

Capital account liberalisation: the Japanese experience and implications for China

Mitsuhiro Fukao

1. Introduction

This paper discusses the experiences of capital account liberalisation in Japan and their implications for China. In Section 2, I provide an overview of the postwar liberalisation process for exchange controls, paying attention to the interaction between exchange controls, the balance of payments and exchange rate movements. In particular, in Section 3 I examine the period 1971-74, when Japan shifted from a fixed rate system to a floating rate system. In my view, this change in the exchange rate regime was not well managed by Japanese policymakers and it may provide an important lesson for China. Then I look into the exchange rate policy in the late 1970s and early 1980s, when Japan liberalised capital account transactions. In this part, I focus on the prudential policy on foreign exchange risk management by financial institutions because it affects international capital movements and exchange rates. Section 4 provides possible lessons for China today. And the last section summarises my conclusions.

2. Overview of the liberalisation process for foreign exchange controls

Japan launched its postwar economy under a state-controlled trade system with extremely strict foreign exchange controls. I will provide a short overview of the liberalisation of exchange controls in Japan based on Fukao (1990) and Fukao et al (1993).

2.1 The immediate postwar period

When Japan surrendered in August 1945, it lost all of its foreign assets. From 1945 until 1949, all international transactions were effected through SCAP (the Supreme Commander of the Allied Powers) and the Japanese government. International prices and domestic prices bore little relationship to each other. Most domestic prices were strictly controlled with a widespread rationing system but black markets thrived. The differences between controlled official prices and black market prices were as large as thirtyfold (3,000%) at the end of 1945 although the price gaps gradually narrowed due to the recovery of production and rapid inflation.

The government purchased exportable goods at elevated prices and sold them at their international prices. The imported necessity goods such as food were sold at low prices to help the starving. As a result, Japan effectively had a multiple exchange rate regime. This multiple exchange rate system provided export and import subsidies, which were financed by Bank of Japan yen credit to the government and aid from the United States. In other words, Japan's current account deficits were financed by the United States (see Table 1). In 1948, the United States demanded that SCAP quickly reduce US subsidies to Japan. In order to halt inflation and current account deficits, SCAP ordered Japan to adopt a very tight monetary and fiscal policy and a single unified exchange rate.

In April 1949, Japan adopted a unified exchange rate of JPY 360 per dollar that lasted until 1971. Owing to an IMF-style stabilisation policy, Japan quickly brought an end to rapid inflation and, as a result, was able to remove most of the price controls and the rationing system. At the end of 1949, the Foreign Exchange and Foreign Trade Law was promulgated. Under this law, foreign exchange transactions were generally prohibited, with exemptions granted only according to directives and notifications by government ministries. Under this system, while exports were carried out relatively freely, imports of goods and services and international financial transactions were heavily regulated.

A surrender requirement that forbade the holding of foreign exchange by private parties was adopted. Any residents who obtained foreign exchange were required to sell it to the monetary authorities

through authorised “foreign exchange banks”. This “foreign exchange concentration system” was maintained with subsequent modifications until May 1972. The foreign exchange holdings that the government built up under this system were allocated for foreign payments on a quarterly basis starting in January 1951 through the Foreign Exchange Budget System (on a semiannual basis from fiscal 1952 and abolished in April 1964). Under this system, the yen was not convertible even for current transactions because it was necessary to obtain a special allocation of foreign exchange from MITI (the Ministry of International Trade and Industry), which controlled this budget process.

Graph 1 shows the current account balance and changes in reserves from 1951 to 1972. In the 1950s, the two lines moved very closely because there were almost no private capital movements under the tight exchange control system.

2.2 The recovery of current account convertibility

In April 1952 Japan regained its independence, and it joined the IMF in 1952 and GATT in 1954. The IMF requested Japan to liberalise current transactions. In July 1960, Japan introduced non-resident free yen accounts. As a result, non-residents were able to deposit yen, received either through current transactions with Japan or through the sale of foreign exchange, into these accounts, which could be freely converted back into foreign currencies. The other side of the coin, however, was that other yen balances could not be converted freely into foreign exchange. With the introduction of the non-resident free yen account, international trade transactions could be settled through the transfer of free yen deposits.

In 1964, when the Olympic Games were held in Tokyo, Japan became an IMF Article VIII country and joined the OECD. OECD membership meant that Japan would liberalise international financial transactions, especially foreign direct investments. Japan also had to liberalise trade-related financial transactions. As a result, international capital movements started to increase gradually in the 1960s. We can observe the small but increasing gap between Japan’s current account balance and its changes in foreign reserves in this period (see Graph 1). However, most countries, including the United States, maintained some foreign exchange controls on pure international financial transactions so as to maintain the pegged rate system. The international financial market was fairly small and Japan borrowed money from the World Bank to build a new motorway between Tokyo and Osaka in the early 1960s.

Even in the 1960s, the potential for large capital flows existed. At that time, exports and imports were equivalent to some 10% of GDP, implying that even with only a two-month shift in the payments and receipts of exports and imports (so-called “leads and lags” of overseas payments), potential capital flows would amount to over 3% of GDP ($20 \times 2/12 = 3.33$). When one considers the fact that Japan’s foreign exchange reserves in the mid-1960s were about USD 2 billion or just over 2% of GDP, it was easy to see that independent monetary policy under a pegged exchange rate system required fairly strict exchange controls on capital transactions.

2.3 The end of the pegged rate system

In the late 1960s, Japan started to accumulate a current account surplus and began to be subjected to political pressure from the United States to revalue the yen. After 1968, the Japanese current balance tended to show surplus, so that foreign exchange reserves, which had fluctuated at about USD 2 billion, reached USD 4.4 billion by the end of 1970. On the other hand, the US economy overheated because of the escalation of the Vietnam War. The US balance of payments showed a trade deficit in 1971 for the first time in the postwar period and the outflow of capital increased sharply. At the same time, the emphasis of foreign exchange controls in Japan switched from trying to prevent capital outflows to trying to encourage them. In April 1970 permission was granted for Japanese mutual funds to purchase foreign securities (with an upper limit of USD 100 million), and in January 1971 insurance companies were also permitted to purchase foreign securities (with the same upper limit). In addition, in August 1971, both mutual funds and insurance companies saw the abolition of upper limits on their purchase of foreign securities, while general investors were also granted blanket permission for the sale and purchase of foreign securities. Despite these measures, capital exports from Japan did not rise significantly because of the strong anticipation of a devaluation of the dollar. As Graph 2 shows, long-term capital outflows rose after 1972 with the expansion of foreign direct investments, credits related to plant exports, and loans for developing overseas resources and securing distribution networks. However, foreign securities investment and short-term capital outflows

did not expand because of the strong expectations that the yen would strengthen in the future (Graph 3).

In May 1971, the German mark began to float, and this gave rise to expectations that the yen would also be revalued. As a result, huge capital flows into Japan occurred, and official exchange reserves rose from the USD 4.4 billion at the end of 1970 to USD 7.9 billion at the end of July 1971. In this situation, the United States suspended the convertibility of the dollar to gold on 15 August, and also announced a 10% import surcharge tax (the so-called Nixon Shocks). Capital inflows in the 11 days between 16 and 27 August, just before Japan's shift to the floating rate system, amounted to USD 4 billion in such forms as prepayment of exports. Foreign exchange reserves by then amounted to USD 12 billion. These figures demonstrate that the liberalisation of exchange controls on current transactions allowed huge amounts of capital flows even with strict exchange controls on pure capital transactions.

As seen in Graph 2, the increase in official exchange reserves during 1971 was considerably larger than that in the current account surplus. These capital flows are believed to have arisen mostly from the activities of Japanese companies abroad. The subsidiaries of Japanese firms borrowed large amounts in dollars, and used these dollars to remit prepayments for exports to parent companies or to purchase yen-denominated securities (see Bank of Japan (1986, page 321) or Komiya and Suda (1983b, page 12)). At this time, there were controls on the prepayment of exports; but when huge profits over a very short period could be foreseen, the effectiveness of such controls was limited. After the United Kingdom shifted to floating exchange rates on 23 August, Japan did likewise on 28 August, and the postwar system of fixed exchange rates collapsed. Still, the floating in this period was very different from the floating experience of recent years. In this early period, extremely tight exchange controls were still imposed to an extent that made even current transactions difficult, while the authorities revalued the yen gradually and intentionally in the market.

The extreme control measures included the freezing of the short-term foreign exchange liabilities of foreign exchange banks at the level of 18 August 1971 (this freezing was abolished on 21 December). Because of this regulation, foreign exchange banks were no longer able to take on the dollar-denominated liabilities necessary to hedge dollar purchases. Consequently, even daily foreign exchange businesses such as the hedging of export contracts and the purchase of export bills and traveller's cheques were disrupted. For this reason, foreign exchange banks suspended the publication of forward rates for customers from 19 August until 29 October and some banks refused to become the counterparty in the hedging of export contracts. In addition, when Japan shifted to the floating exchange rate system on 28 August, upper limits were introduced on the outstanding amount of non-resident free yen accounts at foreign exchange banks. Since some free yen deposits were used for the settlement of international transactions, even normal international transactions were made difficult. For this reason, these controls were abolished in January 1972.

With the Smithsonian Agreement of December 1971, the yen's IMF parity was revalued to JPY 308 per US dollar, and the exchange rate fluctuation band was widened from 1% to 2.5%. Just after the revaluation, the dollar was rather strong, but soon yen buying pressure strengthened and capital controls were imposed during 1972, such as a restrengthening of export prepayment controls, establishment of high reserve requirements on increases in non-resident free yen deposits, and limitation of non-resident purchases of Japanese securities to the amount of non-resident sales. Among these measures, the establishment of reserve requirements on increases in yen deposits was implemented in the form of having foreign exchange banks make non-interest bearing deposits at the Bank of Japan equal to a portion of the non-resident free yen deposit received. In effect, this lowered the yen interest rates that could be offered to non-residents.

In May 1972, the foreign exchange concentration system was abolished and both residents and non-residents were allowed to hold foreign currency deposits with banks in Japan. However, there were important restrictions. For example, residents were not allowed to deposit foreign currency obtained from yen sales and could only deposit that received from transactions stipulated under the laws and regulations, such as export proceeds (it was possible to sell foreign currency deposits to obtain yen). In addition, there were many regulations on deposits into and payments from non-resident foreign currency accounts.

At this time, macroeconomic policymakers feared a deep recession because of the revaluation of the yen after the Smithsonian Agreement. They also tried to avoid a further revaluation and to reduce the current account surplus. Public opinion was strongly against a further revaluation in 1972. At this time, the imposition of export tax and quantitative restrictions on exports was seriously discussed to reduce

the current account surplus. Some politicians and economists advocated “adjustment inflation”: raising general prices to avoid further revaluations. Probably, these politicians and pseudoeconomists could not understand that a real appreciation through inflation is as bad as a nominal appreciation for export industries. Certainly, some serious economists advocated a shift to a floating rate system and explained the benefit of a stronger yen. However, they were unable to obtain wide support from the public. Therefore, the policymakers adopted a highly expansionary fiscal policy together with a very loose monetary policy.

The macroeconomic stimulus led to severe inflation in the second half of 1972 (Graph 4). The inflation rate accelerated to a double digit level in the next year and was further fuelled by the sharp increase in oil prices by the OPEC countries. This was one of the biggest mistakes made by the macroeconomic policymakers, including the Ministry of Finance, the Bank of Japan and the Economic Planning Agency. The Japanese GNP deflator rose by 50% from 1972 to 1975. In spite of the strong macroeconomic stimulus, Japan had to face both an appreciation of the yen and “adjustment inflation”.

In order to enable the supply and demand of foreign exchange towards the end of the fixed rate system to be understood, Graph 5 shows the accumulated current balance along with the accumulated changes in official reserves. The difference between these two values is the portion of the current account surplus not being held as short-term assets by the government; this amount can be seen as roughly equal to the net overall foreign exchange position of the private sector. From this estimate, one can see that the current account in the period 1965-68 was financed almost wholly by an accumulation of foreign exchange holdings by the private sector. From 1969 to 1971, both private sector foreign exchange holdings and increases in official reserves were needed to finance the current account surplus. And, finally, in 1971, while the current account surplus was rising considerably, an imminent devaluation of the dollar was expected. The private sector sold much of its accumulated dollar position, so that official exchange holdings increased by more than USD 10 billion. From this graph, we can see that the private sector shifted its exchange risk to the government.

The Smithsonian system did not last very long. In June 1972, the pound sterling shifted to a floating exchange and, in early 1973, selling pressure on the dollar in foreign exchange markets became so severe that the yen shifted to the floating rate system on 13 February. In March, major member countries of the European Community, including West Germany and France, began a joint float. At that time, policymakers expected that the floating exchange rate would be a temporary system but it has continued to this day.

2.4 Capital account liberalisation under the floating rate system: the 1970s

Graph 6 shows yen/dollar and yen/mark exchange rates since 1970. A strong upward trend in the yen/dollar exchange rate is visible. However, this trend can be explained in part by the inflation rate differential between Japan and the United States. Graph 7 shows the real yen/dollar and yen/mark exchange rates. The upward trend of the real yen/dollar exchange rate is much less pronounced than that of the nominal rate.

The exchange controls on international financial transactions were generally maintained in the 1970s and no significant liberalisations were carried out until 1980. The MOF tried to manipulate foreign exchange controls so as to stabilise the exchange rate, but with very limited success.

Between the stabilisation of monetary conditions in Europe at the end of March 1973 and the outbreak of the oil crisis in mid-October of that year, the yen fluctuated in an extremely narrow margin centring on JPY 265 per dollar. Due to the overheating of the Japanese economy and the effects of yen revaluation, Japan’s current account balance went into deficit in the middle of 1973. With the oil crisis in October, the current account deficit reached 2% of GNP between the end of 1973 and the first half of 1974. In addition to the worsening of the current account balance, there was a very rapid increase in general prices. As a result, strong selling pressure on the yen developed, so that the exchange rate reached JPY 320 per dollar by January 1974.

Facing this selling pressure on the yen, the MOF first abolished the exchange controls that hindered capital inflows and also beefed up controls on capital outflows. At the end of 1973, the strict ceiling on inward securities investment (which limited non-resident purchases of Japanese securities to the amount of non-resident sales) was abolished, and the reserve requirements on increases in non-resident free yen deposits were lowered. Also, in early 1974, there was a relaxation of the controls on receiving export advances.

Corresponding to these relaxations was the tightening on the other side, including the introduction of a voluntary restraint which did not allow net increases in foreign investments by banks, securities companies, investment trusts and insurance companies starting in January 1974 along with the introduction of controls that did not allow net increases in residents' foreign currency deposits. Moreover, macroeconomic policy switched to an extreme tightening of both fiscal and monetary policy.

The Japanese current account returned to near balance by the end of 1974 as the economy went into a deep recession. Due to the lagged recovery of the Japanese economy in 1975 relative to that of the United States, a current account surplus for Japan had resumed by 1976. From 1977, the foreign asset holdings of the private sector began to rise, and the yen exchange rate began to strengthen (see Graph 6 and 7).

In response to the rapid strengthening of the yen in 1977, official market intervention was undertaken to purchase dollars while capital export controls were eased and capital import controls were strengthened. In June 1977, the controls on outstanding balances of residents' foreign currency deposits were abolished, as were the measures that prohibited the acquisition of short-term foreign securities by residents. In addition, in November, a 50% reserve requirement on increases in the free yen deposits of non-residents was instituted. In March 1978, this reserve ratio on increases was raised to 100%, which effectively prohibited the payment of interest on such increases. In addition, the acquisition of yen-denominated securities by non-residents was also strictly controlled. This time, unlike the case of 1971, the extreme control measures that would have made even current transactions difficult were not taken.

However, the huge short-term capital inflows seen in 1971 based on increases in import usage and export advances (leads and lags) were not repeated (see Graph 2). This lack of large short-term capital inflows was presumably due to the fact that, under a floating exchange rate system, large and uncertain changes in exchange rates were possible, in contrast to the easy bet under the fixed exchange rate system. In other words, short-term exchange rate speculation became many times more risky. In this sense, the strength of the yen at this time was not due principally to speculative capital inflows. Rather, as will be explained below, it was attributable to the fact that large current account imbalances were occurring in a regime with exchange controls that made private capital outflows difficult.

The appreciation of the yen continued until November 1978, when dollar defence measures were announced by the Carter administration (see Graph 7). The current account surplus began to shrink at this time, because of the effects of the high yen and expansion of the Japanese economy. With the large increase in crude oil prices in 1979 (the second oil crisis), the Japanese current account fell into large deficit in 1979 and in 1980. Given this changing environment, all capital inflow controls that had been taken in the high yen period were abolished during 1979, and the prohibition of non-resident participation in repo (gensaki) transactions was lifted in May.

2.5 Interest rate differentials and exchange controls

The change of direction in exchange controls can also be observed in the relationship between domestic yen interest rates and euroyen interest rates, which are the yen rates that are used in interbank lending and borrowing transactions by banks abroad. Graph 8 compares three-month gensaki (repo) interest rates with three-month euroyen interest rates (both at the end of the month). Since data on euroyen rates are only available after 1975, rates prior to that time are estimated using the three-month eurodollar rate and the three-month spot-forward spread of the yen/dollar exchange rate in the Tokyo foreign exchange market. This is because one could always carry out yen financial transactions in the euromarkets by combining dollar financial transactions and yen/dollar forward transactions even if euroyen transactions themselves were thin. Therefore, the euroyen interest rate, on the one hand, and the combination of the eurodollar interest rate and the yen/dollar spot-forward spread, on the other, would have the following relationship:

$$\text{Euroyen interest rate} = \text{eurodollar interest rate} + \text{dollar forward premium} \quad (1)$$

The domestic yen interest rate and the euroyen interest rate should be almost identical in the absence of exchange controls because of arbitrage between domestic and foreign markets. But, in fact, until about 1980, Japanese exchange controls were rather strict, and there were large differentials between these two interest rates. Let us now consider why this divergence of yen interest rates at home and overseas occurred.

2.5.1 The case of capital inflow controls

First, let us consider the case of capital inflow controls by the Japanese monetary authorities under strong upward pressure on the yen. In this case, non-residents would seek profits from the yen appreciation through investing in yen-denominated assets such as non-resident free yen deposits and yen-denominated securities. However, if the acquisition of yen-denominated securities were forbidden because of exchange controls, then non-resident free yen deposits would be left as the only means of investment. Moreover, the application of high reserve requirements on increases in non-resident free yen deposits reduced the profitability of such deposits for foreign exchange banks. Japanese banks would lower interest rates on such yen deposits. By arbitrage, the euroyen interest rates would fall relative to domestic yen interest rates, and they even approached zero.

As more strict exchange controls were adopted, banks began to refuse to accept such deposits, and the effective interest rates on yen funds for non-residents even became negative. In cases where foreign banks that had accepted euroyen deposits could not invest them in Japan because of the Japanese exchange controls, they had to lend these yen funds to other non-residents to hedge their foreign exchange risks. This put the banks in a difficult position: because of the large risk of yen liabilities when a yen appreciation was expected, such loans required negative interest rates. The fall of euroyen interest rates therefore lowered the interest income received through yen investments by non-residents and worked towards weakening the buying pressure on the yen. As can be seen from the above equation, a decline in the euroyen interest rate under a given eurodollar interest rate would lead to an expansion of the discount of the dollar against the yen in the forward markets. By purchasing yen cash (ie banknotes) from Japan, a yen investment with a zero interest rate is always possible. However, there would be high transaction costs associated with the transportation of cash funds and short-term gains from such arbitrage would be small. Once a negative euroyen interest rate continued over a prolonged period because of exchange controls, an expansion in cash outflows would work towards making these controls ineffective in the long run.

In times of strong upward pressure on the yen, it was also advantageous for residents to have uncovered dollar liability positions. That is, they would borrow dollars and sell them in the spot market, invest the proceeds in yen and, after a fall in the dollar, repurchase dollars and repay their dollar debts, thus realising a capital gain. For this reason, exchange controls that aimed to prevent an appreciation of the yen would have to be implemented by the monetary authorities in such a way as to limit dollar borrowings by residents.

Imposition of controls on dollar borrowing by Japanese residents is similar in effect to raising the interest rate on dollar borrowings within Japan relative to dollar interest rates abroad. The difference between dollar interest rates at home and abroad and the difference between yen interest rates at home and abroad are opposite sides of the same coin. That is, if forward dollar transactions are permitted in Japan, dollar fund transactions can be carried out using the yen funds market and the forward exchange markets in the dollar. In this case, the effective dollar interest rate in Japan can be calculated from the following formula:

$$\text{Effective dollar interest rate in Japan} = \text{yen interest rate in Japan} + \text{dollar forward discount} \quad (2)$$

A high dollar interest rate in Japan means a large forward discount of the dollar. If there is no separation between domestic and foreign forward exchange markets, the yen interest rate abroad is determined by the following formula:

$$\text{Effective yen interest rate abroad} = \text{dollar interest rate abroad} - \text{dollar forward discount} \quad (3)$$

Therefore, when the forward discount is large because of exchange controls, the effective yen interest rate abroad is lower than the yen interest rate in Japan.

2.5.2 The case of capital outflow control

Let us next consider the case of capital outflow controls by the Japanese monetary authorities under strong downward pressure on the yen. In this case, euroyen interest rates exceed domestic yen interest rates. When market participants expect a depreciation of the yen, non-residents try to carry out yen borrowings, purchase dollars with the proceeds of these borrowings and, once the yen has fallen, earn a profit by repaying their borrowings with yen bought cheaply in the future. For this reason, exchange controls must limit yen lending to non-residents by residents such as Japanese banks. In the case where outflows of yen funds from Japan are completely stopped, any non-resident wishing to speculate against the yen must borrow yen funds from some other non-residents. Such yen funds will

be difficult to obtain, however, when there is an expectation of yen devaluation. Because of a strong possibility of a capital loss on yen lending, non-residents would not lend yen except at high interest rates. For this reason, euroyen interest rates would rise above yen interest rates in Japan. Under the same mechanism as in the case of upward pressure on the yen seen above, the forward premium of the dollar would expand.

Moreover, in this case, Japanese residents would also wish to sell yen and try to realise capital gains by investing in dollars. Therefore, foreign exchange controls would have to limit the acquisition of foreign securities by residents and their placing of foreign currency deposits.

2.5.3 Exchange control and euroyen interest rates

As can be seen in Graph 8, from 1972 until September 1973 euroyen interest rates reflected the controls on capital inflows and were either below domestic gensaki rates or at about the same levels. In November 1971 and February 1973, particularly, the euroyen interest rates calculated from formula (1) went to -10% , which reflects the intensity of the capital controls at that time. In contrast, after October 1973, when the first oil crisis broke out, euroyen interest rates were far above the domestic gensaki interest rates, and reached 40% temporarily. The situation in which euroyen interest rates exceeded domestic yen interest rates by a wide margin continued until the middle of 1974, when the confusion caused by the oil crisis abated.

After the oil crisis, foreign exchange controls were relaxed and the divergences between euroyen interest rates and domestic gensaki rates returned to a relatively narrow margin. Then in November 1977, with the strengthening of capital inflow controls, euroyen interest rates fell far below gensaki rates. As can be seen in Graph 8, euroyen interest rates were 2-5 points below gensaki rates. However, with the abolition of these foreign exchange controls, euroyen rates and gensaki rates came closer together, and particularly after the permission granted in May 1979 to non-residents to participate in the gensaki market, the divergence between these two rates became extremely small.

In this way, one can see how foreign exchange controls limited the arbitrage between yen markets overseas and at home and therefore reduced selling pressure on the yen when it was weak and the buying pressure on it when it was strong. These effects allowed a stabilisation of the spot foreign exchange market with smaller amounts of intervention. However, at the same time, the forward exchange market was disrupted: we have to take account of the costs of hedging import and export transactions in the forward market. When the yen was expected to weaken, foreign exchange controls raised the premium on forward dollars, so that importers who wished to buy dollars forward were forced to buy them at higher prices that included the expected increase in the value of the dollar.

2.6 Exchange control and internationalisation of Japanese financial markets

To provide an overall picture of the effects of exchange control policy in the 1970s on the internationalisation of Japanese financial markets, Graph 9 tracks the development of Japan's external assets and liabilities. It shows the ratio of outstanding foreign assets and liabilities at the end of calendar years to nominal GNP in the same year. These data are displayed from 1971, when the assets and liabilities data were first published. The graph shows that Japan's gross foreign assets and liabilities were roughly stable relative to the Japanese economy in the 1970s. This stability reflects the fact that the relaxations of foreign exchange controls in this period were rather sporadic, responding to changes in the yen exchange rate, and did not attempt to promote capital exchange between foreign and domestic financial markets. Despite the mild liberalisation of foreign securities investment for general investors after 1971, there remained strict controls, based on the real demand principle, against hedging such asset holdings in a flexible way through forward contracts (these rules were eased in April 1978 but not removed until 1984). Moreover, because the old foreign exchange law forbade all foreign transactions in principle, while permitting certain transactions through exemption by administrative order, it was rather difficult for general investors to know which types of transactions were actually liberalised. This was a hindrance to foreign investment.

As far as official regulations are concerned, the large financial institutions such as banks, securities companies, investment trusts and insurance companies were allowed to conduct foreign investment during the years of the floating exchange rate system except for the period of "self restraint" imposed from January 1974 to June 1975, in which no net increases of foreign securities holding were allowed (this period lasted until March 1977 for banks). However, before the adoption of the new foreign exchange law at the end of 1980, only life insurance companies carried out any foreign investments

after 1978 and the other institutions did not carry out any significant foreign investments. This was probably due to the generally negative attitude of the monetary authorities towards foreign securities investments by financial institutions.

Looking therefore at the 1970s as a whole, the internationalisation of the Japanese financial markets did not progress substantially relative to the growing size of the Japanese economy. In short, the level of internationalisation of Japanese financial markets remained as at the beginning of the 1970s when the foreign exchange concentration system was abolished.

Next, let us look at the net foreign asset position and its financing. After the Japanese economy overcame the first oil crisis, a current account surplus emerged by the end of 1975 and continued expanding until the beginning of 1978 (see Graph 10). In contrast, because the liberalisation of international capital transactions had not increased substantially, private capital outflows were relatively small; therefore, it was a necessity to finance these current account surpluses through official intervention. In fact, on an ex post basis, two thirds of the increase in net foreign assets that accompanied the current account surpluses between 1976 and 1978 was financed by increases in official reserves. However, despite this, the yen rose sharply against the dollar between 1977 and 1978. This was probably due to the fact that official intervention in Japan was following the leaning against the wind strategy (for an empirical investigation into Japanese intervention in this period, see Quirk (1977)). Consequently, the intervention was able to absorb the current account surpluses only after the fact of appreciation.

One may interpret this experience as follows. With the current account surplus rising on trend and with liberalisation of capital transactions on foreign securities and other types of investments insufficient, the private sector was unable to absorb increases in foreign currency assets. This situation gave rise to selling pressure on the dollar. To offset this pressure, official dollar purchases were carried out passively. In other words, with relatively strict foreign exchange controls, only foreign exchange intervention was available to absorb large current account surpluses. However, since official intervention strategy was passive in the sense of leaning against the wind, it led to a large appreciation of the yen. This leaves open the possibility that a more aggressive official intervention strategy would have held the yen appreciation to a lower level by absorbing increases in the current account surplus into official reserves. The game theory aspect of the market cannot, however, be ignored. If the authorities had been able to stop the appreciation of the yen through intervention, this would have resulted in a one-way option such as that of summer 1971, which would have increased pressure on the yen even further. Therefore, a rather large appreciation of the yen was not to be avoided.

2.7 Financial market internationalisation under the new foreign exchange law: the 1980s

At the end of 1980, the foreign exchange law was revised. Contrary to the old law, under which all foreign exchange transactions were prohibited in principle, the new law allowed any foreign exchange transactions unless specifically restricted. The restrictions on foreign securities investment by institutional investors such as insurance companies, trust banks and the postal life insurance system (Kampo) were also liberalised thereafter. This liberalisation of international capital transactions, combined with the high interest rates in the United States at that time, made for quite active foreign securities investment and became one of the reasons for the weakness of the yen over most of the first half of the 1980s.

2.7.1 Implementation of the new foreign exchange law

A new foreign exchange law (known officially as the Law Partially Revising the Foreign Exchange and Foreign Trade Control Law) was implemented in December 1980. This law changed the basic principle behind foreign exchange control in Japan from that of “prohibition of foreign transactions with exceptions” to “freedom of transactions with exceptions”. Under the new law, Japanese residents could buy and sell foreign currency assets freely as long as they were dealing with authorised foreign exchange banks and designated securities companies as their counterparties. However, direct foreign currency transactions among residents and direct financial transactions between residents and non-residents were restricted.

Under this law, foreign currency deposits and foreign currency borrowings with authorised foreign exchange banks became completely free. In addition, the interest rates on foreign currency deposits were exempted from the upper limits of the Temporary Interest Rate Adjustment Law and therefore

were free interest rates. At the same time, controls on capital transactions could be implemented in the following emergency situations: (i) when maintenance of balance of payments equilibrium was difficult; (ii) in cases of sharp fluctuations in the foreign exchange market; and (iii) when financial markets were adversely affected because of international capital movements. To date, however, no capital controls have been invoked under these emergency provisions.

The new law enabled residents to freely hold foreign assets and liabilities. This was a fundamental change in exchange controls and was effectively an abolition of virtually all restrictions on the convertibility of the yen. And since the yen became almost fully convertible, non-resident free yen deposits came to be known simply as non-resident yen deposits (see Fukui (1981, page 118)). Reflecting the significant liberalisation measures on international financial transactions, the gap between euroyen and gensaki rates in Graph 8 almost disappeared after the end of 1980.

However, even under the new foreign exchange law, the quotas on banks' net short spot positions in foreign currencies and the real demand requirements for forward exchange transactions were not removed. However, these remaining restrictions were no longer meaningful given the wide-ranging liberalisations under the new law (see Fukao (1990)). The real demand requirements for forward transactions and the restrictions on net short spot positions were both eliminated, in April and June 1984, respectively.

2.7.2 Trends in the Japanese balance of payments and exchange rates in the 1980s

After hitting a high of JPY 175.5 per dollar in October 1978, the yen fell rapidly with the onset of the second oil crisis, the deterioration of Japan's balance of payments, and the sharp rise in dollar interest rates with the monetary tightening in the United States from summer 1979. By the end of 1979, the yen/dollar rate had hit JPY 240 per dollar. However, Japan was able to overcome the inflation of the second oil crisis in a relatively short period of time through timely initiation of a tight-money policy. By the end of 1980, the deficit in the current account had also disappeared. The yen strengthened during 1980 towards JPY 200 per dollar. However, with the continuation of very high real interest rates in the United States, there was increasing pressure for long-term capital outflows from Japan, and the yen followed a downward trend until the beginning of 1985. Because of the yen's weakness, the Japanese current account surplus continued to accumulate. However, in spring 1985, this downward trend of the yen reversed and the currency began to strengthen. Between the Plaza Accord of September 1985 and the end of 1987, there was a sharp increase in the value of the yen.

Graph 10 shows the current account balance, the current account balance plus direct investment balance (hereafter the "basic balance"), and changes in foreign exchange reserves from 1970 to the present. The basic balance is intended to be a proxy for the overall balance of non-financial transactions. The changes in foreign exchange reserves correspond roughly to the amount of intervention by the monetary authorities and can be interpreted as the public sector capital balance. As can be seen from this graph, with the exception of the period of large inflows of short-term capital in 1971, these three balances moved in parallel until the beginning of the 1980s. That is, private sector capital flows were relatively small, and therefore the surpluses in the current balance or the basic balance corresponded closely to increases in official reserves.

This pattern has changed since the 1980s. The gap between the basic balance and the changes in reserves became wide in the first half of the 1980s. Looking at the current account and the changes in reserves, one sees that the current account surplus rose very rapidly after 1983 while the changes in reserves stayed at a very low level. The main reason for the differential between these two balances was the huge increase in long-term capital outflows, particularly of private foreign securities investment.

As the basic balance accumulated, the yen started to appreciate in 1985 (see Graph 7). When the yen appreciated beyond a certain point, official interventions were conducted to limit the appreciation. This intervention pattern is clearly visible for the periods 1986-88, 1993-95 and 1999-2001. On the other hand, when the basic balance declined, the yen weakened and intervention in support of the yen was carried out. This is also visible for the period 1989-90. Let us consider a possible reason for this pattern of balance of payments and exchange rates.

Generally speaking, whenever an international payment is made to settle an international transaction of goods and services, the ownership of some financial asset moves from the buyer country of such goods and services to the seller country. In other words, the ownership of financial assets moves in the opposite direction to the movement of goods and services. On the other hand, in the case of pure

international financial transactions, buyers and sellers simply exchange two kinds of financial assets in the market and there are no changes in the net amounts of financial assets owned by individual countries. Foreign direct investment is not a pure financial transaction but a transaction that involves real assets such as factory or real estates. Therefore, the sum of the current account balance and direct investment balance is equal to the total amount of changes in ownership of financial assets. The country running surplus in this basic balance accumulates net external financial assets issued by the rest of the world.

When Japan runs a basic account surplus without official interventions, the Japanese private sector accumulates foreign assets mostly denominated in US dollars. Since the Japanese household sector has enjoyed a relatively stable monetary environment since the 1950s, it has never invested in foreign currency assets on a large scale, regarding them as risky instruments. The sectors that have invested in foreign currencies are financial institutions including life insurance companies, mutual funds and some banks. When these financial institutions cannot expect any risk premium in foreign financial assets to compensate for a higher risk profile, there will be selling pressure on the dollar.

Thus, in the 1980s, international capital movements through the private sector intensified extraordinarily, and the divergence between the basic balance and the public sector capital balance widened considerably. As a result, the internationalisation of Japanese financial markets progressed at an extremely rapid pace. This can be seen from the ratios of Japan's overseas assets and liabilities to GDP in Graph 9. These ratios rose extremely quickly after the beginning of the 1980s. For example, at the end of 1980, foreign assets were about 13% of GDP but by the end of 1989 had reached 62%. The liabilities rose from about 12% of GNP at the end of 1980 to approximately 52% at the end of 1989. During this period, the net foreign asset position continued to improve because of current account surpluses - from 1% of GDP at the end of 1980 to 10% at the end of 1989.

The composition of these assets and liabilities naturally reflects the structure of the balance of payments. On the asset side, the major contributors were private overseas securities investment by institutional investors and private short-term capital outflows by foreign exchange banks. On the liability side, the major increases were in private sector short-term capital inflows by foreign exchange banks and increased acquisition of Japanese securities by non-residents. Among these, the increases in short-term overseas assets and liabilities of foreign exchange banks were notable.

2.7.3 Foreign securities investment by institutional investors

The new foreign investment law did not fundamentally change the prudential regulations on foreign securities investment for institutional investors. However, with the implementation of the new law, the attitude of the MOF towards foreign investment by such institutional investors became much more lenient. Prior to the 1980s, foreign investment by institutional investors was in fact quite limited. For example, the outstanding holdings of foreign securities by life insurance companies were merely 2.7% of total assets at the end of 1980 (the upper limit on such investment was 10% of total assets between 1971 and 1986).

However, from the start of the 1980s, there was a rapid liberalisation of foreign securities investment (see Appendix B of Fukao (1990) for details of the controls on foreign securities investment by institutional investors). In January 1981, pension trusts were permitted to invest up to 10% of total assets in foreign currency denominated instruments. In addition, in May 1983 the postal life insurance system was allowed to acquire foreign securities equivalent to up to 10% of total assets. These liberalisations of foreign securities investment for institutional investors occurred in the first half of the 1980s when the demand for funds was low because of the weak recovery of the Japanese economy and when real interest rates in the United States were extremely high. For this reason, institutional investors such as life insurance companies started to acquire dollar-denominated securities en masse.

The increasing foreign securities investment by institutional investors generated very strong capital outflow pressure and the yen remained weak between 1981 and 1985. Responding to this weakness of the yen, the monetary authorities introduced temporary controls on certain types of foreign securities investment. For example, life insurance companies were subjected to an upper limit on increases in foreign investment between April 1982 and August 1986. In addition, non-life insurance companies, pension trusts and postal life insurance were also subjected to similar controls.

However, after 1985, with the sharp appreciation of the yen, these controls were abolished, and the upper limits on the ratio of foreign securities holdings to total assets were loosened. During 1986, the upper limit for life and casualty insurance companies was raised from 10% to 30%, while the limit for

the postal life insurance system was raised to 20%. After these changes, the actual amounts of foreign securities investment by institutional investors have been far less than these upper limits permitted by regulations, so that these limits have not constituted a binding constraint.

Graph 11 shows the outstanding amounts of foreign securities investment for major institutional investors. The five categories of financial institutions shown in the graph held about three quarters of the Japan's total foreign securities holdings at the end of 1988. The foreign securities held by banks are generally hedged through foreign currency borrowings because of prudential regulations on banks' foreign exchange positions. In contrast, the foreign securities holdings of insurance companies and securities investment trusts (mutual funds) are not fully hedged and these institutions are the most important holders of foreign securities on an unhedged basis. The share of foreign securities in the total assets of institutional investors rose very rapidly from the beginning of the 1980s.

2.8 Further liberalisation under the Japanese big bang

The Foreign Exchange Law was further amended to liberalise international financial transactions in 1998. Even after the 1980 revision of the law, the following regulations were not removed:

(i) *Authorised foreign exchange bank system*

Ever since the first Foreign Exchange Law of 1949, the authorised foreign exchange bank system has been the pillar of foreign exchange control in Japan. Japanese residents have to go through foreign exchange banks to conduct international financial transactions unless they have special authorisation from the MOF. Even big Japanese companies with extensive international networks have to use authorised foreign exchange banks to carry out settlements of individual transactions. Cost-minimising techniques such as payment netting were not allowed under the old law and some big Japanese firms moved their settlement centres to much more accommodating locations such as London, Hong Kong and Singapore. One senior MOF official characterised this system as a “cartel among banks” to protect foreign exchange business.

(ii) *Regulations on special payments*

In order to restrict circumvention of exchange controls by “leads and lags” (see Section 2.2), the 1980 law set limits on the periods for prepayment and deferred payment of international transactions. As a result, exports of big items such as chemical plants and public infrastructure projects entailed a very cumbersome procedure for gaining approval from the MOF.

(iii) *Restrictions on direct transactions with foreign counterparties*

The 1980s law required residents to obtain individual permission from the MOF when conducting direct international financial transactions with banks and other entities located abroad. In order to open a demand deposit account with a New York bank, a resident had to obtain special permission from the MOF. Direct derivatives transactions with foreign financial institutions located abroad also required prior approval. In order to buy foreign securities without red tape, Japanese residents had to go through designated securities companies in Japan.

The 1998 revision of the Foreign Exchange and Foreign Trade Law removed all of the above restrictions and, in the new environment, Japanese firms and individuals can execute direct transactions with foreign counterparties.

On the other hand, reporting requirements and penalties for non-reporting were strengthened for statistics and taxation purposes. Exemption clauses were retained for emergency situations.

It is my impression that the liberalisation of the financial sector lagged behind development in the non-financial sectors. The Japanese administration tried to slow the pace of liberalisation and removed controls only after being subjected to a large dose of foreign pressure (“gaiatsu” in Japanese). When I read the history of exchange control liberalisation, I learned that some drafters of the 1949 law did not expect such a strict control law to survive for more than 30 years. Certainly, the bureaucrats tinkered with directives and notifications to adapt it to the fast growing Japanese economy of the 1960s and 1970s. However, the Foreign Exchange Control Law became a source of rent for regulated banks and bureaucracy.

3. Implications for Chinese foreign exchange policy

The biggest mistakes Japan made in its foreign exchange policy were the transition from an adjustable peg system to a floating rate system in 1971-73 and the policy against a strong yen in 1977-78. Since these episodes would be illustrative for Chinese policymakers, we examine them in this section.

3.1 Transition from pegged system to floating system

It is well known that it is not possible to achieve all three of the following desirable objectives of international monetary arrangements:

- (i) maintaining an independent monetary policy;
- (ii) allowing free international transactions, including foreign direct investment and financial transactions; and
- (iii) keeping the exchange rate pegged to an anchor currency.

Japan was facing this choice in 1971. As the Japanese economy developed rapidly, industry wanted to have more freedom in international transactions. When the Japanese economy was less developed, free current transactions had been enough to sustain growth. However, as Japan started to export complex products and services, exporting firms wished to set up distribution networks and factories in foreign countries. They also desired to import sophisticated technology and software from foreign firms. Japanese financial institutions wanted to establish foreign branches and subsidiaries so as to provide services for Japanese as well as foreign customers. In order to allow such transactions, the government had to liberalise a wider range of international transactions.

When Japan selected the second objective (free international transactions) in the late 1960s, it had to choose between an independent monetary policy and a pegged exchange rate system. However, Japan tried to keep all three objectives. If a country liberalises international transactions under a pegged rate system, capital will move from a low interest rate country to a high interest country. This would make it very difficult to maintain an independent monetary policy. Japan tried hard to maintain a pegged rate system when the economy was overheating in 1972. It tightened exchange controls. In the early 1970s, the Japanese foreign exchange control system was reputed to be “watertight.” However, Japanese firms and financial institutions that had established foreign subsidiaries and branches could cheat this exchange control system. For example, in order to receive a large amount of export prepayments, a firm had to obtain special permission from the MOF. However, it was possible to receive a small amount of export prepayments through simple notification. Some Japanese firms asked foreign subsidiaries to send a large number of small export prepayments to hedge future dollar export receipts. In view of these actions, the MOF reduced the threshold to one tenth but found that it had to process a tenfold volume of notification. Once internationalised, a firm can easily disguise financial transactions as current transactions through transfer pricing, leads and lags, and so on.

Japan could neither stop capital inflows nor maintain an independent monetary policy in the early 1970s. Monetary policy remained very loose in 1972 and money supply (M2) rose by 27%. In 1973, Japan experienced serious inflation. To make matters worse, the first oil crisis broke out in late 1973. Had Japan shifted to floating in 1972, it could have minimised this inflation.

In this context, it is necessary to take account of the following factors:

- (i) For a large and relatively closed economy like Japan with an export/GDP ratio of 10% in the early 1970s, it was not possible to abandon independent monetary policy as a macro instrument.
- (ii) The losers (the Japanese export industries) were politically very noisy while the winners (the Japanese import industries and household sector) were quiet.
- (iii) Tightening of exchange controls tended to punish honest parties that did not sell dollars at the time.

Sooner or later, China will have to liberalise international transactions to the extent that Japan did in the early 1970s. Then, China as a large economy has to opt for an independent monetary policy rather than a pegged exchange rate system.

3.2 Sequencing of liberalisation and exchange rate management in the 1970s

Table 2 shows the liberalisation process Japan has been following over the past 50 years. The liberalisation started with trade and foreign direct investment and expanded to financial transactions. Japan could not choose the timing for floating its exchange rate. Probably, it should have liberalised its bond market before the floating. In order to have stabilising market forces in the foreign exchange market, it is necessary to have two-way movements of long-term capital. Japan did not have a deep government bond market until 1977. Moreover, simple deregulation of foreign exchange control itself is not enough to provide such two-way capital flows. Japan maintained fairly strict prudential regulations on the foreign exchange exposures of major financial institutions until the early 1980s. Finally, without the active participation of large financial institutions, the foreign exchange market will be thin and the monetary authority has to intervene to stabilise the currency market. As I explained in Section 2.6, the passive intervention policy and the shallow foreign exchange market may have created a highly unstable yen/dollar foreign exchange market in the 1970s.

Apparently, the MOF did not pay enough attention to the following identity:

$$\text{Current account surplus} = \text{private capital outflows} + \text{increase in reserves} \quad (4)$$

Since the MOF restricted private capital outflows, the Japanese government had to mop up the excess supply of foreign currency through official interventions.

In order to prepare for the inevitable floating of the renminbi, it will be wise for the Chinese government to develop an active government bond market. Based on the Japanese experience, the stock market is less important for the functioning of the foreign exchange market. Financial institutions such as life insurance companies and mutual funds have to develop the capacity to manage foreign exchange risk. Since it takes time to develop dealing, accounting and risk controlling capacity for such financial transactions, the Chinese government should start early to allow domestic financial institutions to undertake limited foreign exchange transactions.

4. Conclusions

There are both similarities and differences between Japan in its high-growth period and China today. Like China today, Japan maintained high economic growth with a strong manufacturing sector; internationalisation of business firms and financial institutions proceeded rapidly; both have controls on deposit interest rates. On the other hand, the economic environments are very different. Japan gradually liberalised foreign exchange controls when such controls were the norm in most developed countries. As a result, the pressure for liberalisation in Japan was less strong in the 1970s and 1980s. Japan's problem of state-owned enterprises was much less severe in the 1970s and 1980s than that of China today.

Many countries have made mistakes in the transition from a pegged rate system with exchange controls and independent monetary policy to a new regime with much more liberalised exchange controls. The Asian currency crisis in 1997 was partly induced by excessive adherence to pegging to the US dollar. If Thailand and Korea had allowed appreciation of their currencies at an earlier stage so as to implement a tighter monetary policy, they could have mitigated the severe downturn in the crisis.

A move to a floating rate system is a difficult decision for macro policymakers in any country. However, the long-run cost of adjustment through floating would be much lower than the passive strategy of "adjustment inflation" followed by Japan in the 1970s.

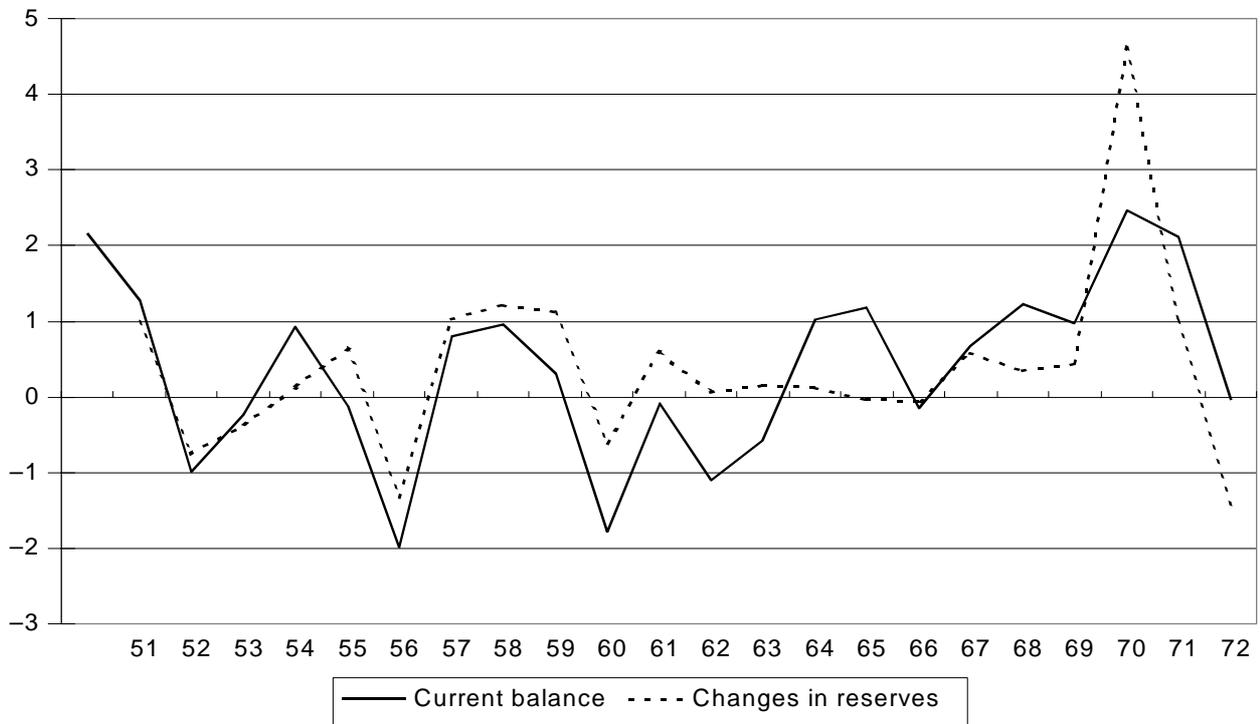
Table 1
Balance of payments in occupied Japan
(in millions of US dollars)

Year	Exports	Imports	Trade balance	Freight and insurance	Military procurements	Transfers	Current balance
1946	65	303	-238	-36	0	195	-78
1947	182	449	-267	-88	0	405	46
1948	262	547	-285	-120	19	462	75
1949	533	728	-195	-164	49	514	207
1950	920	886	34	-90	63	429	476
1951	1,354	1,645	-291	-226	624	170	329

Note: The 1946 figure includes September 1945 to December 1946.

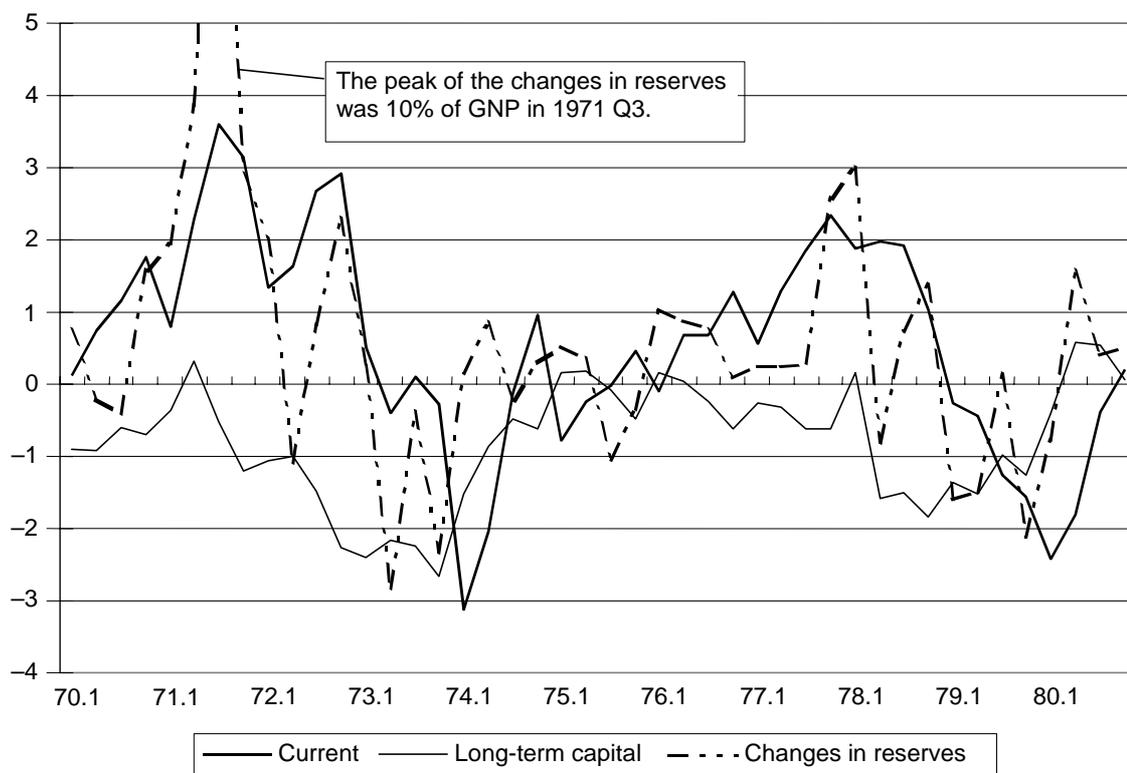
Source: Ministry of Finance (1978), pp 120-1.

Graph 1
Current account balance and changes in reserves
(as a percentage of GNP)



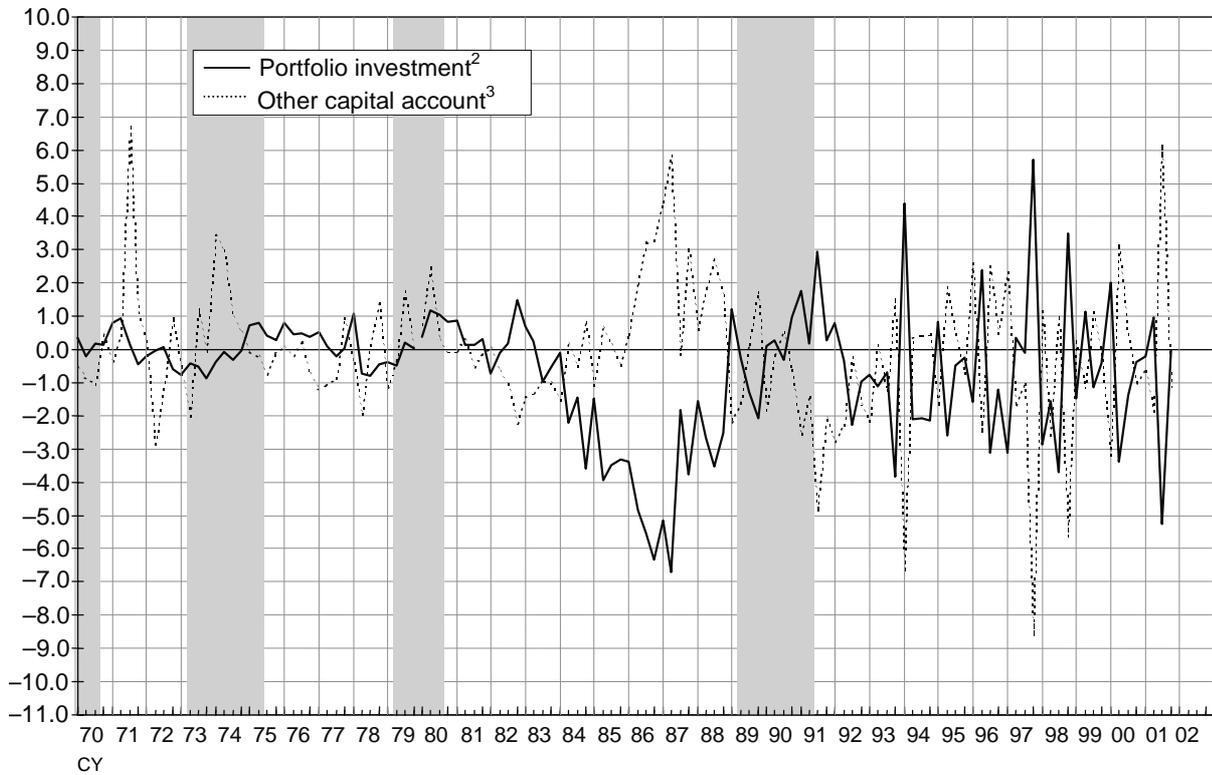
Source: Balance of Payments Statistics, Bank of Japan.

Graph 2
Current balance and capital flows
 (as a percentage of GNP)



Source: Balance of Payments Statistics, Bank of Japan.

Graph 3
Balance of payments¹
 Percentage of nominal GDP

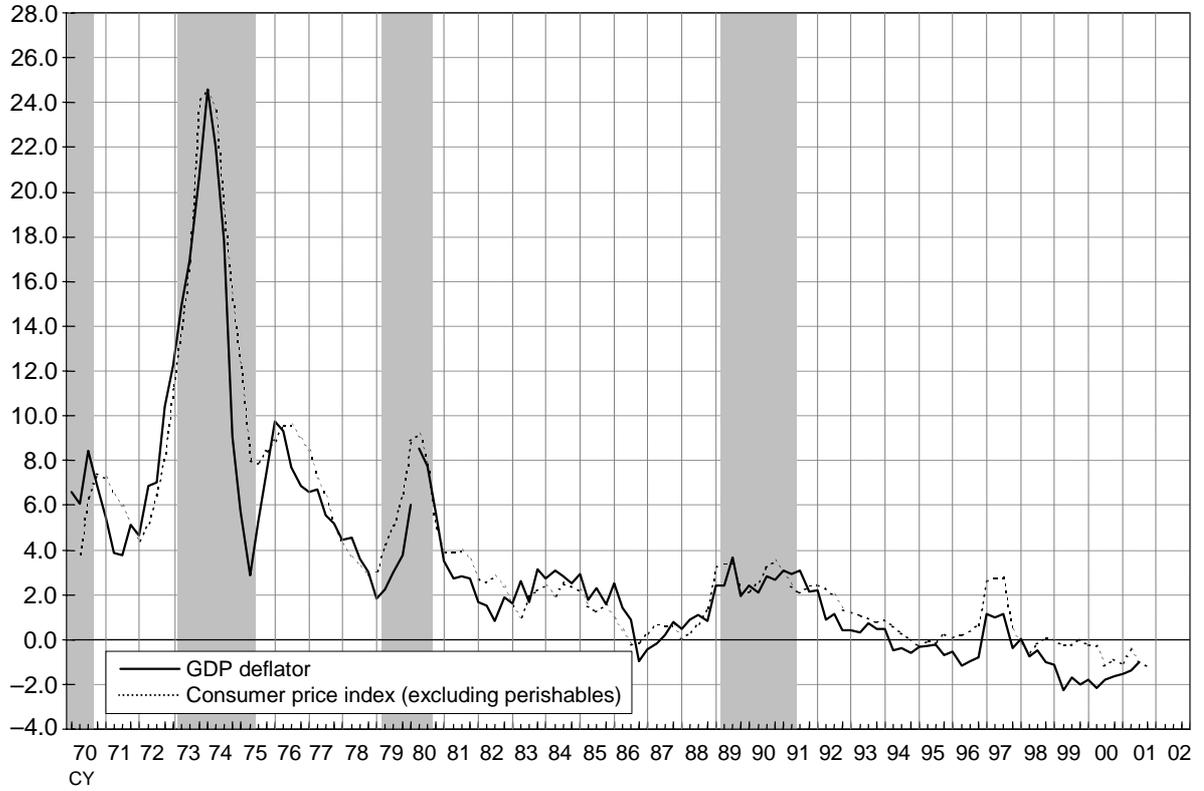


¹ Figures are based on revised balance of payments statistics from January 1996. In line with this revision, the data have been retroactively revised until 85 Q1 on the new basis (figures on the old basis until 84 Q4). ² Original figures. Data until 79 Q4 = 68SNA basis; data from 80 Q1 = 93SNA basis. ³ Other capital account = Changes in reserve assets – (Current account + Direct investment + Portfolio investment).

Source: Bank of Japan CD-ROM, 2002.

Graph 4

GDP deflator and CPI inflation
(percentage change from previous period)

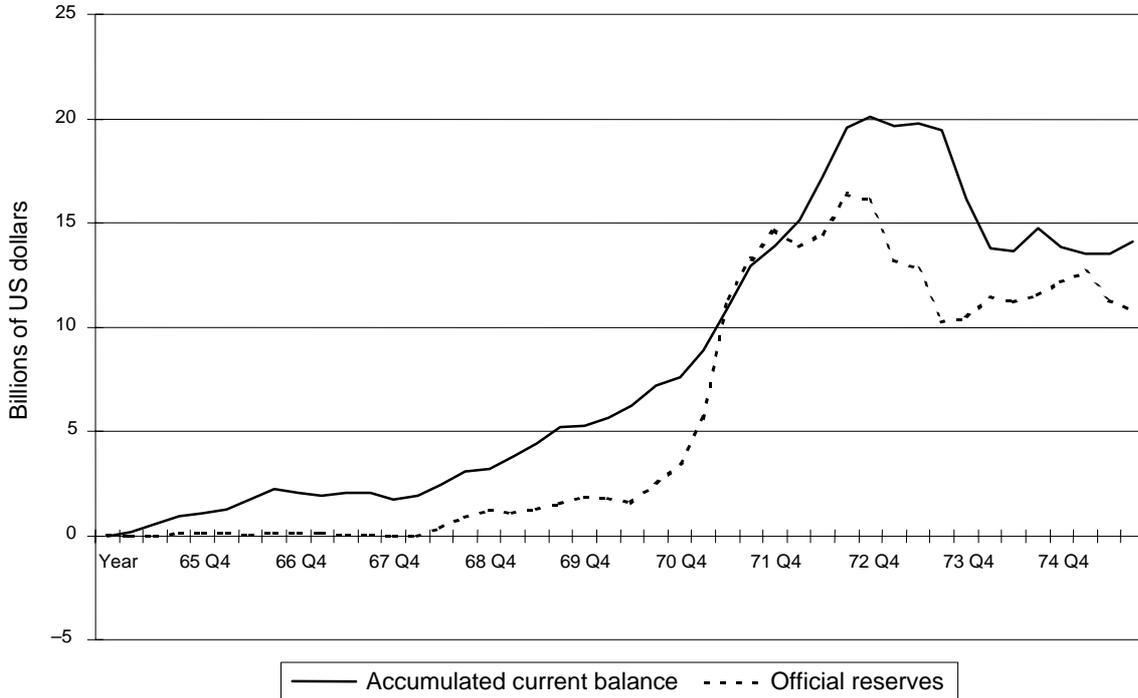


(seasonally adjusted at an annual rate, 3-qtr MA)

Note: GDP deflator: data until 80 Q1 = 68SNA basis, data from 80 Q2 = 93SNA basis.

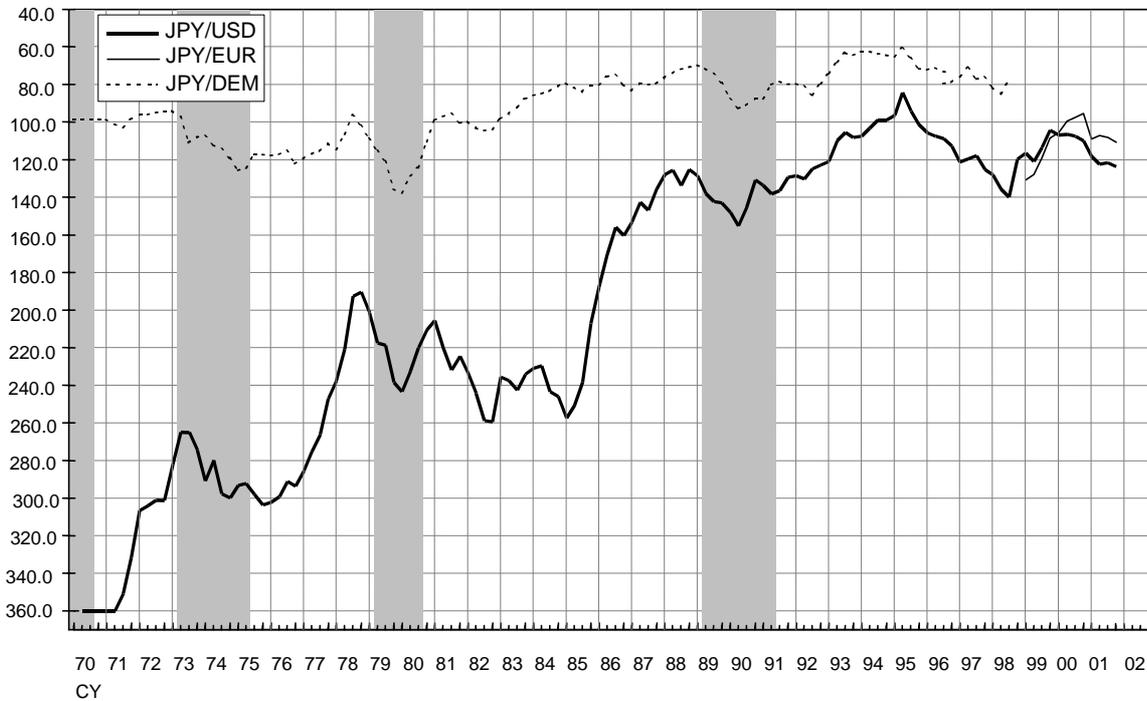
Source: See Graph 3.

Graph 5
Accumulated current balance and reserves



Source Fukao (1990).

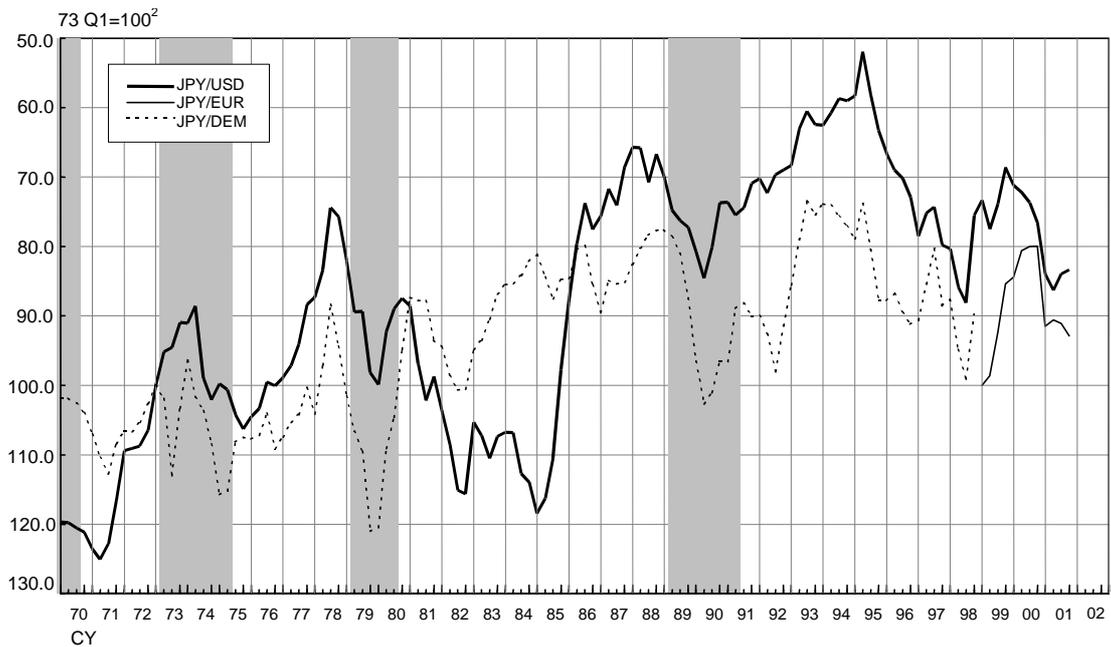
Graph 6
Nominal foreign exchange rates¹



¹ Spot rate on the Tokyo foreign exchange market, monthly (quarterly) average. Until 21 December 1994: closing rate. From 22 December 1994: spot rate at 15:30. From 1 March 1995: spot rate at 17:00. From January 1999, JPY/EUR. JPY/DEM = JPY/USD ÷ USD/DEM (from 1970 to 1998); JPY/EUR = JPY/USD ÷ USD/EUR (from 1999).

Source: See Graph 3.

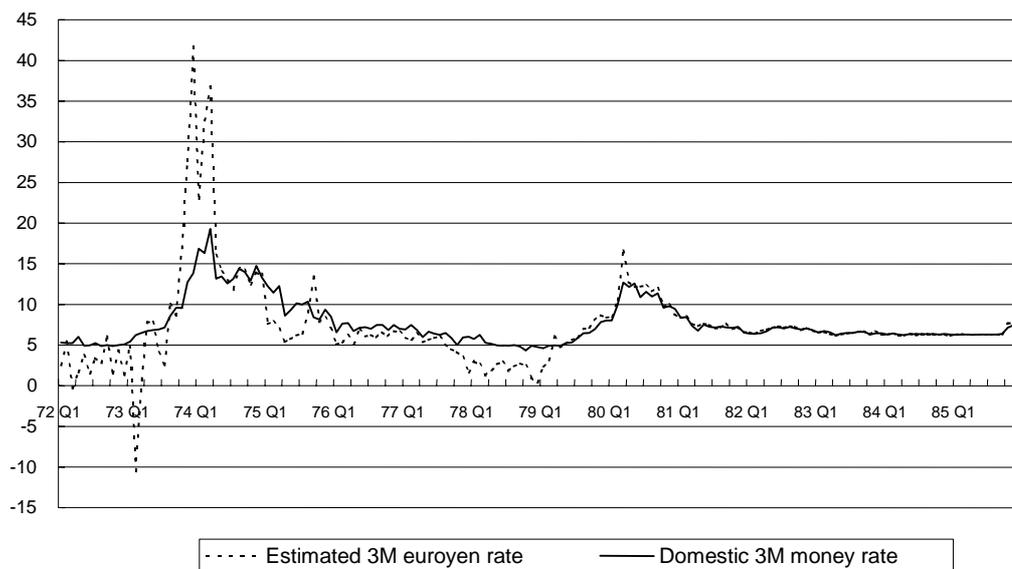
Graph 7
Real foreign exchange rates¹



¹ Spot rate on the Tokyo foreign exchange market, monthly (quarterly) average. Until 21 December 1994: closing rate. From 22 December 1994: spot rate at 15:30. From 1 March 1995: spot rate at 17:00. Figures deflated by PPI (United States, Germany and euro area) and domestic wholesale price index (Japan) (present figures based on the latest actual figures available). ² From January 1999, JPY/EUR. $JPY/DEM = JPY/USD \div USD/DEM$ (from 1970 to 1998, 1973 Q1=100). $JPY/EUR = JPY/USD \div USD/EUR$ (from 1999, 1999 Q1=100).

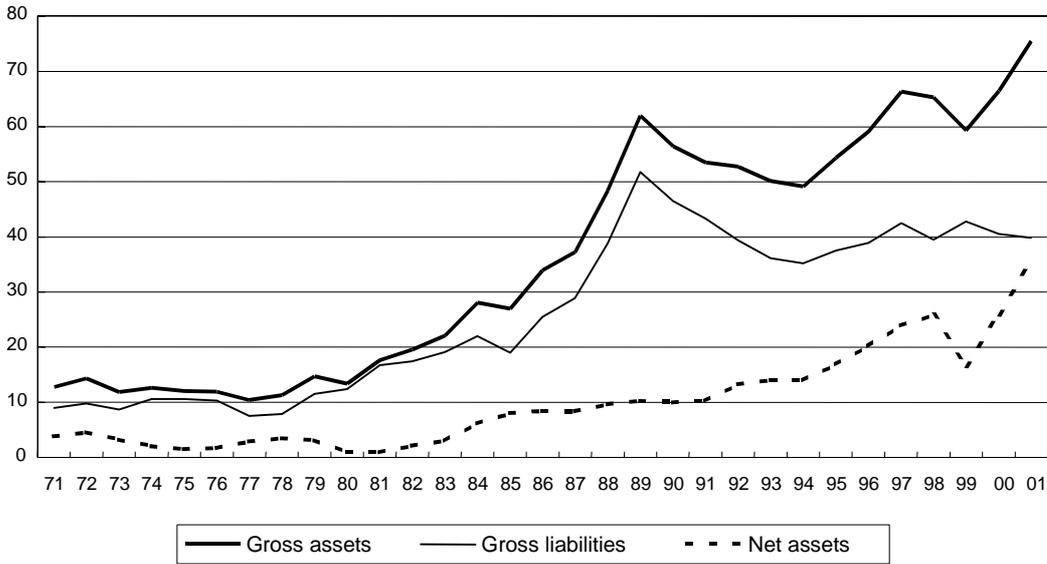
Source: See Graph 3.

Graph 8
Interest arbitrage conditions



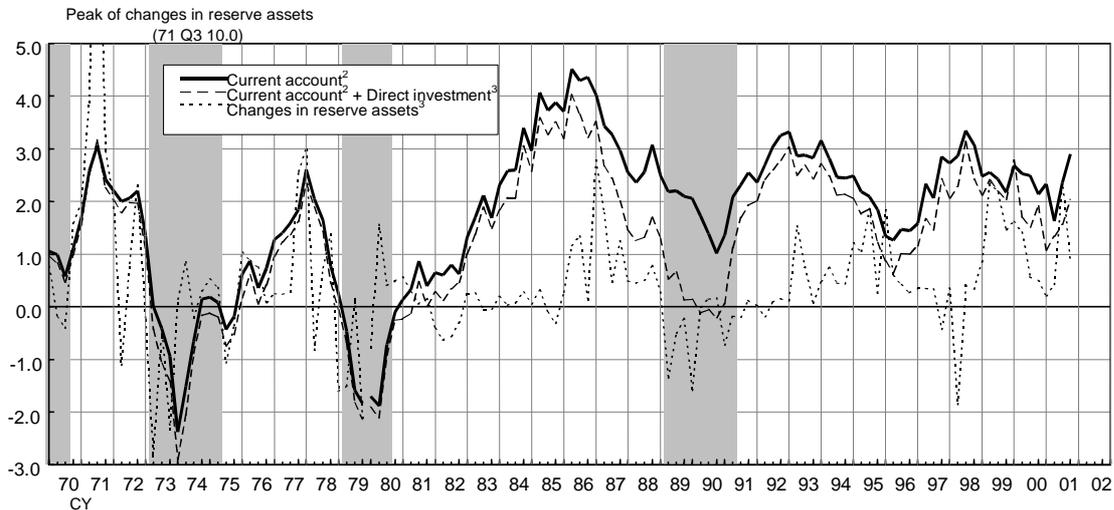
Source: Fukao (1990).

Graph 9
Japan's external assets and liabilities
 (as a percentage of GDP)



Source: Balance of Indebtedness Statistics, Ministry of Finance.

Graph 10
Current account balance and changes in reserves¹
 (as a percentage of nominal GDP)

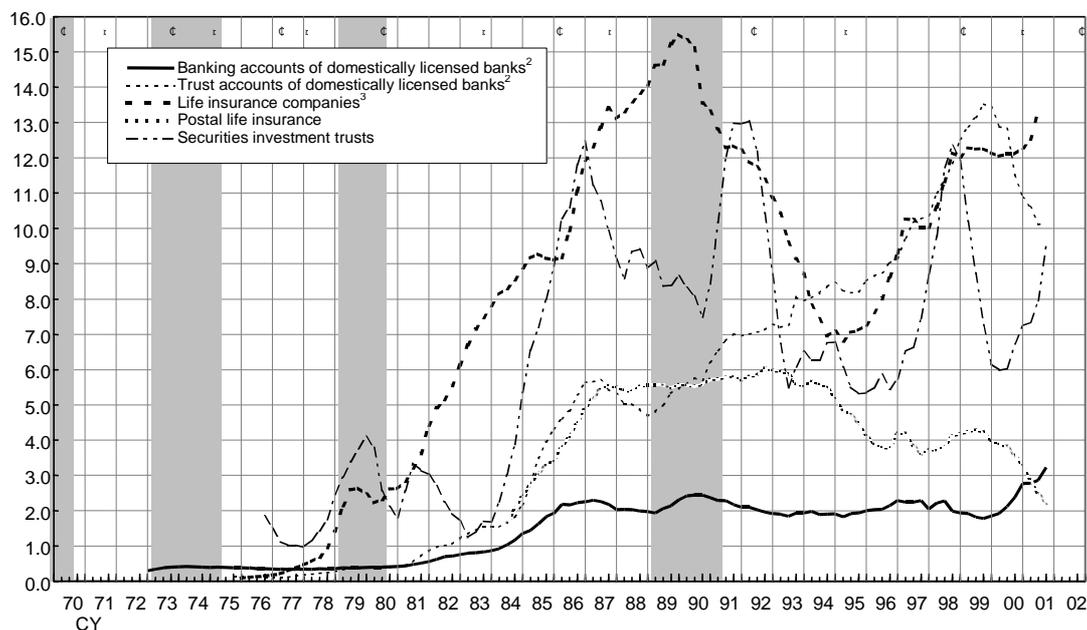


¹ Figures are based on revised balance of payments statistics from January 1996. In line with this revision, the data have been retroactively revised until 85 Q1 on the new basis (figures on the old basis until 84 Q4). Financial capital flow = Current account + Direct investment - Changes in reserve assets. Data until 79 Q4 = 68SNA basis; data from 80 Q1 = 93SNA basis. ² Seasonally adjusted by X-12-ARIMA. ³ Original figures.

Source: See Graph 3.

Graph 11

Ratio of foreign securities investment to total assets¹
(percentages)



¹ Total assets outstanding by financial institution (end of 2001).

Banking accounts of domestically licensed banks	JPY 759 trillion	Postal life insurance	JPY 123 trillion
Trust accounts of domestically licensed banks	JPY 397 trillion	Life insurance companies (end of 2000)	JPY 180 trillion
Securities investment trusts	JPY 45 trillion		

² Domestically licensed banks: until 93 Q3, banking accounts of member banks of the Federation of Bankers Association of Japan. ³ Life insurance companies: until 91 Q4, 27 companies basis; from 92 Q1, all insurance companies basis. Source: Total Life Insurance Association of Japan.

Source: See Graph 3.

Table 2

Japanese liberalisation sequence

1949	Removal of most rationing and price controls Unified exchange rate at JPY 360 per dollar Free exports
1964	Free current transactions: current account convertibility
Late 1960s	Free direct investment
Early 1970s	Spontaneous development of Gensaki (repo) market New entry of foreign banks Japanese banks enter foreign markets More flexible deposit interest rates
1973	Shift to floating rate system
1977	Termination of government bond price support system Emergence of large domestic bond market
1979	Introduction of large negotiable CDs
1980	Foreign currency deposits with free interest rates Free foreign investment: capital account convertibility
1984	Free forward exchange transactions
Mid-1980s	Liberalisation of foreign portfolio investment by financial institutions
1985-94	Gradual liberalisation of yen deposit interest rates
1998	Free direct international financial transactions
1999-2004	Introduction of International Accounting Standard

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