deposits were reduced in 1973. On capital outflows, foreign bond issues were banned in 1973, while foreign portfolio investments were limited in 1974.

On the other hand, during the phase of appreciated yen from 1976 to 1978, the government shifted to a policy of promoting outflows and restricting inflows, expecting net capital outflows would put a brake on the yen appreciation. On the outflow side, the upper limit on foreign portfolio investments by residents was raised in 1976, and the authorizing procedures for FDI were removed in 1977. To restrict capital inflows, reserve requirements for yen-deposits were increased in both 1977 and 1978, while purchase of bonds (maturity within 5 years) by non-residents were banned. However, during the second oil crisis, the policy turned again to promoting inflows and restricting outflows, similarly to the first oil crisis; additional reserve requirements for yen-deposits were removed, Gen-saki transactions by non-residents were liberalized, while on the capital outflow-side, foreign bond issues were temporarily terminated, and forex banks were guided to reduce overseas lending.

Since capital controls limit opportunities for private sector (firms) to

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<sup>34</sup> For more details, see Komiya and Suda (1991, Tables 3-5, 8-4,5), and Fukao (1990, Supplement A). Until the amended Forex Law of 1980, inward investments by non-residents as well as outward investments by residents were authorized case by case basis. Komiya (1990, p.117). Accordingly, we cannot verify reasons for each deregulation measure.

hedge against foreign exchange risks, the Forex Law would have been modified sooner or later. The financing oil import was facilitated by the amended Law of 1980. Discussions to modify the Law were officially set in motion by the "Gaikoku Kawase/ Boeki Hosei Konwakai" (Round Table on the Foreign Exchange and Trade Law) established August in 1978, sponsored jointly by MOF and MITI<sup>35</sup>. Since it was in the phase of yen appreciation, the government did not need to consider for the sake of capital import. But it was neither rational nor effective to have different policy between the in- and outflows, and the overall liberalization turned out to be a right policy.

Although foreigners claimed that Japanese financial markets were closed, pressures from overseas were rather weaker than thereafter. The administrative authorities (MOF) took the lead of the legislation, without almost any influence from the political parties and the Diet. Non-financial firms and financial institutions (security houses as well as banks) found merits rather than demerits from free capital movements. But there existed a conflict within the government, between the MITI and the MOF, over the idea that the forex business would be allowed to the trading companies (Sogo Shosha) as well. The MOF finally succeeded in rejecting this proposal, on the principle of concentrating business onto forex banks<sup>36</sup>. This conflict was rather an exceptional episode, and in this sense, liberalizing international capital movements was different from other domestic financial reforms which intensifies potential confrontations.

Nevertheless, it is true that reforms of the domestic finance, on the one hand, and international finance, on the other, make up two sides of the same

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<sup>35</sup> For discussions on the amendment of the Forex Law, mainly Horne (1985, chapter 6) and Kakizaki (1979).

<sup>36</sup> This principle was justified that concentration to banks is more convenient for monitoring and, if necessary, restricting foreign exchange business.

coin and naturally influence each other. The MOF took generous attitudes towards requests from banks, probably because the administrative authority expected that banks would actively purchase government bonds<sup>37</sup>.

#### 4.3 After the Yen/Dollar Committee

The second wave of deregulation measures was facilitated by the trade imbalance between Japan and foreign countries (the United States among others), being introduced as one of the concessions to the trade conflicts. The United States insisted that the Japanese current account surplus is caused by "undervalued" yen which should be corrected by liberalized capital transactions and the internationalization of yen, as Frankel (1984) clearly illustrated. The US government firmly held the notion that Japanese policy still continues the same stance even under the floating regime, as in the Bretton Woods System era<sup>38</sup>. The internationalization of yen, or the development of euro-yen market does not always bring about appreciated yen, however. Indeed, to the larger extent non-residents demand for yen-denominated assets, the higher level yen exchange rate would reach, but the capital export in yen would also press the yen exchange rate down, when this fund is converted into other currencies.

Both the breakdown of the fixed exchange rate system in the early 1970s, and the Yen/Dollar committee almost ten years later have the same background of increasing surplus in Japanese current account. But the pressure from the U.S. side was far severer in the latter case<sup>39</sup>, because the scale of Japanese

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<sup>37</sup> For this interpretation, Feldman (1986, p.157).

<sup>38</sup> For Japanese policy in this era, see Iwami (1992).

<sup>39</sup> The Bank of Japan (1986, pp.303-04) interpreted that, in 1970 and 1971 the United States was more inclined to "benign neglect" policy than enforcing West Germany and Japan to reevaluate. "The first official request for yen

economy expanded to such an extent in the mean time, that its surplus tends to affect more seriously upon the rest of the world. For the causes of the high level of the dollar exchange rate and the deficits in the U.S. current account, most of the economists arrive at the same conclusion, as above discussed. While the notion that Japanese government guided the undervalued yen, thereby generating the U.S. deficits, is wrong, it is worth stressing that such a misunderstanding was capable of opening the Japanese closed system. Not surprisingly, even the wrong argument in the economists' sense has political influence, in particular when used by a big power. Even if possessing the "right" understanding, politicians have to respond to firms in difficulties and mass employment, and in such a case the foreign country can be a convenient target.

The measures after the report of the yen/Dollar Committee include 1) more liberalization of capital movements, 2) promoting entry of foreign financial institutions into Japan, 3) developing the euro-yen transactions, and the internationalization of yen, and 4) liberalization of Japanese financial markets, deregulation of interest rates among others. Of these four, items from the 1) to 3) were soon realized in accordance with the U.S. requests. We add several comments on each item.

1) at the time of the Committee, the U.S. side did not fully understand the causality that the larger deregulation of Japanese capital controls promotes investments in the United States, thereby depreciating the yen exchange rate. As a matter of fact, Japanese capital outflows from 1981 through early 1985 pressed the yen down. Accordingly, the government set the upper limit on foreign portfolio investments by institutional investors<sup>40</sup>. This limit was

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reevaluation" was addressed from the United States and West Germany on the next day after Nixon's gold-inconvertibility statement, at the secret meeting of the monetary representatives in London (*ibid*, p.336).

<sup>40</sup>Fukao (1990, p.145 and Supplement B).

raised at last in 1986, after the yen began to appreciate.

2) the open door policy towards foreign financial institutions resulted in the different performance between the security houses and banks. The entry into the Tokyo Stock Exchange and trust business was realized relatively in a smooth way. However, the liberalization of "impact loans" rather increased share of Japanese banks at the expense of foreign banks. Under the similar conditions between foreign and Japanese banks, the long-term relationship actually took effect in favor of Japanese banks<sup>41</sup>. In security business, American firms have been realizing full advantages of better financial technology, partly overwhelming the Japanese Big Four.

3) along with the deregulation of euro-finance in general, euro-yen business was also accelerated. The Japan Offshore Market (JOM) was established in 1986, in order to enable transactions similar to euro-offshore market, separated from domestic accounts and regulations such as interest rates, deposit insurance, required reserves, and withdrawing tax.

Legislatures expected this market would expand international business opportunities for Japanese financial institutions and provide non-residents as well as residents with better facilities for yen-denominated transactions. But as a matter of fact, the larger part of business in the Japan Offshore Market consists of the "by-path" finance by Japanese banks<sup>42</sup>. The amount of business in this market reached at the end of 1992, 6.7 times as much as the established year, with the yen share growing from 22% to 63% during the same interval<sup>43</sup>.

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<sup>41</sup> To be discussed again, in Iwami (1994a).

<sup>42</sup> For the function of the JOM, Fukao (1990, p.148) and Osugi (1990, pp.26-28, 64-65).

<sup>43</sup> MOF, *Annual Report of the IF Bureau*, 1993, p.113.

## 5. Concluding Remarks

The above discussions can be summarized as follows.

The causality that the competitiveness in trade leads to liberalization of international finance, does not appear so clearly as under the closed system in the high-growth period. Since the shift from the fixed rate to floating rate regime, sooner or later, turn the rising competitiveness to higher nominal exchange rate, the real exchange rate does not necessarily yield surplus in current account, which does not reveal an increasing trend, either. In short, the floating exchange rate changed the cause for more liberalization from the pressure of accumulated foreign assets to the need of hedging and demand for arbitrage transactions. The removal of capital controls was a common feature among developed countries, and the Japanese deregulation policy formed a part of this international transformation under the floating regime.

Without a series of the external shocks; the breakdown of the fixed exchange rate system, oil crises, and the Reagan policy, internationalization of Japanese finance had not been attained in such a short period. Moreover, the U.S. government pressed Japanese strongly for liberalization, associated with requirement on macroeconomic policy, as two lines from the U.S. in Figure 6 indicate. In this sense, Japan's financial internationalization was forced from exogenous factors.

The liberalization of the domestic financial system was caused by the changing pattern of fund flows, promoted by the large amount of government bond issues. The liberalization of domestic and international finance should be interpreted against separated backgrounds. However, the internal and external financial liberalization was interrelated by a common factor, namely the oil crisis. The recession following the first oil crisis decreased fixed capital formation in the private sector and increased government bond issues,

thereby heightened pressure for deregulation of the financial system. The Ministry of Finance, while administrating financial institutions, put primal importance on government bond sales, and inclined towards liberalization.

Although the international capital movements were initially liberalized in the early 1970s, the policy thereafter restlessly waved back and forth, in order to smooth out large fluctuation in balance of payments and exchange rates. Thus, the changing policy stance can be also attributed to exogenous shocks.

Against the rising competitiveness of Japanese export industries, foreign countries complained the "undervalued" yen and the policy seemingly guiding it, but the official intervention in the foreign exchange market remained in such a small scale relative to private transactions, that the official power was quite limited in this sphere. The monetary authority was, so to speak, tossed about by the wave of international capital movements. As the Japanese industries succeeded in dealing with a series of external shocks, the United States was more confirmed by the notion of the "undervalued" yen, which resulted in the most important factor which induced Japan to financially open system.



Table 1 External Assets and liabilities, the United States,  
Germany and Japan (billion dollars)

U.S.

Year	1972	1981	1985	1991
Assets	198.7	719.7	952.4	1880.1
Liabilities	161.7	579.0	1059.8	2240.7
Sum	360.4	1298.7	2012.2	4120.8
GDP	1201.6	3000.5	3957.0	5513.8
Sum/GDP	30.0	43.3	50.9	74.7%

Germany

Year	1972	1981	1985	1991
Assets	69.5	250.6	339.9	1153.0
Liabilities	51.4	221.0	288.5	807.6
Sum	120.9	471.6	628.4	1960.6
GDP	825.1	1545.1	1845.6	2599.3
Sum/GDP	46.9	68.8	83.8	114.3%

Japan

Year	1972	1981	1985	1991
Assets	43.6	209.3	437.7	2006.5
Liabilities	29.7	198.3	307.9	1623.4
Sum	73.3	407.6	745.6	3629.9
GDP	304.8	1167.0	1329.3	3617.6
Sum/GDP	24.0	34.9	51.6	100.3%

Source: Bryant (1987), Table 3-6, 3-11, Deutsche Bundesbank, *40 Jahre Deutsche Mark, Monetäre Statistiken 1948-1987*, Bank of Japan, *International Comparative Statistics*.

Table 2 International Assets of Banks, Share of Nationalities

(Year end, %)

country	1983	1985	1987	1988	1989	1990	1991
Japan	21.1	26.1	35.4	38.2	38.0	33.9	31.4
U.S.	28.0	21.7	14.8	14.7	14.1	11.4	10.6
France	8.0	9.0	8.6	8.4	8.4	8.8	9.5
Britain	8.3	7.1	5.8	5.2	4.8	4.4	4.6
Germany	6.7	7.0	7.9	7.7	8.4	9.7	10.4

Source: BIS, *Annual Report*, various issues, Takeda and Turner (1992), Table 31.

Table 3 Foreign Assets of Banks, Share of Location ( Year end, % )

country	1979	1983	1985	1987	1989	1990	1991
Japan	4.1	6.2	7.7	13.9	16.7	16.1	14.7
U.S.	12.3	22.6	16.9	12.2	11.9	9.8	9.2
France	11.1	8.0	6.5	6.4	6.6	7.2	6.4
Germany	6.2	3.6	3.9	5.0	5.3	6.2	6.0
Britain	25.7	27.5	22.0	21.0	18.4	18.1	15.9

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

Table 4 Liabilities in the eurocurrency market, Share of currency

(Year end, %)

currency	1979	1983	1985	1987	1989	1990	1991
U.S. dollar	68.4	75.9	68.9	60.3	59.6	59.3	52.7
DM	17.5	10.1	10.6	13.0	13.8	15.0	14.7
Swiss Franc	5.7	5.7	6.2	7.4	4.6	5.2	4.8
Yen	1.4	1.9	3.7	5.7	5.0	5.2	4.8
Pound	2.1	1.3	1.5	2.5	3.2	4.0	3.7
ECU	---	0.6	2.8	2.8	3.6	4.4	5.6

Note: For 1979,1983, cross-border liabilities in foreign currency only, thereafter including domestic liabilities in foreign currency.

Source: MOF, *Annual Report of International Finance Bureau*, 1986, 1989. Takeda and Turner (1992), p.74 Table 25.

Table 5 Historical Change of Current Accounts and Long-term Capital Flows  
 Britain, the United States, Germany and Japan, (year average, %)

period	1900-13	1920-29	1930-39	1950-60	1960-70	1970-85
<u>Britain</u>						
current balance	4.97	2.58	-0.93*	0.99	0.07	0.24
long-term						
capital balance	-5.49	-2.35	-0.26*	-0.59	-0.37	-1.45
gross capital						
movements	5.49	3.30	2.75*	---	3.03	6.09
<u>The United States</u>						
current balance	0.59	1.18	0.44	-0.03	0.36	-0.53
long-term						
capital balance	-0.14	-0.71	0.31	-0.45	-0.24	-0.12
gross capital						
movements	0.85	1.09	0.42	0.61	1.01	1.85
<u>Germany</u>						
current balance	-3.80*	-1.41**		1.83	0.65	0.75
long-term						
capital balance	-0.94	-0.77**		-0.27	-0.68	-0.07
gross capital						
movements	---	0.99**		0.61	2.09	3.26
<u>Japan</u>						
current balance	-1.88	-1.52	-0.12	0.68	0.16	0.90

long-term						
capital balance	2.71	-0.68	-2.37	-0.18	-0.18	-1.28
gross capital						
movements	3.51	1.21	3.14	0.71	1.13	2.43

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Note: gross long-term capital movements = long-term capital export + capital import.

Source: Britain; C. H. Feinstein, *Statistical Tables of National Income, Expenditure and Output of the U.K. 1855-1965*, Central Statistical Office, *Economic Trends*. M. Simon, "The pattern of New British Portfolio Foreign Investment, 1865-1914", in A. R. Hall(ed), *The Export of Capital from Britain 1870-1914.*, R. S. Sayers, *The Bank of England*, Appendix, 1976, Central Statistical Office, *Economic Trends, United Kingdom Balance of Payments*.

\*1930-1938. After 1960, excluding changes in assets and liabilities of banks. U.S.; U.S. Department of Commerce, *Historical Statistics of the United States, Colonial Times to 1970, Survey of Current Business*.

After 1971, excluding changes in assets and liabilities of banks.

Germany; Deutsche Bundesbank, *Deutsches Geld- und Bankwesen in Zahlen 1876-1975. 40 Jahre Deutsche Mark, Monetäre Statistiken 1948-1987*.

\* trade balance only. \*\*1925-1935.

Japan: Ohkawa et al (1974), *Chohki Keizai-Tohkei: Kokumin Shotoku*, (*Long-term Economic Statistics: National Income*), Yamazawa/Yamamoto (1979), *Chohki Keizai-Tohkei: Boheki to Kokusaishushi*, (*Long-term Economic Statistics: Foreign Trade and Balance of Payments*), BOJ, *Keizai Tohkei Nenpo (Economic Statistics Annual)*, various issues.

Table 6 Fund Raising and Employment by Big Firms\*,

(Share in total increase , %)

Fund Raising

year	1970 -74	75-79	80-84	81	82	83	84
in Foreign Currency	1.3	7.8	22.7	19.1	24.5	45.3	22.7
Impact Loans	1.4	3.1	11.6	14.5	13.1	21.0	3.7
Foreign Bonds	-0.1	4.0	9.8	2.7	10.0	22.9	18.4
DR	0.0	0.6	1.3	1.9	1.4	1.5	0.6
in Yen	98.7	92.2	77.3	80.9	75.5	54.1	77.3

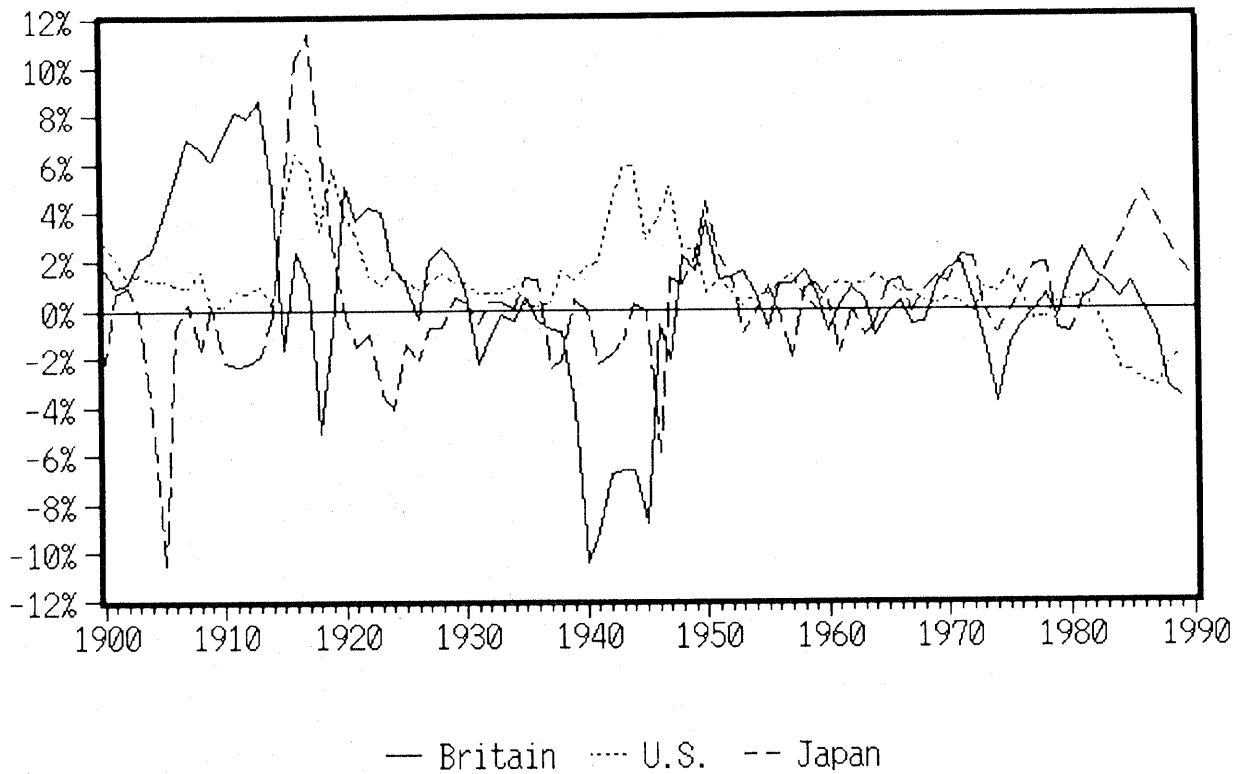
Fund Employment

in Foreign Currency	2.8	2.4	33.0	14.1	31.4	47.8	45.4
Deposit	2.2	0.9	22.2	9.2	22.7	34.1	23.2
Securities etc.	0.6	1.5	10.8	4.9	8.7	13.7	22.2
in Yen	97.2	97.6	73.7	85.9	68.6	52.2	54.6

Source: Bank of Japan, *Monthly Research*, May 1985.

Note: \* owned capital over 1 billion yen, all industries.

Figure 1 Current Accounts of Britain and Japan, the Balance on Goods and Services of the United States (Ratio to GNP: %)



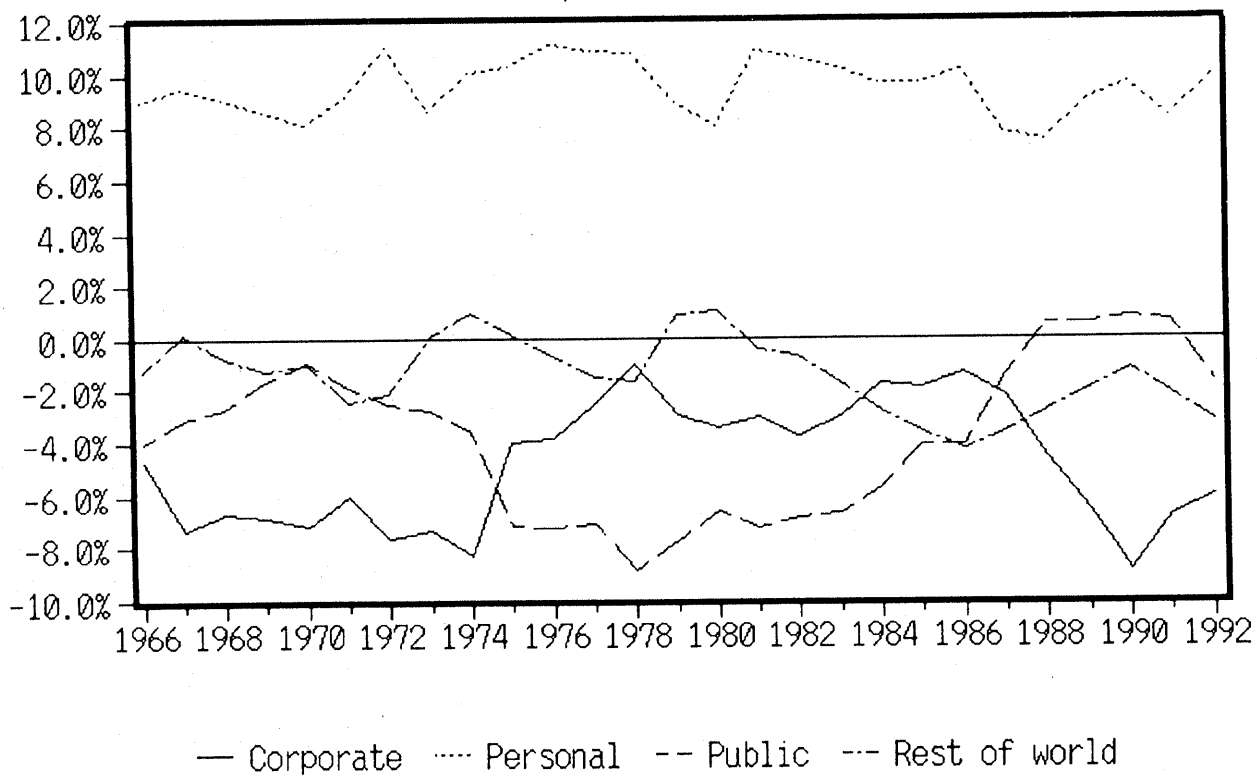
Source: Britain; Feinstein, *op. cit.*, Central Statistical Office, *op. cit.*

U.S.; U.S. Department of Commerce, *op. cit.*

Japan: Ohkawa, *op. cit.*, Yamazawa/Yamamoto, *op. cit.*, BOJ, *op. cit.*

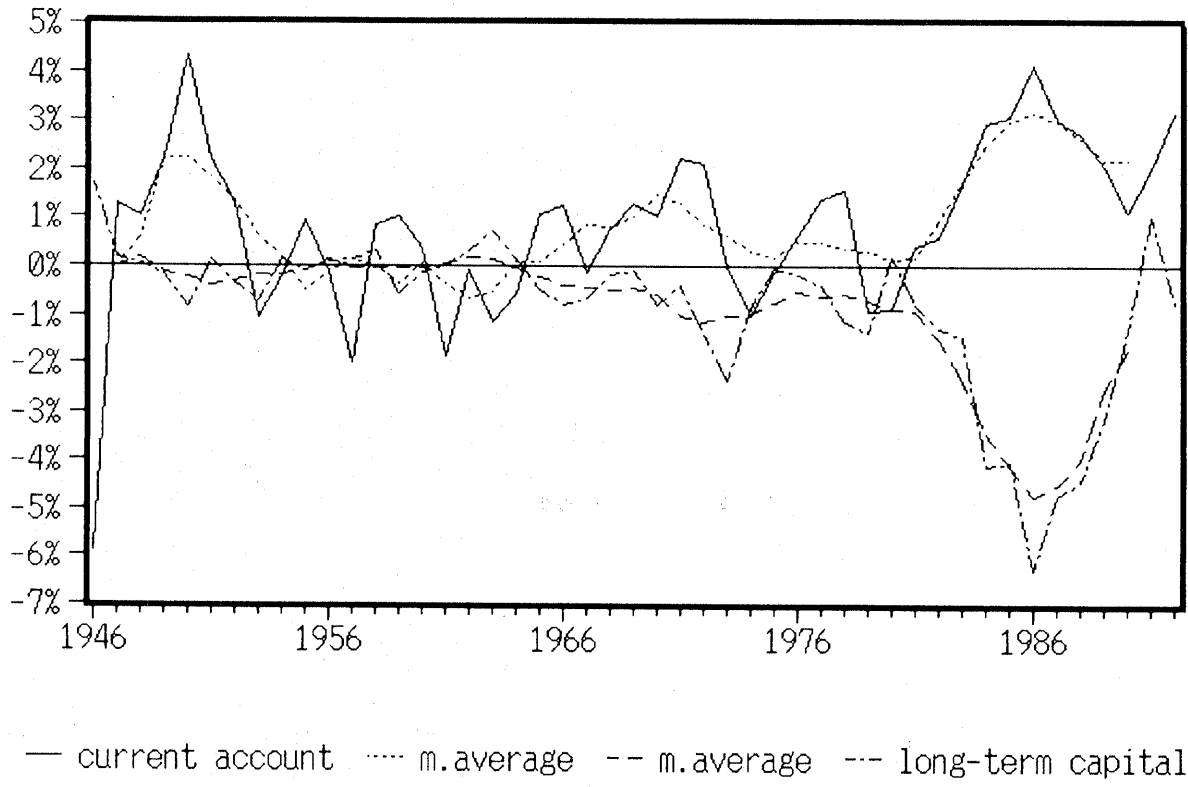


Figure 2 Fund Flows (Relative to GNP, %)



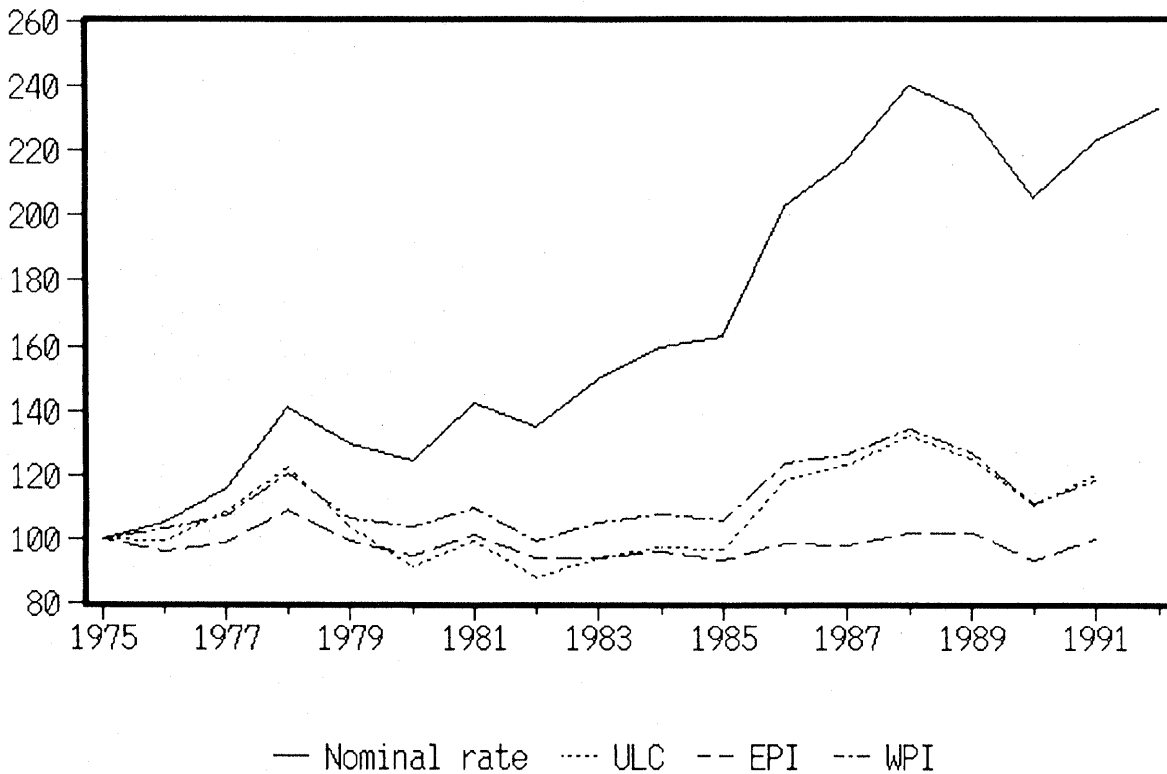
Source: Bank of Japan, *Fund Flow Accounts*, various issues.

Figure 3 Japanese Current Account and Long-term Capital Account  
(Relative to GNP, 1950 - 1991)



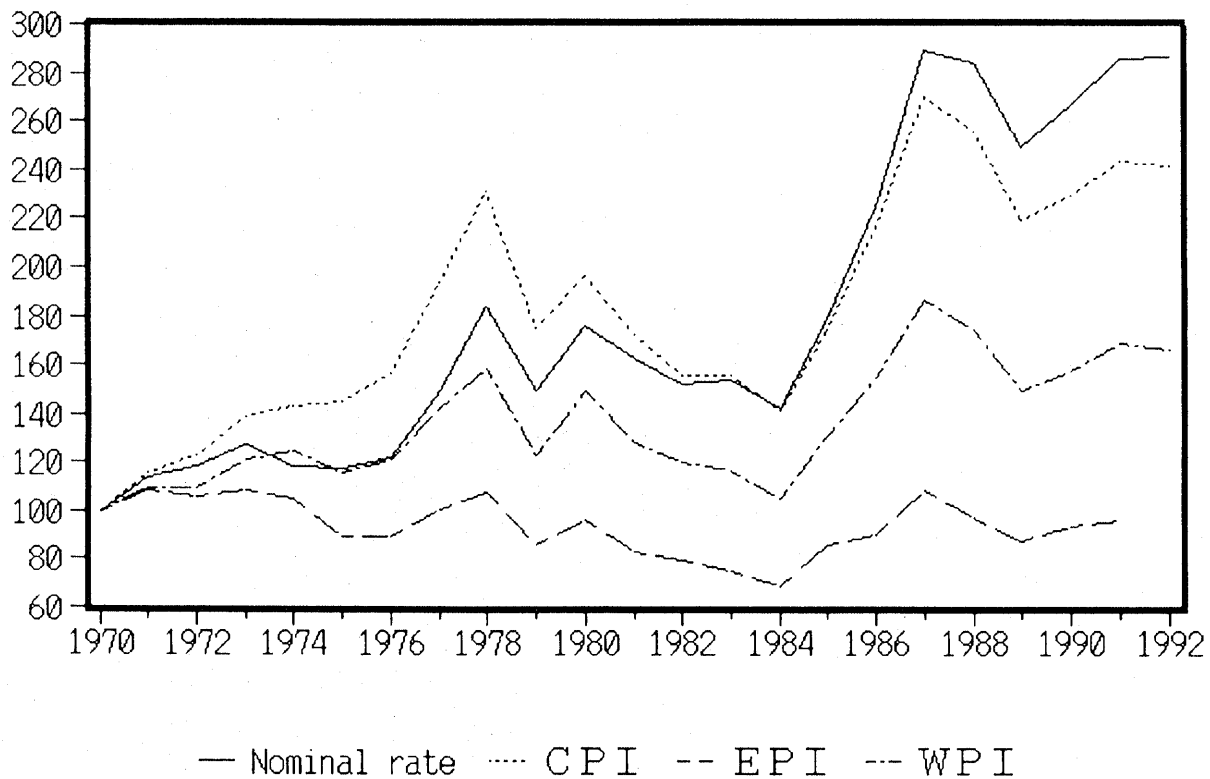
Source: Bank of Japan, *Economic Statistics Annual*.

Figure 4 Real Effective Exchange Rate of Yen (1975 = 100)



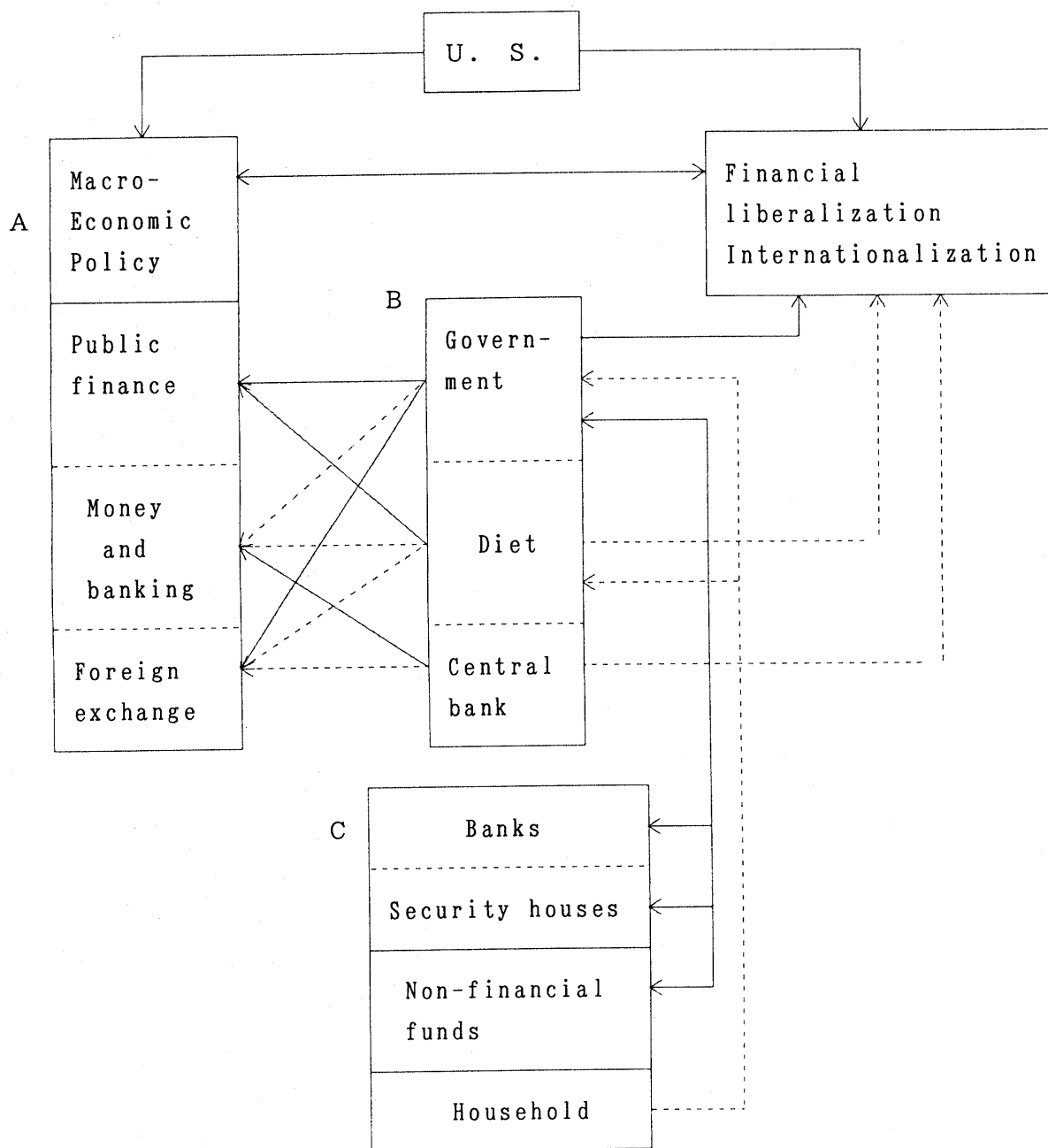
Source: IMF, *International Financial Statistics*.

Figure 5 Real Yen/Dollar Exchange Rate (1970 = 100)



Source: IMF, *International Financial Statistics*

Figure 6 A Model of Policy Making



Note: — strong influence, - - - weak influence.

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