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Exchange and Trade Relations Department

Integration of Domestic and International Financial Markets: The Japanese Experience 1/

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I. Introduction

Japan's financial system played a key role during the 1960s in the capital formation process and the allocation of investment resources, and contributed substantially to the successful performance of the economy. However, the country's ever-increasing importance in the world economy and in the international financial system; the substantial structural changes in the domestic economy and the shift in the flow of funds following the oil price increases of 1973-74; and the breakdown of the fixed exchange rate system created an environment with which Japan's past financial practices were no longer compatible. In response, major changes in the direction of liberalizing interest rates and financial flows have been implemented since the mid-1970s.

This paper traces the evolution of Japan's financial system during the past decade. Forces affecting the pace and direction of changes are described, and the impact of these changes on the domestic financial system and on Japan's role in the international financial system are discussed. Section II briefly outlines the Japanese financial system during the 1960s. Section III describes the pattern of liberalization of Japan's financial system, first focusing on changes in domestic markets and then on the liberalization of international capital flows. Section IV profiles the Japanese financial markets. In Section V, the impact of the integration of domestic and international financial markets on the internationalization of the yen, on Japan's role as a major financial center, and on the yen exchange rate are discussed. Section VI concludes with a summary and comments on future prospects.

II. Japanese Financial System During the 1960s

Following World War II, the Japanese economy experienced unprecedented rates of growth, averaging about 10 percent per year during the 1960s. As a result, Japan emerged as the western world's second largest industrial economy. A high level of investment and the competitiveness of Japanese goods in world markets led to a sharp increase in exports, raising the share of Japan in world trade from 1.4 percent in 1950 to 6.8 percent by 1970. In addition, Japan switched from being a net borrower in international capital markets to being a net lender to other countries.

Despite Japan's growing importance in the industrial world and in international trade, its financial system during the 1960s remained highly regulated 1/ and cut off from the rest of the world. Features of the system, which had been designed to support the investment-led pattern of growth, included: (1) a predominance of indirect financing over direct financing; (2) controls on the quantity and distribution of credit and on interest rates, which were generally below market clearing rates; and (3) a high degree of specialization among financial institutions.

1/ See Iwata, K. "Japanese Financial System and its Recent Changes," Komiya, R. (ed.), Postwar Economic Growth in Japan, Patrick, H. and Rosovsky, H. (eds.), Asia's New Giant, Sakakibara, E. "The Japanese Financial System in Transition," and Suzuki, U. Money and Banking in Contemporary Japan.

During the 1960s, the corporate sector's financial deficit was continuously expanding. Japanese businesses were not able to generate needed capital from internal sources to finance rapid expansion. Direct financing by the corporate sector was also limited for various reasons. First, because of historical experiences with securities markets, Japanese investors did not yet perceive bonds and stocks as safe assets. As a result of this attitude and the tax incentives for deposit holding, the high level of household savings was predominantly channeled into the banking system. Second, corporate tax policies and the preference of institutional investors to buy new issues at par rather than at market prices (see Section IV.3 below), by increasing the cost of capital raised through the stock market, encouraged financing through bank loans. Third, corporations benefited from close relationships with banks which also provided managerial expertise and marketing facilities to Japanese enterprises. Fourth, there were restrictions on foreign issues of securities by Japanese companies and on nonresident acquisitions of Japanese equity. As a result of these factors, the securities market in Japan remained undeveloped 1/ and Japanese firms relied heavily on the banking system--that is, on indirect financing--for funds. 2/

Interest rates on the supply of credit to firms were set below equilibrium rates and, as a result, there was usually excess demand for credit from the banking system. 3/ In these circumstances, Japanese city banks 4/ were heavily dependent on the Bank of Japan (BOJ) for funds to meet the demands of their corporate customers. The Bank of Japan used the volume of lending to the city banks and the call market as major channels to implement monetary policy. The setting of the discount rate at levels below market clearing prices created an excess demand for BOJ money and gave the Central Bank the power to ration credit. By increasing or cutting back on loans to the city banks, the BOJ was able to affect the level of bank loans both directly, through availability, and indirectly, through cost effects as banks were forced to secure funds in the higher-cost call money market. The BOJ also closely monitored the rates and the allocation of funds in the call market and intervened directly through call market brokers. In conducting its monetary policy, the BOJ supplemented its discount policy by window guidance which set bank-by-bank quotas on loans to customers during periods of monetary restraint. As a result of these mechanisms, the impact of adjustments in monetary policy fell promptly on the volume of bank loans and, consequently, by squeezing corporate liquidity, on economic activity.

1/ Profiles of Japanese financial markets are presented in Section IV.

2/ The small amount of government debt and the low level of consumer credit meant that most funds went to corporations for investment purposes.

3/ See Bronte, S., Japanese Finance: Markets and Institutions, p. 4, and Suzuki, op. cit., p. 46.

4/ The banking system in Japan consists of 76 ordinary commercial banks (13 city banks, headquartered in major metropolitan centers, and 63 regional banks, headquartered outside metropolitan areas), 3 long-term credit banks, 7 trust banks, and 74 foreign banks.

Open market operations were not an important policy tool, mainly because of the absence of a well-developed securities market, particularly for government securities. Until the mid-1960s, the Government pursued a balanced budget policy and issued only short-term bills to finance seasonal deficits. Since rates on these bills were fixed at low levels, private holdings were negligible, and these bills were generally purchased by the Bank of Japan. Hence, no secondary market for Treasury bills evolved. When the Government started issuing long-term bonds to finance public works in 1965, yields on these bonds were fixed by the Government, and the Government's Trust Fund Bureau and the syndicate of financial institutions underwrote them. Banks were willing to do so on the understanding that the Bank of Japan would purchase the bonds in the course of open market operations.

Services provided by financial institutions were restricted, and there was also a high degree of specialization among banking institutions. City and regional banks had to fund their lending through deposits, the interbank market, and borrowing from the Bank of Japan, and were not allowed to issue negotiable certificates of deposit or debentures. Reflecting the short-term nature of their liabilities, their lending was also short term. Long-term credit banks, on the other hand, were allowed to raise funds by issuing debentures, but were prohibited from deposit taking. 1/ This more stable funding base enabled them to provide fixed-rate long-term loans. The Japanese Securities and Exchange Law differentiated between banking and brokerage business, specifically prohibiting banks from acting as underwriters or dealers in the securities market. These limitations on asset/liability choices of financial institutions and access to financial markets served to enforce interest rate controls by limiting substitution among assets and preventing arbitrage among markets.

These characteristics of the domestic financial system were supported by controls on capital flows into and out of Japan. Virtually all capital transactions were subject to government approval, including foreign acquisition of stocks, foreign borrowing by nonbank residents, foreign bond issues, and long-term trade financing. These restrictions were imposed to prevent the takeover of Japanese corporations by foreign capital and Japanese companies from circumventing credit restraints by borrowing abroad. On the other hand, nonresidents were not permitted to float yen-denominated bonds without authorization. This worked to further retard the development of domestic securities markets. Furthermore, the ability of Japanese banks to borrow in the Eurodollar market was controlled, initially through restrictions on the rate of interest payable for Eurodollars, and later, through quantitative limits on amounts that could be borrowed. Short-term capital inflows through banks were also restricted by means of yen-conversion limits. Finally, although branches of foreign banks in Japan were permitted to supply funds to the call market, they were not allowed to borrow funds from that market or from the Bank of Japan. These restrictions on capital flows were instrumental in preserving the characteristics of Japan's financial structure at that time.

1/ The only other bank permitted to sell debentures was the Bank of Tokyo, one of the city banks, because of its charter as the country's principal foreign exchange bank.

III. Pattern of Liberalization

The Japanese economy underwent substantial structural changes in the 1970s, in response to a number of internal and external developments. The forces for change came largely from the surge in inflation in the early 1970s, the breakdown of the fixed exchange rate system, and the slowing of economic growth following the oil price increases. These forces created a new economic environment that was not compatible with Japan's past financial practices. As a result, the domestic financial system has been transformed from one dependent on bank lending largely funded by deposits with officially controlled interest rates, to one with a variety of assets available to both foreign and domestic investors and in which market forces of both domestic and international origin play an increasingly important role. Furthermore, Japan's financial markets have been virtually freed of formal restrictions on capital flows into and out of Japan, although administrative guidelines remain in effect for certain transactions.

Although forces for change were also experienced worldwide, straining the financial systems of other countries, the changes in Japan were more dramatic and more extensive than in other countries. 1/ For example, as shown in Table 1, the financing needs of the public sector increased and the needs of the private nonfinancial sector declined more dramatically in Japan than in the United States and Germany. Furthermore, the proportion of funds raised directly in capital markets by nonfinancial sectors more than doubled in Japan, whereas changes in the role of capital markets were relatively less significant in other countries.

Because of its highly regulated nature, the existing financial system in Japan did not permit spontaneous change. Hence, to some extent, the authorities have been able to control the pace and direction of these changes in the financial system. The process of liberalizing interest rates and financial flows and the consequent evolution of the financial system are described in the following sections.

1. Financial reform in domestic markets

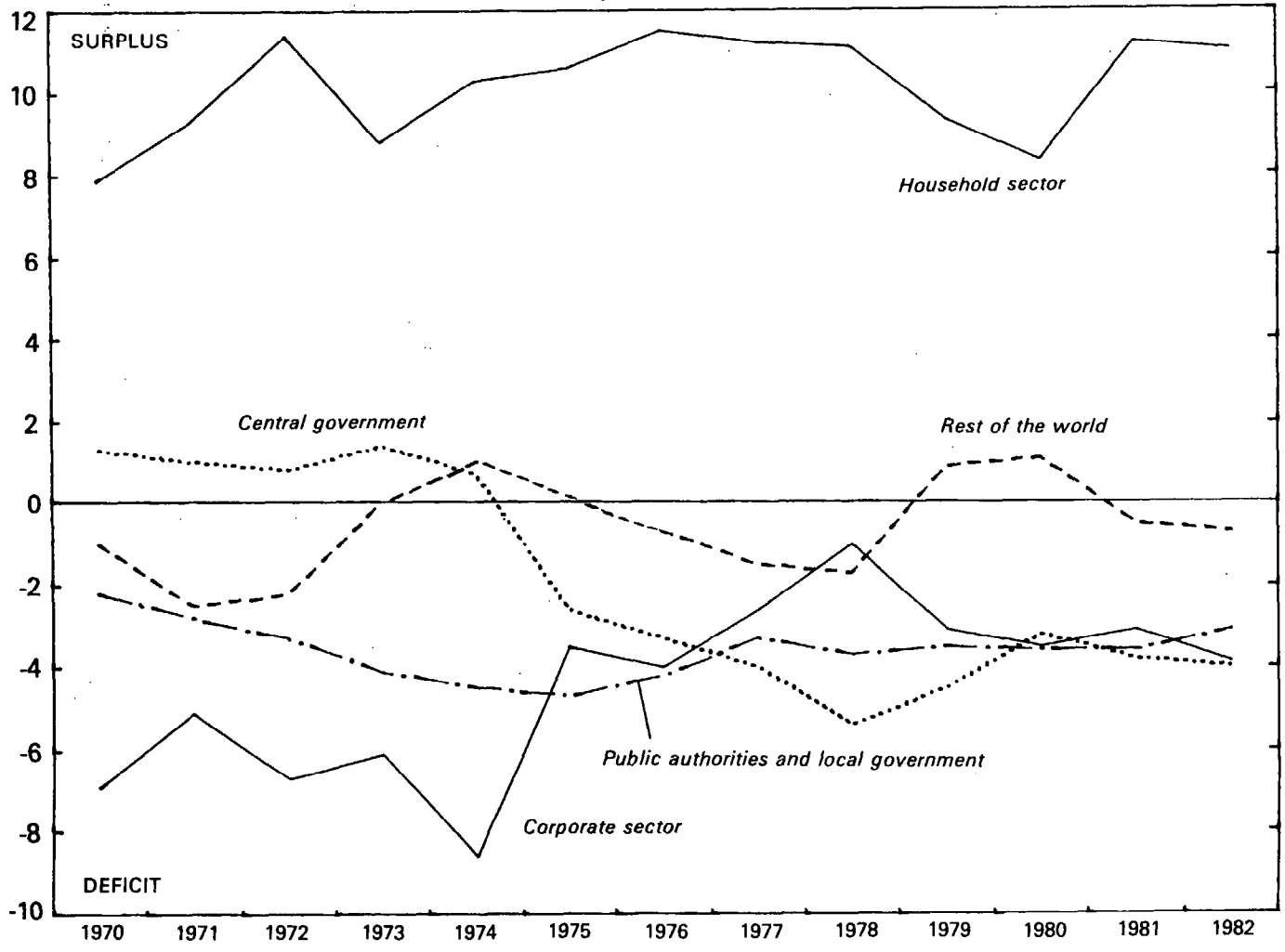
After the first major oil price increases, potential growth slowed, and the expansion in business investment slowed down significantly. As a result, business demand for funds subsided, and companies were able to generate a large share of needed funds from internal sources, including retained earnings, depreciation, and reserves. The Government's deficit began to rise sharply in fiscal year 1975/76 (April-March) as a result of the sharp drop in revenue due to the severe recession following the oil price increase. With this shift in funding requirements, the public sector assumed the position of major net borrower (Chart 1). To finance its deficits, large amounts of government bonds were issued within a relatively short period. While the sharp drop in revenue was the

1/ For a comparison of financial changes in Japan and the United States, see Pigott, Charles, "Financial Reform in Japan," in Federal Reserve Bank of San Francisco Economic Review, Winter 1983.

CHART 1
JAPAN

FLOW OF FUNDS: NET FINANCIAL SURPLUS OR DEFICIT BY SECTOR , 1970-82

(In percent of GNP)



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

Table 1. Comparison of Financial Indicators

(In percent)

	1970-71 (Average)			1980-81 (Average)		
	Japan	United States	Germany	Japan	United States	Germany
Gross savings/GNP	39.15	15.00	27.59	31.70	15.80	21.43
Share of total funds raised by each domestic nonfinancial sector 1/						
Public sector	15.86	26.02	14.42	46.52	28.92	25.74
Private nonfinancial enterprises	66.31	46.23	78.72	35.27	39.25	68.68
Households	17.84	27.76	6.87	18.22	31.83	5.58
Proportion of funds raised directly in capital markets by nonfinancial sectors 1/	17.04	50.35	8.20	39.21	42.82	3.58 2/
Sources of net funds raised by nonfinancial enterprises						
Loans	88.79	47.90	90.98	86.80	63.92	95.02
Bonds	3.82	37.20	3.34	5.32	35.44	1.06 3/
Shares	7.39	14.91	5.68	7.89	0.65 4/	3.93

Sources: OECD Financial Statistics, OECD National Accounts; Department of Commerce, Bureau of Economic Analysis, Survey of Current Business; and Federal Statistics Office, Konten und Standardtabellen, 1981.

1/ Includes public sector, private nonfinancial enterprises, and personal sector.

2/ This ratio was unusually low in 1981-82 because of a very low level of bond issues. Average for 1978-82 amounted to 9.8 percent.

3/ In 1982, the share of funds raised by bonds amounted to 3.8 percent.

4/ The low level of average reflects the net repurchases of shares in 1981.

immediate cause of the increase in government bond issues, the continuing increase in expenditures in the late 1970s contributed to it. Total amounts of government bonds outstanding increased more than eightfold during fiscal years 1974/75-1981/82, from the equivalent of 7 percent of GNP to 32 percent. This resulted in a rapid growth of Japan's primary and secondary bond markets and gave rise to pressures from the financial community for improvements in the efficiency of these markets.

Under institutional arrangements by which long-term government bonds with a maturity of ten years were underwritten by a syndicate consisting of major financial institutions required to purchase and hold for specified periods the bonds they had underwritten, the Government was able to issue large amounts of debt below secondary market yields. In the late 1970s, however, the banks became increasingly reluctant to absorb the large issues of government bonds because of various factors. First, the wider availability of instruments (described below) with market-determined interest rates adversely affected the deposit base of banks, as interest rates on commercial bank deposits remained insulated from market forces by official regulation. As the amount of government bonds held by banks under the syndicate system increased at a faster rate than their deposits, the share of government bonds in their total assets also rose, resulting in lower profits (Table 2). Second, because of greater interest rate volatility, the risk of capital losses arising from higher interest rates from sales of banks' bond holdings in the secondary market increased. Third, the increased holdings of government bonds lengthened the maturity of commercial banks' assets while their deposit liabilities remained short term, resulting in a growing mismatch of their financial positions.

In order to increase the attractiveness of government bonds to investors, the authorities revised some of the issuing and trading practices. 1/ In 1977, the Government began issuing five-year discount bonds. The following year, the Government started issuing bonds with maturities of 2-4 years through public offerings which allowed investors to purchase these bonds directly at market rates. This also promoted the development of a secondary market for government bonds. While the financial institutions continued to subscribe to a substantial portion of new government bond issues through the underwriting syndicate system, the share of bonds subscribed to by securities houses increased, resulting in larger purchases by corporate and individual investors. 2/ This growth and diversification of the government bond market substantially increased investment opportunities and has contributed to the widening of the capital market to include a broader array of participants.

By 1979, the commercial banks had ceased net acquisition of bonds and had become more actively involved in selling surplus holdings of government bonds in the secondary market (Table 2). Thus, banks became

1/ For a summary of bond issuing practices in Japan, see Appendix I.
2/ The share of banks as syndicate members declined from 72 percent in fiscal year 1974 to about 63 percent in fiscal years 1981 and 1982.

Table 2. Japanese Central Government Debt, 1972-82 1/

(Amount outstanding; in percent)

	1972	1976	1979	1980	1981	1982
Fraction of total assets						
Bank of Japan	18.3	49.6	52.7	60.0	70.5	88.5
Private banks	1.8	3.9	10.0	9.1	8.7	7.8
Other private financial institutions	) 0.6	) 1.0	3.9	5.3	6.1	7.4
Public financial institutions	)	)	13.7	10.7	13.1	13.6
Share held by						
Bank of Japan	20.2	36.7	17.9	20.1	18.4	19.8
Financial institutions	22.5	28.0	62.9	53.5	53.4	51.5
Private banks	17.8	22.4	29.5	23.8	19.6	16.2
Other financial institutions	) 4.7	) 5.6	10.4	13.1	14.4	16.4
Public financial institutions	)	)	23.0	16.7	19.4	18.9

Source: Bank of Japan, Economic Statistics Annual, various issues.

1/ Fiscal years ending in March.
2/ Most government debt held by the Bank of Japan is short-term, and debt held by private and public financial institutions is mostly medium- and long-term.

increasingly reluctant to absorb new issues at rates significantly different from those prevailing in the secondary market. To accommodate new issues of government bonds, the time period required for banks to hold these issues before selling them in the secondary market was reduced from one year to 100 days in April 1981. As a result of these growing linkages between the primary and secondary bond markets, terms of new government bond issues were increasingly set reflecting conditions in the secondary bond markets (Chart 2).

Along with other changes in regulations, a new banking law in 1982 allowed banks, in principle, to purchase, sell, and underwrite bonds. Since April 1983, banks have been allowed to make over-the-counter sales of new-issue long-term government bonds, 1/ and since October 1983, of new-issue medium-term interest bearing and discount government bonds. New issues which are not sold to the public during the specified issue period must be held in banks' portfolios for a minimum of 100 days before being traded. From June 1984, banks will be allowed to deal in government bonds in secondary markets. Although these measures were taken partly to facilitate the issuance of government bonds and partly to help resolve the mismatch between the funding ability of certain financial institutions and their share in the underwriting syndicate for government bonds, they constitute significant changes in the traditional division of functions between banks and nonbank financial institutions.

There was also a change in corporate finance after the mid-1970s. As the Japanese economy began to show signs of recovery, the demand for new funds by the private sector started to grow. Corporations increased their resort to direct means of financing, such as issues of straight and convertible bonds. 2/ Factors influencing the shift from indirect to direct financing by corporations included: (1) the liberalization of bond issues by Japanese corporations in foreign markets; (2) the increased purchases of government bonds by banks, which reduced available bank financing for corporations; and (3) the realization on the part of corporations that they could not rely on banks as a continuous source of cheap financing. The development of the government bond market was also instrumental in the development of the corporate bond market, as the risk-free government securities provided a reference for determining appropriate bond yields. Primary yields on corporate bonds are influenced by the terms on government bonds: coupon rates on bank debentures, and corporate bonds are determined by a preset formula based on government bond rates, and issue prices of corporate bonds are decided by the Bond Issue Adjustment Committee, taking into account the secondary market yields for government bonds. 3/ Furthermore, the

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1/ As well as local government and government-guaranteed bonds.

2/ Corporate bond issues in Japan in general require collateral. Along with the relaxation of the rules for issuance of Euro-yen bonds, which do not require collateral, the domestic collateral requirement for corporate bond issuance was relaxed effective April 1, 1984.

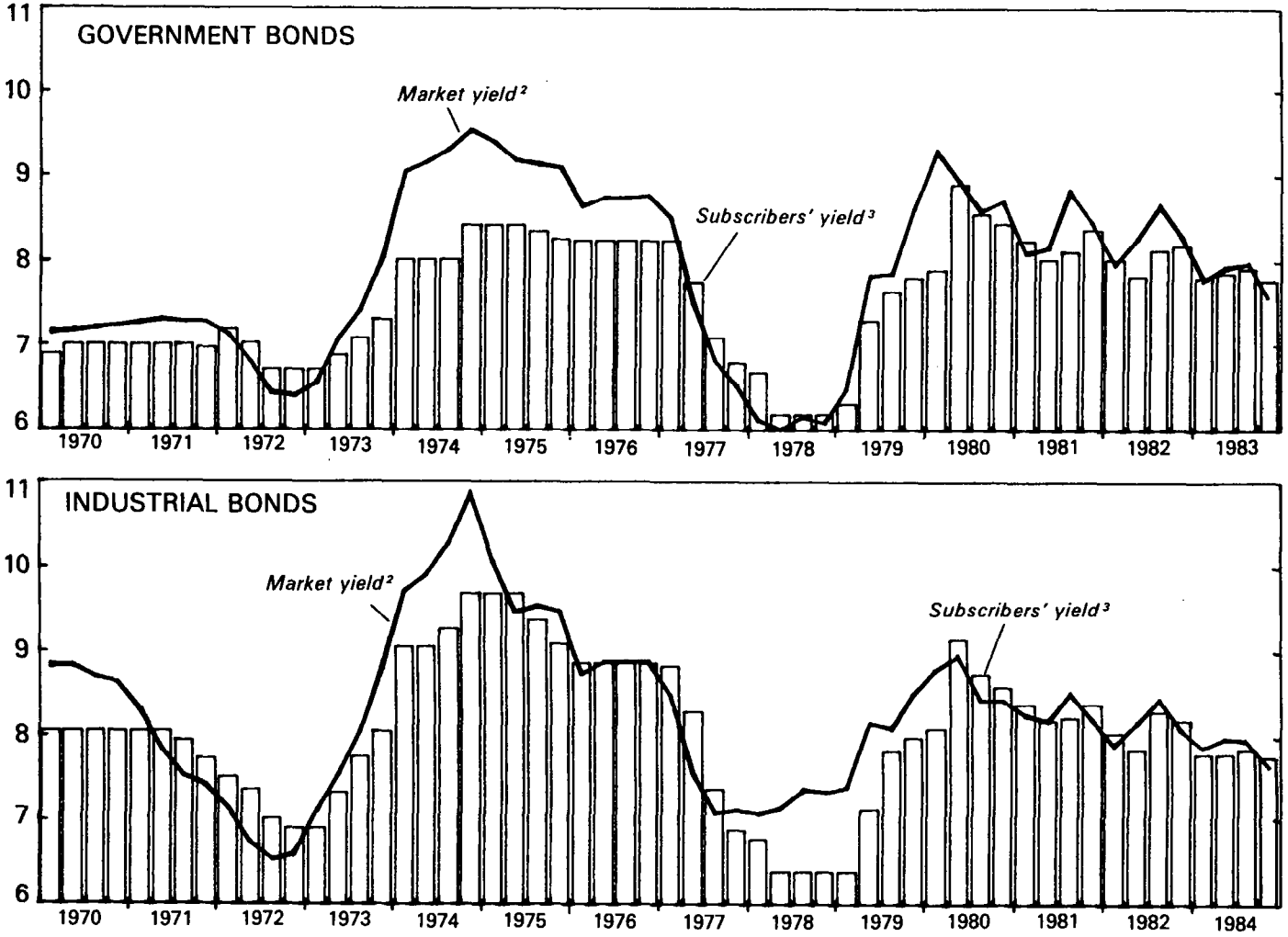
3/ The Bond Issue Adjustment Committee is a private entity which reports to the Ministry of Finance and is made up of securities houses and commissioned banks.

CHART 2

JAPAN

YIELDS IN SECURITIES MARKETS, 1970-83[1]

(In percent per annum)



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

[1]Quarterly averages.

[2]Market yields of securities with the longest remaining maturity.

[3]Bonds with a ten year maturity.

development of secondary markets made investments in corporate bonds more attractive by increasing their marketability and, hence, their liquidity. This change in corporate finance enlarged the supply of marketable securities, although to a lesser extent than government bond issues. The outstanding level of industrial bonds, which amounted to ¥ 4.5 trillion in fiscal year 1974/75, had more than doubled by the end of fiscal year 1981/82. However, their share in total bonds outstanding had declined from 12.3 percent to 6.6 percent during the same period. Corporate bond issues abroad accelerated in 1977, after the Government removed restrictions on small- and medium-sized Japanese corporations floating bond issues.

The considerations described above led to a rapid expansion of the capital market and a diversification of financial instruments, and influenced developments in the money markets. In the early 1970s, as a concomitant to official control over the credit extension process, the interbank market remained rigidly controlled. The surge in inflation in the early 1970s, together with constraints on the flexibility of nominal interest rates, increased the volatility of real rates. Also, the decline of corporate sector dependence on bank loans after the oil price increases reduced the effectiveness of the Bank of Japan's window guidance in influencing the level of liquidity. Because of these developments, and reflecting the emphasis placed on controlling inflation, the focus of policymakers shifted from control of bank credit to control over the growth of the money stock. Thus, the short-run transmission of monetary policy actions had to rely on affecting the cost of credit, necessitating greater flexibility in short-term interest rates.

After the first oil price increase, the Bank of Japan started deregulating interest rates in the short-term money markets, initially by increasing the fluctuations in posted call rates. 1/ The posted rates in the call market were discontinued in April 1979. Decontrol of the bill discount market was completed following the introduction of one- and three-month bills with unregulated interest rates in November 1978, and decontrol of interest rates on two-month bills, in October 1979. Although "official controls" over both the bill discount and call markets were removed in 1979, the Bank of Japan maintains a close day-to-day surveillance over these markets and intervenes in both markets, more in the former, to smooth out seasonal fluctuations in the flow of funds and to support the changes in the official discount policy.

Interest rates in the Gensaki market 2/ during the 1970s were virtually free of official regulation and offered investors higher yields than could be obtained through bank deposits. While the corporate sector remained a net borrower, corporations with surplus funds seeking

1/ See Appendix II for a summary of characteristics of Japanese short-term money markets.

2/ The Gensaki market consists of a conditional purchase of a government or corporate bond for a fixed period with a resale agreement at a specified date.

investment opportunities at market interest rates turned to the Gensaki market. As corporations shifted their surplus funds from bank deposits to more attractive Gensaki instruments and increasingly rate-conscious households transferred their money to higher-yielding postal savings accounts, funding of city banks deteriorated. 1/ To allow banks room to adapt to the changing financial environment, the authorities permitted the issuance of negotiable certificates of deposit in May 1979, despite strong opposition from long-term credit banks and securities houses. 2/ Secondary trading in these instruments started in April 1980. Their introduction has been important in fostering the intermediation function of banks, as they have increased the funding capacity of the banking system. Although the cost of funds in the CD market reflects market conditions, there are ceilings on the total amount of CDs that can be issued and restrictions on minimum denominations of individual certificates. The high minimum denomination of CDs, which attracted corporate rather than household funds, was reduced from ¥ 500 million to ¥ 300 million as of January 1984. Limits on the amount of such issues by Japanese and foreign banks have been gradually raised and further increases are planned. The restrictions on nonresident participation in the Gensaki and CD markets were lifted in 1979, opening the way for the integration of Japan's short-term financial markets with those abroad.

The removal of restrictions on banks' participation in the Gensaki market in 1979 facilitated the integration of the interbank markets with unregulated markets outside the banking system, enabling greater interest rate arbitrage across markets. As a result, most of the money market rates have moved parallel and much closer to each other since 1979. The remaining differences in the level of interest rates largely reflect tax treatment of earnings on these assets. However, seasonal movements in some money market rates, 3/ though small, suggest that some degree of compartmentalization among money markets remains.

Nonfinancial corporations in Japan may borrow short-term funds in money markets only if they have the appropriate securities to sell in the Gensaki market. The banking law of 1982 in principle authorized the introduction of commercial papers (CPs); however, in practice, domestic

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1/ The postal savings system is a major source of funding for the Government's Fiscal Investment and Loan Program (FILP). Postal savings deposits offer interest rates comparable to those on bank deposits plus the opportunity for investors to lock in initial deposit rates for up to ten years while having the option to withdraw after six months. About 30 percent of Japanese personal savings is held in postal savings accounts now, compared with less than 20 percent in the early 1970s.

2/ Long-term credit banks saw CDs as strong competitors to debentures, and securities houses were concerned that CDs would drain money away from the Gensaki market.

3/ Gensaki rates tend to rise in March and September, as companies cooperate with financial institutions to increase deposits for window-dressing purposes and securities firms use Gensaki instruments to adjust their inventory of government bonds at the end of their accounting period.

sales of yen-denominated CPs have not yet begun. Domestic sales of foreign CPs, which started together with sales of foreign CDs effective April 1, 1984, are likely to lead to the creation of a full-fledged CP market in Japan. The treasury bill market in Japan remains limited. Although the outstanding level of treasury bills increased from about 3 percent of GNP in the early 1970s to over 5 percent of GNP in the past few years, they do not comprise a large proportion of total government debt. At the end of fiscal year 1982, for example, the proportion was less than 8 percent. These bills are generally issued at rates below market levels and absorbed primarily by the Bank of Japan. Since 1981, open market operations using treasury bills have been undertaken by the Bank of Japan, though the amounts have remained small. These operations involve placing treasury bills with yields equivalent to those of comparable maturities in the bill discount market with brokers in the bill discount market who are free to sell them to commercial banks, securities houses, and other financial institutions.

Although banks remain subject to official interest rate regulation on most deposit categories, they have recently introduced new types of deposit instruments with market-related interest rates to enable them to compete more effectively for funds. These include a two-year deposit, with the interest rate determined by a weighted average of ten-year bond yields (60 percent weight) and the two-year bank deposit rate (40 percent weight), a bank debenture with compound interest, and a new type of deposit whose maturity can be designated by depositors.

2. Liberalization of capital flows

During the past decade, rules governing Japan's international capital flows were largely liberalized, contributing to a significant increase in financial flows between Japan and other countries (Chart 3). However, adverse developments in the balance of payments and wide fluctuations in the exchange rate of the yen during the 1970s at times resulted in a slowdown or a temporary reversal of the trend toward liberalization (Chart 4).

After the first major oil price increases, when the current account deteriorated and the yen depreciated, the authorities took various measures to liberalize capital inflows. In 1973, limits on nonresident stock and bond purchases were abolished, inward direct investments by foreigners in various industries were liberalized, and nonresident acquisition of free yen account balances was eased for certain types of transactions. In 1974, ceilings on loans from abroad were raised, the issuing of bonds abroad by residents was facilitated, marginal reserves on nonresident free yen accounts were eliminated, and the withholding tax on payments of interest to sovereign investors was removed. Concerned about capital outflows, the Government, at the end of 1973, banned foreign bond issues in Japan, limited residents' foreign exchange holdings, and restricted overseas lending by Japanese banks.

Following the turnaround in the exchange rate during the fourth quarter of 1974 and the first quarter of 1975, the authorities eased restrictions on resident purchases of foreign securities and allowed Samurai bond issues. 1/ During 1976-78, with the yen appreciating, most of the measures taken by the authorities were in the direction of liberalizing capital outflows. In 1976, restrictions on resident purchases of foreign securities were eased and the frequency of Samurai bond issues was increased. In 1977, the Government granted Japanese foreign exchange banks greater freedom to lend abroad, eliminated the approval requirement for outward direct investments, and resumed the private placement of foreign yen bonds with Japanese institutional investors. However, to slow down capital inflows, in 1977 a 50 percent marginal reserve requirement on free yen accounts was enacted. In 1978, marginal reserve requirements on free yen deposits were increased to 100 percent, and nonresidents were prohibited from purchasing Japanese bonds with less than five years' maturity.

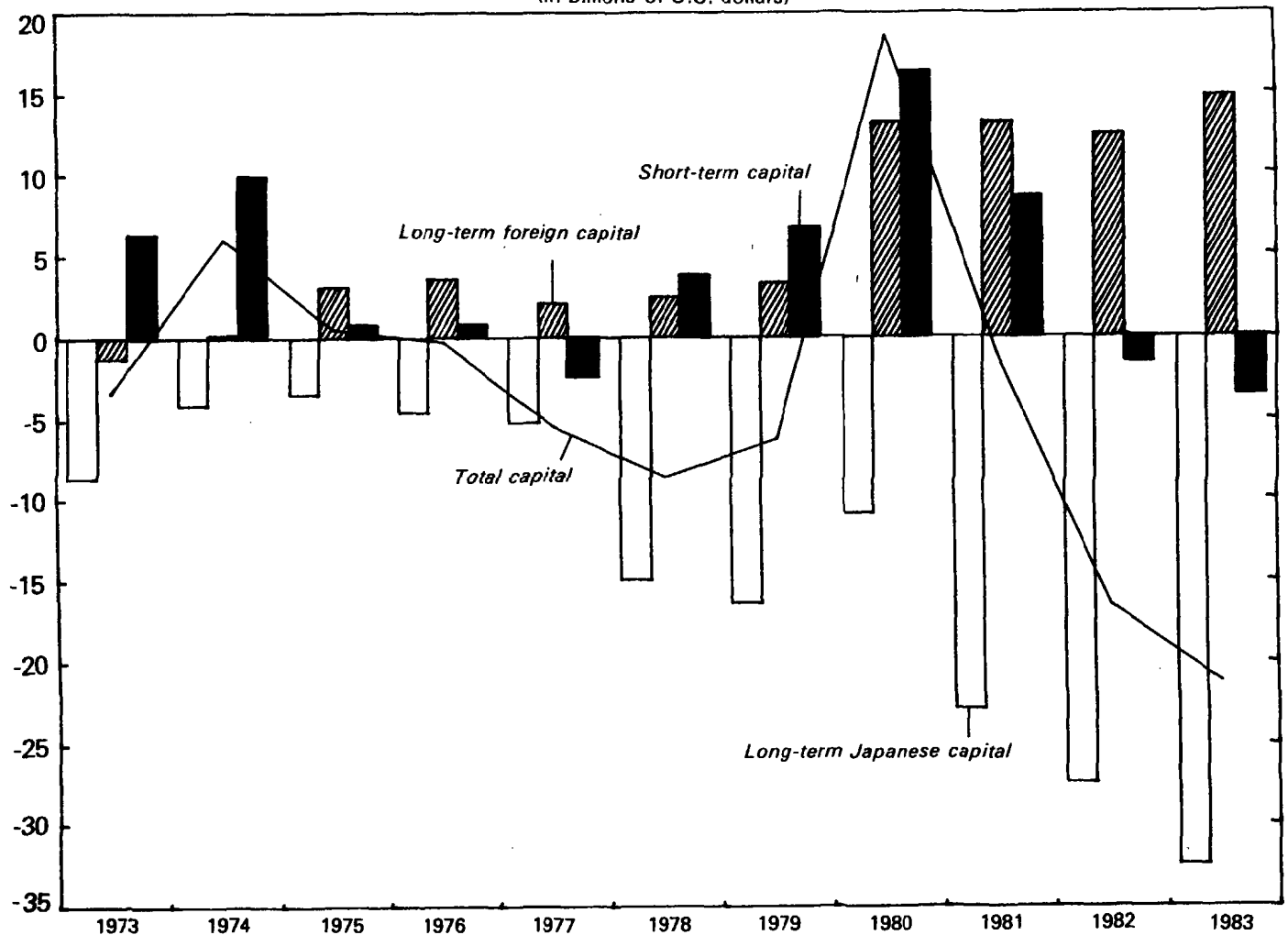
Following the second major oil price increases, the current account deteriorated and the yen again depreciated sharply. During this period, the authorities substantially liberalized capital inflows. In 1979, marginal reserves on free yen accounts were eliminated, nonresident access to the Gensaki market was allowed, the ban on short-term impact loans (foreign currency loans to nonbank residents) was ended, and Japanese and foreign banks operating in Japan were authorized to issue yen-denominated negotiable certificates of deposit, which could also be purchased by foreigners. To slow down capital outflows, the market for private placement of foreign yen bonds was temporarily closed in late 1979, and banks were asked to be prudent in lending overseas. In the first quarter of 1980, controls on Japanese companies issuing bonds abroad were eased, free yen accounts held by foreign public institutions were exempted from interest rate control, authorized foreign exchange banks were permitted to transfer funds from abroad through their inter-office free yen accounts, and Japanese banks were allowed to make medium- and long-term impact loans. With the turnaround in the exchange rate, loan-by-loan monitoring of foreign lending by Japanese banks was eased during the second half of 1980.

Finally, the liberalization process undertaken during the 1970s led to the passage of the new Foreign Exchange and Foreign Trade Control Law in December 1980, which represented a formalization of the principle that all external transactions may be freely carried out unless otherwise specified. 2/ Besides the codification of many of the steps taken in the process of liberalization, the new law significantly affected four types of international transactions:

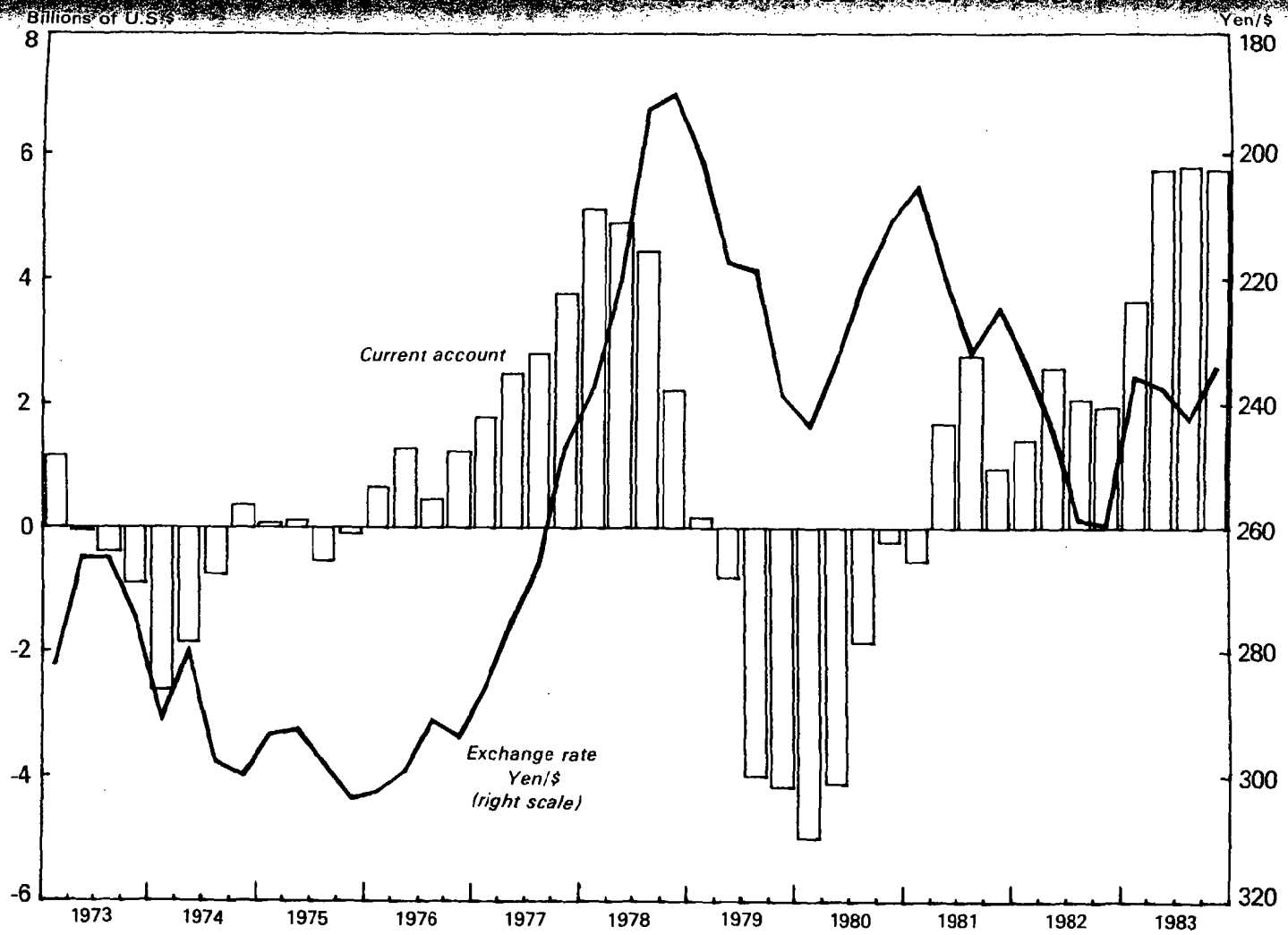
1/ Long-term bonds denominated in yen and issued by foreign borrowers in Japan by public offerings.

2/ Although, according to the new law, external transactions are generally free, the implementing regulations contain a large number of reporting and prior notice provisions, as well as requirements for approval of some transactions. For details, see Japan Economic Institute, "Capital Market Liberalization in Japan," JEI Economic Report, No. 104, March 9, 1984.

CHART 3
JAPAN
CAPITAL ACCOUNT, 1973-83
(In billions of U.S. dollars)



Source: Bank of Japan, *Balance of Payments Monthly*.



Sources: Bank of Japan, *Balance of Payments Monthly;* IMF, *International Financial Statistics.*

(1) In principle, Japanese banks were allowed to borrow and lend foreign currencies at home and abroad without restrictions (but still subject to prudential guidelines).

(2) Japanese residents were given unlimited freedom to exchange yen into foreign currencies for deposit with Japanese banks. 1/

(3) The scope for foreign portfolio investment in Japan was widened, particularly in the area of equities, with the lifting of the limitation of 25 percent foreign ownership except for a limited list of companies. 2/

(4) Japanese companies were given greater freedom to borrow abroad.

The relationship between the yen rate and the pace of liberalization of capital flows, evident during the 1970s, has not been observed since 1980. Despite the weakening of the yen during most of 1981 and 1982, the authorities generally refrained from imposing restrictions, as they remained committed to continuing the opening up of capital markets. With this objective, in 1981 the authorities lifted the suspension on private placement of bonds by nonresidents imposed in 1979 and relaxed the limits on syndicated loans arranged by Japanese banks. Measures were also taken to encourage inflows, including a reduction of the reserve requirement ratios for foreign currency deposits and a relaxation of restrictions on Japanese banks' subsidiaries regarding issuance of bonds in foreign markets. In 1982, although securities companies temporarily suspended sales of zero coupon bonds following a large outflow of funds, 3/ outflows of capital were generally liberalized despite the continued depreciation of the yen. Japanese banks were allowed to lend yen long-term to borrowers of their choice by removing priority categories on overseas yen lending. Also as part of the liberalization process, yen-dollar swap limits of foreign banks operating in Japan were increased.

During 1983, the authorities took additional measures to liberalize international capital flows. At the same time, to reinforce Japanese banks' capability to cope with the strains in the international financial system that emerged in the second half of 1982, prudential guidelines

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1/ The limit of ¥ 3 million was in effect previously.

2/ At present, 11 companies are so designated. The limit of 10 percent remains in effect for a single investor, as investments of more than 10 percent in a company are considered direct investments and require approval by the ministries concerned.

3/ The motivation for the suspension of sales of such instruments was presumably related to the tax avoidance aspect of these bonds and to fears that returns promised to investors might not be realized if the markets could not absorb the large sales of these instruments which would be required just prior to maturity to realize the capital gains.

on banks' international banking practices were strengthened. 1/ City banks' subsidiaries were allowed to issue bonds abroad to increase the parent bank's funding sources for lending abroad. 2/ Changes were made in practices relating to yen-denominated foreign bond issues in Japan to increase the flexibility of the issuing procedures and to help accommodate a larger number of borrowers. 3/ Euro-yen lending by Japanese banks with a one-year or shorter maturity was liberalized completely; such lending was previously limited to transactions related to trade financing. 4/ Yen-dollar swap limits for foreign banks operating in Japan were increased by 20 percent, and the limit on the overall foreign exchange position of foreign banks was doubled to $1 million.

1/ (1) For loans maturing beyond one year, the percentage to be backed by procurement of funds of more than a one-year term was increased from 40 to 45 percent; for loans due beyond three years, the ratio was raised from 10 to 15 percent. Banks were required, in due course, to comply with these maturity-matching requirements. (2) The ceiling on each bank's lending to any single country, previously 20 percent of shareholders' equity and reserves (40 percent for the Bank of Tokyo), was relaxed, allowing banks to exceed this limit in the cases of "rescue loans." However, banks have had to match fully any increase in medium- and long-term loans over the 20 percent ceiling by a corresponding increase in medium- and long-term funds. (3) Each bank was requested to restrict foreign currency assets to 15 times its capital. (4) To provide for possible overseas loan losses, a loss reserve system against loans to certain sovereign borrowers was created from the accounting period ending March 1983. A country was to be included in the scheme if it fell into one of these categories: (a) it had a rescheduling operation in the last five years; (b) it was more than one month in arrears on principal and/or interest payment; or (c) it was in the process of arranging rescheduling of its debt. Banks are free to fix the level of loan loss provision within 1-5 percent.

2/ Issuance of bonds by city banks in the domestic market continues to be prohibited.

3/ These changes were formalized into new rules effective January 1983. Principal changes were: (1) The annual queueing system for issuance of yen-denominated foreign bonds was replaced by a quarterly queueing system. (2) For public offerings, maximum amounts per issue were reduced from ¥ 15 to ¥ 10 billion for nonrated issues, and from ¥ 30 to ¥ 20 billion for rated issues. Furthermore, maturities were reduced from 12 to 10 years for rated issues, and from 10 to 7 years for nonrated issues. World Bank, ADB, and IDB issues were allowed 12-year maturities. Since January 1983, maximum amounts per issue were reduced from ¥ 20 to ¥ 15 billion for certain rated issuers. (3) For private placements, maturities were reduced from 20 to 5-10 years, and the maximum amount per issue was reduced from ¥ 10 billion to ¥ 5 billion. However, the amount per issue was increased to ¥ 10 billion for high credit-standing borrowers, effective August 1983, and to ¥ 30 billion for international agencies in which Japan is a member, effective April 1, 1984.

4/ Euro-yen lending with more than one year maturity still remains subject to prior notice requirements; in fact, no medium-term Euro-yen loans have been extended by Japanese banks.

Further changes in the direction of liberalization of international financial flows were implemented effective April 1984. These included the abolition of the "real demand" principle 1/ applied to forward exchange transactions by residents, the introduction of foreign CPs and CDs in the Japanese market, the elimination of the notification requirement on sales of yen-denominated securities, such as government bonds, by authorized foreign exchange banks to foreigners, and the relaxation of rules for issuance of Euro-yen bonds, specifically lifting the ban on the issuance of such bonds by residents. Concomitant to the easing of eligibility criteria for residents' Euro-yen issues, those for non-residents' issues of yen bonds in Japan have also been relaxed.

Regulatory changes in recent years have virtually freed Japan's financial markets of formal restrictions on the international movements of funds. Although they have been substantially eased during the past few years, administrative guidelines and reporting requirements remain in effect with respect to certain international movement of funds, as they do in most other countries.

IV. Profile of the Japanese Financial Markets

With the liberalization of the domestic financial system and exchange controls, capital markets in Japan underwent substantial changes. 2/ The evolution of the bond, money, and stock markets in Japan since the beginning of the 1970s is briefly described and documented in this section. A brief description of the evolution of the foreign exchange market is also included.

1. The bond market

Japan's bond market has expanded rapidly during the last decade. The rapid increase in government bond issues has been the major factor contributing to the expansion of the market in terms of the volume of issues and transactions (Table 3). In 1969/70, new bond issues in Japanese capital markets amounted to ¥ 4,364 billion, of which public sector bonds accounted for 31 percent. By 1981/82, the amount of new issues had reached ¥ 33,119 billion, a compound annual rate of increase of over 18 percent. The public sector share increased to about 52 percent. The sharpest increase was in issues of central government bonds, whose share in the total more than quadrupled to 39 percent. During the same period, total bonds outstanding increased from ¥ 15,597 billion to ¥ 146,121 billion, with the share of government bonds increasing from less than 16 percent to more than 56 percent.

1/ The requirement of underlying trade or securities transactions for forward exchange transactions by residents.

2/ For a detailed description of Japanese financial markets, see Bronte, S., op. cit. and Emery, R., The Japanese Money Market.

Table 3. Japan: Bonds Issued, Outstanding and Traded, 1969/70-1981/82

(In billions of yen)

	1969/70	1972/73	1974/75	1975/76	1978/79	1979/80	1980/81	1981/82
Total bonds issued	4,364	9,225	11,607	17,157	27,305	30,540	32,739	33,119
Public sector bonds	1,353	3,543	4,104	7,573	14,598	17,517	18,182	17,075
Central Government	421	1,968	2,200	5,362	10,792	13,635	14,264	12,950
Local government 1/	82	120	177	311	697	815	729	681
Public corporation	850	1,455	1,728	1,900	3,109	3,067	3,190	3,444
Private sector bonds	3,011	5,682	7,503	9,584	12,707	13,023	14,557	16,043
Industrial bonds	495	655	987	1,504	1,313	1,298	994	1,269
Bank debentures	2,516	5,027	6,516	8,080	11,394	11,725	13,563	14,774
Total bonds outstanding	15,597	26,506	36,697	47,007	89,830	108,408	128,211	146,121
Public sector bonds	7,510	13,120	18,860	25,550	59,674	76,109	93,260	107,908
Central government	2,463	5,818	9,658	14,973	42,645	56,251	70,510	82,273
Local government 1/	428	572	757	991	2,398	3,138	3,784	4,342
Public corporation	4,619	6,730	8,445	9,586	14,631	16,720	18,966	21,292
Private sector bonds	8,087	13,386	17,837	21,457	30,156	32,299	34,951	38,213
Industrial bonds	2,616	3,680	4,518	5,537	7,300	8,227	8,794	9,588
Bank debentures	5,471	9,706	13,319	15,920	22,856	24,072	26,157	28,625
Total bonds traded 2/	6,500	18,300	39,000	57,600	206,300	229,700	289,900	312,000
Of which: Central Government	320	550	1,800	1,300	69,800	114,100	168,400	199,100

Source: Data provided by the Ministry of Finance.

1/ Excludes bonds issued by private placement.
2/ Includes over-the-counter transactions.

Since the beginning of the 1970s, developments in the secondary bond market have been even more dramatic. The total amount of bonds traded increased from ¥ 6,500 billion in 1969/70 to ¥ 312,000 billion in 1981/82, and the share of central government bonds in total transactions increased from a mere 5 percent to almost 64 percent. This implies that the trading in central government bonds increased at a compound annual rate of 70 percent during this period.

A significant change in the maturity distribution of long-term bonds outstanding has also been taking place. In 1975, the Government first issued large amounts of deficit financing bonds with a ten-year maturity. As a result, in the next few years, there will be large amounts of short-term bonds (bonds approaching maturity) in the market. This will expand the opportunities for trading in government securities with very short remaining maturities.

In addition to yen bonds issued by residents, two kinds of foreign yen bonds are issued in Japan: the first is the so-called Samurai bond issued on the Japanese market by public offerings; and the second is the foreign yen bond privately placed with Japanese institutional investors. The growth of foreign yen bonds has not been very steady because developments in this market were linked to Japan's balance of payments position and official policy toward capital flows (Table 4). After the oil price increases in 1973-74, the market for foreign yen bonds was closed; the Samurai bond market was reopened after 20 months in July 1975, and private placements after three-and-a-half years in June 1977. After the oil price increase in 1979, the Government did not ban new public issues of Samurai bonds, although they were depressed because of high interest rates and the volatility of the yen. However, the market for private placements was closed for 16 months until February 1981. With the liberalization of regulations, foreign yen bond issues increased significantly in the last two years, the level of new issues reaching ten times the levels registered a decade ago.

2. The short-term money markets

Short-term money markets in Japan consist of the call market, the bill discount market, the yen CD market, and the Gensaki market. Outstanding balances in the short-term money markets in Japan increased from ¥ 2.4 trillion at the end of 1970 to ¥ 18.6 trillion at the end of 1982, a compound annual rate of increase of over 18 percent (Table 5). However, developments in individual markets have been diverse.

At the beginning of 1970, the call market and the relatively small Gensaki market were the only short-term money markets in Japan. Balances in the call market, which averaged less than ¥ 1.5 trillion during 1970-73, amounted on average to ¥ 2.5 trillion during the following five years. After the liberalization of interest rates in 1979, there was some increase in outstanding balances. However, these have remained at around ¥ 4.5 trillion in the past three years. A separate bill discount market, which was established in May 1971, grew rapidly

Table 4. Issues of Foreign Yen Bonds, 1970-82

(In billions of yen)

Fiscal years	Samurai Bonds		Private Placements	
	Issues	Amount	Issues	Amount
1970	1	6	--	--
1971	3	33	--	--
1972	6	85	1	11
1973	3	40	6	40
1974	--	--	--	--
1975	2	20	--	--
1976	6	65	--	--
1977	15	296	3	30
1978	29	722	11	105
1979	16	333	6	67
1980	14	261	--	--
1981	28	495	12	118
1982	37	663	30	193

Source: Nomura Securities.

Table 5. Outstanding Balances in Money Markets, 1970-82

(In billions of yen; end of period)

	Call Market	Bill Discount Market	Yen CD Market	Gensaki Market
1970	1,816.9	--	--	619.0
1971	1,472.3	--	--	882.0
1972	1,048.2	802.5	--	1,224.0
1973	1,226.7	2,447.9	--	1,738.0
1974	2,159.5	4,399.6	--	1,673.0
1975	2,331.6	4,403.3	--	1,835.0
1976	2,567.1	5,091.0	--	2,084.0
1977	2,616.4	6,084.0	--	3,136.2
1978	2,326.0	6,590.2	--	4,206.9
1979	3,472.5	6,326.8	1,819.8	3,960.4
1980	4,133.3	5,738.1	2,357.4	4,506.8
1981	4,698.7	4,015.5	3,290.7	4,481.0
1982	4,493.5	5,412.8	4,342.0	4,303.5

Source: Economic Statistics Annual, 1982.

in its first few years, and by 1978 outstanding balances in the bill discount market were almost three times the level of outstanding balances in the call market. Short-term bills issued by the Bank of Japan and "accommodation bills" issued by banks are traded in the bill discount market (see Appendix II). Although its growth was slowed by the development of the CD market, at the end of 1982 the bill discount market was Japan's largest short-term money market, with outstanding balances exceeding ¥ 5.4 trillion.

Negotiable certificates of deposit were first introduced in May 1979 and secondary trading in these instruments started in April 1982. Even though CDs were not issued until a few years ago, by the end of 1982 outstanding balances in the CD market amounted to about one fourth of total balances in Japan's money markets. Foreign interest in yen CDs appears to fluctuate with the value of the yen. 1/ The Gensaki market expanded steadily in the 1970s. However, with the introduction of negotiable certificates of deposit, transactions in this market slowed down. The lifting of restrictions on both nonresident participation and the limit on city banks' debt outstanding in the Gensaki market spurred a revival of this market. Outstanding balances remained around ¥ 4.4 trillion in the past two years. The share of foreign investors in purchases in the Gensaki market has increased steadily from 2.5 percent in 1980 to 14.0 percent in 1982.

3. The stock market

The growth of the Japanese stock market has been uneven during the past decade. After reaching a record high level in 1972, the number of shares traded started to decline after the first large oil price increases in 1973-74 (Table 6). In 1975, the volume of trading was only 62.9 billion shares, less than half the level three years earlier. This trend was reversed in the following years, as the number of shares traded increased relatively steadily, reaching 128.3 billion shares in 1981. Major factors behind this recent growth were the shift by Japanese corporations from indirect to direct financing, the increases in inward foreign investment, and the very high investment returns on stocks. 2/

Although share issues in Japan have not shown a steady trend during the 1970s, there has been a shift from new share issues at par toward new share issues on the market (Table 7). In 1970, new issues at market prices accounted for only 20 percent of total domestic equity issues as companies traditionally issued new equity at par value to existing shareholders or to employees of the firm as part of a profit-sharing program

1/ For example, in mid-1980 foreign purchases amounted to 10 percent of the outstanding issues; the weakening of the yen led to liquidations of these positions and foreign holdings dropped sharply by the end of the year.

2/ See Bronte, op. cit., p. 169. Annual average return during 1970-79 was 18.3 percent in Japan, compared with 6.2 percent in the United States.

Table 6. Trading on Stock Exchanges, 1970-82 1/

	Sales volume (million stock)	Sales value (billions of yen)
1970	57,099	12,030
1971	81,436	18,851
1972	135,475	28,814
1973	79,361	20,139
1974	65,081	15,933
1975	62,854	18,976
1976	82,597	27,930
1977	85,111	25,527
1978	118,493	38,880
1979	115,594	40,879
1980	118,931	42,161
1981	128,317	58,747
1982	91,240	42,668

Source: Bank of Japan, Economic Statistics Annual, 1982.

1/ Includes Tokyo, Nagoya, Osaka and Kyoto Stock Exchanges.

Table 7. New Share Issues by Type, 1970-82

(In billions of yen)

	Share Issues on the Market		Other Issues		Total	
	No. of issues	Amount raised	No. of issues	Amount raised	No. of issues	Amount raised
1970	171	132.7	282	523.5	453	656.2
1971	121	76.7	201	431.3	322	508.0
1972	239	637.7	177	361.1	416	998.8
1973	206	519.9	172	349.6	378	869.5
1974	167	261.8	188	246.0	355	507.8
1975	87	212.4	140	757.4	227	969.8
1976	160	484.9	95	176.0	255	660.9
1977	196	565.5	133	307.5	329	873.0
1978	162	530.4	76	316.4	238	846.8
1979	189	580.2	67	313.3	256	893.5
1980	177	842.3	41	156.0	218	998.3
1981	210	1,331.0	70	516.9	280	1,847.9
1982	174	1,048.0	148	236.5	222	1,284.5

Source: Tokyo Stock Exchange.

or a wage package. New shares issued on the market, which allowed profitable companies access to cheaper sources of funds, rose sharply during the last decade, except for a temporary reversal after the oil price increases in 1973. In 1982, the share of market issues in the total amounted to 82 percent.

Trading on stock exchanges in Japan increased from ¥ 12.0 trillion in 1970 to ¥ 28.8 trillion in 1972 (Table 6). However, this unprecedented growth was not long-lived, and following the sharp increase in oil prices, trading declined to ¥ 15.9 trillion in 1974. In the subsequent years, sales increased continously and reached a record high of over ¥ 58.7 trillion in 1981. Because of the low level of trading during the first three quarters of 1982, reflecting the low level of foreign equity purchases, trading in 1982 declined to ¥ 42.7 trillion.

Foreign investment in Japanese securities has also fluctuated substantially (Table 8). Purchases of Japanese stocks by foreigners, which amounted to $2.8 billion in 1972, declined to $0.6 billion in 1974 after the oil price increases. Following the oil price increase in 1979, however, foreign interest in Japanese stocks increased sharply as oil producing countries began to diversify to yen instruments. Furthermore, the Foreign Exchange and Foreign Trade Control Law of 1980 eased investment procedures for foreign investors and lifted ceilings on foreign investments in a specific company. 1/ As a result, foreign purchases of stocks, which amounted to less than $5.5 billion in 1979, reached about $25 billion in 1981. As the economic situation of oil producing countries started to deteriorate and the yen continued to depreciate, foreign investments in Japanese stocks declined in 1982. There was a sharp increase in investments in Japanese stocks in 1983, 2/ especially high-technology related stocks, as Japanese stocks appeared relatively undervalued after the surge in the New York market in late 1982. There was also a substantial increase in purchases of stocks in Japanese industries centered on export sectors in anticipation of the recovery of the global economy.

4. The foreign exchange market

The Tokyo Foreign Exchange Market expanded rapidly during the last decade. Trading volume, which amounted to $11.8 billion in 1970, was about $1,213.6 billion in 1982 (Table 9). Several factors were influential in the growth of the exchange market. First, trade transactions increased sharply. Second, the internationalization of Japanese companies led to increased yen lending to finance investments, and to profits being remitted back in dollars. Third, favorable developments

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1/ At present, only when a foreign takeover "would have a major impact on the nation's economy or security" is the purchase of more than 25 percent of a firm's shares subject to prior review. The ceiling of 10 percent for a single investor remains in effect.

2/ Net foreign investment in Japanese stocks during January-September 1983 amounted to over $3.8 billion.

Table 8. Foreign Investment in Japanese Stocks, 1970-82

(In millions of U.S. dollars)

	Purchases	Sales	Net
1970	1,020	865	155
1971	1,579	1,149	430
1972	2,762	2,410	352
1973	1,699	2,337	-638
1974	605	1,738	-1,133
1975	2,064	1,474	590
1976	2,960	3,068	-109
1977	2,671	3,446	-775
1978	4,830	5,635	-804
1979	5,486	6,171	-685
1980	12,171	7,183	4,988
1981	24,972	21,450	3,523
1982	17,276	15,664	1,612

Source: Ministry of Finance.

Table 9. Volume of Spot, Forward, and Swap Transactions in the Tokyo Foreign Exchange Market, 1970-82

Calendar Year	Turnover (US$ million)			
	Spot	Forward	Swap 1/	Total
1970	4,915	4,237	2,604	11,756
1971	20,537	5,398	3,423	29,358
1972	13,027	11,241	4,872	29,141
1973	20,194	18,175	8,558	45,927
1974	18,891	24,305	16,115	59,311
1975	22,919	25,960	24,551	73,430
1976	34,972	28,616	34,924	98,512
1977	62,305	24,611	60,363	147,279
1978	117,890	34,767	128,886	281,543
1979	172,210	51,751	221,042	445,003
1980	211,844	66,782	300,593	579,219
1981	296,432	77,696	527,948	902,076
1982	365,260	63,283	785,034	1,213,577

Source: Bank of Japan.

1/ A simultaneous purchase and resale, or sale and repurchase, of currency at a later date.

in the Japanese economy increased the demand for yen as an investment medium and, hence, increased capital flows into Japan. Fourth, the liberalization of markets in Japan increased investment opportunities for nonresidents in yen-denominated assets. Fifth, with the liberalization of access of Japanese companies to markets abroad for funding, conversion of these funds into yen in Tokyo increased. Sixth, again with the liberalization of exchange controls, Japanese portfolio managers and corporate treasurers started investing abroad. Seventh, brokerage commissions were reduced on several occasions, bringing them in line with charges in other countries. 1/

To complement the foreign exchange market, a dollar call market was created in 1972, which allows banks to settle their foreign exchange transactions in Tokyo instead of abroad and to invest their foreign exchange positions locally. Transactions in the Tokyo dollar market remain restricted to resident foreign exchange banks. Nevertheless, the total volume of transactions in this market has increased markedly in the last few years (Table 10). The increase has been largely attributed to three factors: (1) sharp fluctuations in dollar interest rates which made banks more concerned about time lags; (2) the foreign exchange law of 1980 which allowed banks to increase their domestic dollar liabilities; and (3) reductions in commissions charged by brokers. The size of the dollar call market is still relatively small, with a daily turnover of $1.3 billion and an outstanding balance of $32.1 billion, less than 5 percent the size of the Euromarket.

V. The Impact of Integration of Financial Markets

The structure and operation of the Japanese financial system has changed significantly since the early 1970s. New markets and a wide array of instruments were created, and transactions in existing markets were substantially decontrolled. Services provided by banks and securities houses at home and abroad were expanded. Controls on financial transactions abroad by Japanese residents, as well as those in Japanese financial markets by foreigners, were liberalized or, in many cases, abolished. An assessment of these developments requires an analysis of the impact of the integration of financial markets on the internationalization of the yen, on Japan's role as a major capital center, and on the exchange rate of the yen.

1. Internationalization of the yen

The internationalization of a currency is measured by the extent of its use: as a transaction currency or unit of account in international trade; as an investment currency by nonresidents; and as a reserve currency by foreign monetary authorities. Although the role of the yen has increased on all accounts in the past few years, its growth has not been wholly commensurate with the development of Japan as a global economic power.

1/ The commission for spot dollar transactions, the most common form of dealing, is ¥ 600,000 per $1 million for each party to a transaction.

Table 10. The Tokyo Dollar Call Market, 1972-82

(In millions of U.S. dollars)

	Turnover	Outstanding Balance
1972	5,574	352
1973	18,921	718
1974	32,979	1,282
1975	41,779	1,300
1976	45,171	1,230
1977	53,795	1,350
1978	69,241	2,701
1979	125,909	4,941
1980	189,992	11,564
1981	276,207	23,834
1982	480,451	32,122

Source: Bank of Japan.

The Japanese yen plays a comparatively minor role as a transaction currency. Its use is generally limited to Japanese foreign trade and it does not serve as a transaction currency in trade between third countries. In the early 1970s, about 2 percent of Japanese exports were denominated in yen. A decade later, this ratio had increased to about 35 percent, 1/ but remained considerably smaller than the corresponding figures for the United States (90 percent) and major European countries (60-85 percent). The role of the yen in Japanese imports has remained negligible at about 3 percent. This compares to the use of domestic currencies of about 70 percent for the United States and a range of 30-45 percent for major European countries.

The limited use of yen in trade transactions is associated with various factors. First, in the past, quantitative controls on bank lending may have encouraged trade financing to be arranged abroad in foreign currencies rather than in Japan. Second, the lack in earlier years of forward yen markets, where Japanese goods were exported, made it difficult to hedge the exchange risk if the exports were denominated in yen. 2/ In fact, among major export markets, yen invoicing is most used for exports to the European countries where the yen forward market is well developed. While the ratio of yen-based contracts for sale to the United States is below 20 percent, that for shipments to Europe is 60 percent. 3/ Third, a large proportion of Japanese imports is accounted for by energy, agricultural products, and raw materials. Prices of most of these goods are determined or fixed in U.S. dollars and are settled in the currency in which the price is set. In addition, the domestic market prices of these goods tend to be fairly sensitive to exchange rate changes, and, hence, a part of the importer's risk is automatically hedged. Fourth, without a local bankers' acceptance market, Japanese traders continue to depend on the U.S. dollar acceptance market in New York. 4/

To the extent that liberalization of capital controls and integration of domestic and foreign capital markets increase access to yen financing, enhance the growth of the Euro-yen market, promote diversification of domestic financial instruments, and deepen the market for yen-denominated assets, the role of the yen as a transaction currency is likely to continue to expand. The Japanese authorities' desire to enhance its role is evidenced by the recently initiated study on the establishment of a bankers' acceptance market. However, the denomination of trade cannot be determined unilaterally, and progress may therefore be gradual.

1/ During the first quarter of 1983, the ratio of yen-based contracts to all of Japan's export deals exceeded 40 percent for the first time.

2/ Taguchi, "A Survey of the International Use of the Yen," BIS Working Papers, No. 6, July 1982, p. 5.

3/ Japan Economic Journal, March 29, 1983.

4/ Hayden, op. cit., p. 106; and Morgan Guaranty Trust Company of New York, World Financial Markets, March 1981, p. 6.

The liberalization of exchange controls and the increased availability of investment opportunities in yen assets have had a large impact on the role of the yen as an investment currency. Yen assets held by foreigners include yen deposits in Japan and in the Euromarket, and investments in yen-denominated securities and Japanese stocks. Although complete data are not available on the amount of yen assets held by foreigners, the importance of the yen as an investment currency has been growing.

Yen deposits by foreigners in Japan increased from $0.5 billion at the end of 1970 to about $14.1 billion at the end of 1982 (Table 11). While the pace of increase was not steady, since 1979 the expansion has been relatively stable, partly reflecting the lifting of interest rate controls on deposits of foreign public institutions. The growth of Euro-yen deposits has been even more rapid. Euro-yen deposits, which amounted to $1.7 billion at the end of 1977, about half the level of foreign yen deposits in Japan, reached $15.7 billion at the end of 1982, 1/ or 1.1 times foreign yen deposits in Japan. If past trends in the growth of yen deposits in Japan and in the Euromarket continue, yen deposits held outside Japan could exceed the former substantially. These trends will depend on policies adopted for encouraging foreign yen deposit accounts in Japan by eliminating residual interest rate regulations.

Outstanding nonresident claims resulting from investments in yen-denominated securities have also increased sharply. Although precise data are not available, Table 12 provides some indication of the growth of foreign investments in Japanese notes, securities and equities.

Table 12. Japanese Securities Held by Nonresidents, 1970-1982 1/

(In billions of U.S. dollars; at end of period)

1970	1973	1976	1979	1980	1981	1982
2.7	5.2	12.6	30.7	42.6	68.3	71.5

Sources: Matsukawa, M., "The Yen--A Newly Emerging Reserve Currency," in Group of Thirty, Reserve Currencies in Transition; and data provided by the Ministry of Finance.

1/ These include securities issued by Japanese entities in foreign markets in the latter's currencies. An estimated 80 percent represents investments in yen-denominated securities.

1/ Compared to $1,020 billion of total deposits in the narrowly defined Euromarket at the end of 1982, Euro-yen deposits were relatively small, but it is estimated that yen-denominated deposits in all institutions outside Japan, including, e.g., those in Hong Kong and Singapore, amount to about $50 billion. The Japan Economic Journal, January 17, 1984.

Table 11. Yen Deposits of Nonresidents in Japan and in the Euromarket, 1970-82

(In billions of U.S. dollars; end of period)

Year	In Japan 1/	In Euromarket 2/			
		Of Monetary Authorities	Of Banks	Of Non-banks	Total
1970	0.54	...	...	...	...
1971	0.94	...	...	...	...
1972	0.90	...	...	...	...
1973	0.63	...	...	...	...
1974	0.86	...	...	...	...
1975	1.47	...	...	...	...
1976	1.78	...	...	...	...
1977	3.20	--	1.4	0.3	1.7
1978	7.23	--	4.6	0.8	5.4
1979	4.44	--	5.2	1.1	6.3
1980	10.13	--	8.4	2.2	10.6
1981	13.56	0.1	12.5	3.8	16.3
1982	14.08	0.1	11.9	3.8	15.7

Sources: The Bank of Japan, Economic Statistics Annual, 1982; and BIS, International Banking Developments (Quarterly), various issues.

1/ Short-term external liabilities of authorized foreign exchange banks denominated in yen.

2/ Yen-denominated liabilities of banks in the BIS reporting area. No data are reported prior to 1977.

Further evidence of the growing role of the yen as an investment currency can be found in the currency denomination of international bond issues (Table 13). The share of yen-denominated bonds averaged 6 percent during 1981-82, compared with about 61 percent for U.S. dollar-denominated bonds and 17 percent for Swiss franc-denominated bonds. While a movement toward denominating Eurobonds in Japanese yen can be observed in recent years, the share of Japanese yen in total Eurobond issues and placements remained relatively small, amounting to less than 2 percent.

The liberalization of capital flows and the trend toward domestic money-market liberalization have also increased the role of the yen as a reserve currency. One indication of this increased use of the yen is the growth of yen assets of foreign monetary authorities in Japan. In addition, there are yen reserves invested outside Japan. It is estimated that, at the end of 1982, the total amount of yen held as a reserve currency was on the order of SDR 9.2 billion ($10.15 billion), compared with SDR 0.673 billion ($0.79 billion) at the end of 1975. 1/

Concurrently, the share of yen in official holdings of foreign exchange also increased (Table 14). The share of the yen in the SDR value of foreign exchange reserves increased continuously from 0.5 percent at the end of 1975 to 3.9 percent in 1982, despite fluctuations in the value of the yen. However, compared with shares of the U.S. dollar and the deutsche mark, which amounted to about 71 percent and 12 percent, respectively, in 1982, the yen's role remains relatively small. The importance of the yen as a reserve currency among developing countries has been greater than among industrial countries. This partly reflects the attempts made by OPEC countries, which are classified as developing countries, to diversify their foreign exchange holdings.

The composition of foreign exchange reserves in individual countries depends on various factors, including historical ties, regional financial and trade agreements, the nature of exchange arrangements, the currency composition of external payments (especially related to trade and debt), and, to some extent, profit and risk considerations. Even though the role of the yen remains small as a reserve currency in the portfolios of central banks, it is likely to make headway in the future if viewed in the context of the above factors. With the liberalization of restrictions on yen lending, the volume of yen debt will be increasing, and, with the liberalization of short-term Euro-yen lending and the growth of the Euro-yen market, the role of the yen in trade transactions is likely to expand. As the availability and variety of yen-denominated instruments with competitive yields increase, monetary authorities will be further encouraged to diversify into yen.

1/ IMF, Annual Report 1983.

Table 13. Currency Denomination of International Bond Issues, 1976-82

(In percent)

	1976	1977	1978	1979	1980	1981	1982
Japanese yen							
Total international	0.8	3.9	12.7	7.8	5.6	6.6	5.4
Eurobonds	--	0.6	0.5	0.9	1.5	1.6	1.3
Deutsche mark							
Total international	12.0	18.6	21.9	20.1	22.1	5.3	7.5
Eurobonds	18.4	26.8	41.1	30.1	17.2	5.2	7.0
Pound Sterling							
Total international	--	0.6	0.9	0.7	3.0	3.0	2.7
Eurobonds	--	1.1	1.8	1.5	4.9	2.0	1.7
Swiss franc							
Total international	15.9	13.7	20.2	23.7	19.7	17.0	16.0
Eurobonds	...	...	...	...	...	...	...
U.S. dollar							
Total international	60.1	55.5	37.4	38.6	42.2	60.4	62.4
Eurobonds	65.1	63.3	48.1	56.8	66.4	80.2	83.3

Sources: World Bank, Borrowings in International Capital Markets; and Organization for Economic Cooperation and Development, Financial Statistics Monthly.

Table 14. Share of National Currencies in SDR Value of Total Identified Official Holdings of Foreign Exchange, 1975-82

(In percent; end of period)

Year	Japanese Yen			U.S. dollar	Deutsche mark	Swiss franc	Pound Sterling	French franc
	Industrial Countries	Developing Countries	All Countries					
1975	0.2	0.9	0.5	79.4	6.3	1.6	3.9	1.2
1976	0.4	1.1	0.8	79.7	7.0	1.4	2.0	0.9
1977	0.3	2.1	1.2	79.4	8.2	2.0	1.6	1.0
1978	1.6	4.0	2.5	76.9	9.9	1.4	1.5	0.9
1979	2.0	4.0	2.9	73.7	11.5	2.2	1.9	0.9
1980	2.8	4.3	3.5	68.7	13.8	3.1	2.9	1.2
1981	3.2	4.5	3.8	71.1	12.3	2.9	2.2	1.1
1982	3.9	4.0	3.9	71.4	11.6	2.7	2.2	1.1

Source: International Monetary Fund, Annual Report, various issues.

2. Japan's role as a major capital center

As described in previous sections, Japan's capital markets expanded rapidly during the past decade, developing into a major source of funds for public and private borrowers, and providing investors with a wide range of assets. As a result, Japan's capital market has evolved into one of the world's largest. The growth of domestic markets, together with the liberalization of foreign exchange controls, has also enhanced the role of Japan's capital markets in international financing.

In terms of gross bond issues, Japan is the second largest (excluding the Euromarket) in the world, ranking after the United States (Table 15). In 1982, the value of bond issues in Japan amounted to about $177 billion, less than half the value of issues in the United States, but far greater than the amount recorded in any other market. Of the total bond issues in Japan, $3.3 billion (1.9 percent) were issued by foreigners.

The currency composition of foreign bonds reflects, in part, the expectations of borrowers and lenders regarding movements in interest rates, inflation, and exchange rates. Prevailing expectations, as well as the liberalization of regulations regarding foreign bond issues, made Japan an important market for foreign bond issues. Japan accounted for about 13 percent of foreign bond issues and placements in 1982, the third largest market country, with Switzerland accounting for 45 percent and the United States for 24 percent. 1/

What seems striking in the case of Japan is the pace at which it has become a major market for foreign bond issues. As recently as 1976, foreign issues accounted for 0.3 percent of total issues in Japan. Since then, this ratio has increased steadily, amounting to almost 2 percent in 1982, about the same as in the United States. In the same period, Japan's share in total foreign bond issues increased from less than 2 percent to over 13 percent, while that of the United States showed a declining trend.

Japan's stock markets have also undergone rapid growth in the past decade. In terms of gross share issues, Japan is the second largest among industrial countries after the United States. Similarly, the Tokyo Stock Exchange (TSE) is the second largest in the world, ranking after the New York Stock Exchange (NYSE) (Table 16). The market values of listed stocks in the TSE amounted to $417.9 billion at the end of 1981, less than one half that of the NYSE, but more than twice that of the London Stock Exchange and seven times that of the Frankfurt Stock Exchange. The transaction value of stocks for the year on the TSE was $224.5 billion, about two thirds that transacted on the NYSE, but much greater than the values recorded in other markets.

1/ The share of Japan in foreign bond issues increased to 14.3 percent in 1983.

Table 15. Securities Issues in Major Capital Markets, 1976-82

	1976	1977	1980	1981	1982
Gross bond issues		(In millions of U.S. dollars)			
Japan					
Total	84,930	105,613	161,330	181,337	176,997
Of which: Foreign	287	1,394	1,543	2,723	3,301
Germany					
Total	29,819	35,694	78,645	82,603	88,085
Of which: Foreign	1,309	1,511	4,952	1,190	2,109
Switzerland					
Total	9,513	7,818	13,194	12,414	16,929
Of which: Foreign	5,444	4,959	7,470	8,118	11,325
United Kingdom					
Total	17,307	24,582	37,579	28,705	21,948
Of which: Foreign	--	--	178	913	1,129
United States					
Total	194,500	201,400	272,400	291,600	378,300
Of which: Foreign	10,632	7,668	2,736	7,576	6,025
Gross share issues					
Japan	3,706	5,046	6,757	10,846	8,645
Germany	2,415	1,881	3,822	2,441	2,440
United Kingdom	1,907	1,377	2,222	3,831	1,899
United States	11,100	11,400	22,600	26,900	28,900
Foreign bond issues and placements by market		(In percent of world total)			
Japan	1.5	8.4	8.6	12.8	13.1
Germany	6.9	9.1	27.6	5.6	8.4
Switzerland	28.7	29.9	41.6	38.2	45.0
United Kingdom	--	--	1.0	4.3	4.5
United States	56.1	46.2	15.2	35.6	24.0

Sources: Organization of Economic Cooperation and Development, Financial Statistics Monthly; and World Bank, Borrowing in International Capital Markets.

Table 16. Stock Exchanges, 1981

	Tokyo	Frankfurt	London	New York
Number of listed companies				
Domestic	1,412	198	2,403	1,523
Foreign	15	177	478	42
Market value of stocks at end of year (in millions of U.S. dollars)	417,945	55,792	189,560	1,098,561
Transaction volume of stocks during the year (in millions of US dollars)	224,516	7,047	30,896	389,219

Source: Nomura Securities, Manual of Securities Statistics, 1983.

The number of listed companies on the TSE was 1,412 in 1981, compared with 2,403 in London and 1,523 in New York. However, only 15 foreign companies were listed on the TSE, whereas London listed 478 such companies, and Frankfurt 177. The first equity issues by a foreign company in Tokyo were in 1973, and, by the end of 1976, 17 foreign companies had been listed on the TSE. Since then, however, some companies have de-listed their shares and others are reportedly considering de-listing. The relatively small number of foreign companies listed on the TSE may result from various factors, such as the cost of keeping shares listed on the TSE, the three-month deadline date for submission of financial reports, 1/ and the lack of interest on the part of Japanese investors in locally listed foreign shares because of higher trading commissions for these shares and tax advantages on dividend payments for holders of Japanese shares. 2/

3. Yen exchange rate

To moderate the fluctuations of the yen exchange rate following the adoption of the flexible exchange rate system, the Japanese Government sometimes resorted to capital controls along with other policy measures. It is difficult to identify exactly when the modification of the system led to tightening or relaxation of controls because of the complexity

1/ Firms in Japan are required to submit their financial reports within three months after closing their accounting year, whereas many European countries allow six months for submission of reports.

2/ Except for the withholding tax, dividends worth less than ¥ 100,000 per share per year are exempt from taxes in the case of Japanese shares, while such a system does not apply to foreign stocks.

of the measures taken and the different time periods in which they were implemented. In a broad sense, the modification of the system was such that, from mid-1978 to early 1979, measures were implemented to discourage net inflows of capital, and, from early 1979 to late 1980, measures were implemented to discourage net outflows of capital. Since the end of 1980, with the new Foreign Exchange and Trade Control Law, the principle of free capital transactions has been in effect, although implementing regulations contain administrative guidelines and reporting requirements.

Two empirical studies have been undertaken by the Fund staff to examine whether or not these changes in capital controls had an impact on the yen exchange rate. 1/ Both studies indicate that controls aimed at discouraging inflows and encouraging outflows contributed to a weaker yen. Conversely, controls aimed at encouraging inflows and discouraging outflows contributed to a stronger yen. Therefore, the nature of capital control measures introduced and modified by the Japanese Government were consistent with the exchange rate objectives.

As the Japanese and international capital markets became better integrated, the impact of this development on the volatility of the yen exchange rate became a matter of debate. Basically, there are two opposing hypotheses. The first is that large swings in the exchange rate are the result of momentum or bandwagon effects, and that the liberalization of exchange controls--by making it easier to shift in and out of yen and by increasing the sensitivity of capital flows to changes in interest rate differentials and exchange rate expectations--will likely exacerbate this tendency. Thus, it is held that liberalization of exchange controls creates the potential for more volatility. The second hypothesis is that, while the imposition of controls on net

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1/ (a) In Eken, "The Impact of Integration of Financial Markets on the Yen Exchange Rate, 1978-83" (unpublished, delivered at a conference sponsored by Bogazici University, the Wharton School, and the OECD in Istanbul, August 1983), dummy variables representing controls were introduced into an equation explaining fluctuations in the exchange rate to measure the impact of capital controls on the exchange rate. The equation used is based on the view that, over the long run, exchange rates tend to move in order to maintain purchasing power parity between currencies; however, in the short run, conditions in asset markets tend to dominate exchange rate movements because capital flows can respond more quickly than the flow of goods to perceived changes in conditions. The primary influences in asset markets are assumed to come from changes in interest rate differentials and in expected movements of the exchange rate. While exchange rate expectations are not observable, current account developments, which indicate the need for exchange rate adjustments to alter competitiveness, tend to affect exchange rate expectations.

(b) In Otani, "Exchange Rate Instability and Capital Controls: The Japanese Experience, 1978-81" (DM/82/67, 10/22/82), the effects of capital controls on exchange rates were analyzed through their impact on transactions costs, domestic interest rates, and the forward premium.

inflows at times of strong current account positions and a strong yen, and on net outflows at times of current account deficits and a weak yen, was successful in limiting certain capital flows, these controls contributed to thin markets. The liberalization of exchange controls would lead to a deepening of the market for yen assets, and sharp exchange rate fluctuations resulting from a thin market would thus be avoided. There is some logic in both of these hypotheses, and it is not possible to predict a priori whether or not the liberalization of capital controls would lead to greater exchange rate variability.

In as much as capital flows into and out of Japan are free of formal restrictions and administrative guidelines biased toward either capital inflows or outflows, and financial markets in Japan function efficiently, there can be increased confidence that over the longer term the exchange rate would move to reflect economic fundamentals such as changes in purchasing power parity and current account developments.

VI. Summary and Conclusions

The Japanese financial system has undergone far-reaching changes during the past decade. The highly regulated system of the 1960s, dependent on bank lending with controls on interest rates and the quantity and distribution of credit and highly specialized financial institutions, has evolved into one in which market forces of both domestic and foreign origin play a major role.

Large-scale issues of government bonds after 1975 resulted in a rapid growth of Japan's primary and secondary financial markets and necessitated changes in issuing practices. To facilitate new issues, the government started issuing medium-term bonds through the open bidding system, the time period that the banks were required to hold new issues was reduced, and the new bonds were increasingly issued at rates reflecting those in the secondary market.

Extensive reforms also took place in short-term financial markets. These markets expanded substantially with the creation of the bill discount and CD markets. Official controls on both the bill discount and call markets were removed, although the Bank of Japan continues to intervene in both markets. Restrictions on banks' participation in the Gensaki market were removed, facilitating the integration of interbank markets with unregulated markets, and thus enabling greater interest rate arbitrage across markets. These reforms in the money markets and the development of the government bond market altered the transmission mechanism of monetary policy.

The development of financial markets, while official regulations on deposit rates have remained in effect, has reduced the relative importance of commercial banks in financial intermediation. To enable banks to adjust to the changing financial environment, the Government authorized them to issue CDs subject to certain restrictions. Also, in an effort to compete for funds, commercial banks have introduced various new instruments with higher yields than those on regular bank deposits.

Largely to facilitate the issuance of government bonds, compartmentalization of the roles of financial institutions has been reduced. The Banking Law of 1982 authorized banks to purchase, sell, and underwrite government securities. Banks initially started selling new issues of long-term government bonds and, subsequently, new issues of medium-term and discount bonds. Effective April 1, 1984, both banks and securities firms were allowed to deal in CDs and commercial paper issued abroad and denominated in foreign currencies, and, from June 1984, banks will also be able to deal in domestic bonds in the secondary market. Securities companies, on the other hand, may now sell investment trusts, which are highly liquid and similar to bank deposits, and may engage in lending with government bonds as collateral. The sale of new issues of government bonds by banks has led to increased purchases of newly issued bonds by individuals, and is serving as a stabilizing factor in the government bond market.

These developments in domestic financial markets, by providing investors with a wider array of assets with market-determined interest rates, together with the liberalization of capital flows in and out of Japan, have led to a higher degree of integration of the Japanese financial system with the rest of the world. Particularly important in the integration of Japanese money markets with those abroad was the removal of barriers to foreign participation in the Gensaki and CD markets. Permission for new equity issues by foreign companies in the Japanese stock market, as well as issuance of foreign yen bonds in Japan, increased the access of foreigners to Japanese capital markets, though at times access was temporarily limited because of developments in the balance of payments and the exchange rate. Although initially the foreign yen bond market was dominated by international organizations and sovereign borrowers, the relaxation of eligibility criteria and changes in issuing procedures broadened the range of potential participants. Moreover, the scope for foreign investment in Japan was widened in the area of equities with the lifting of the limitation on foreign ownership except for designated companies.

Japanese access to markets abroad also increased substantially, as Japanese corporations were given greater freedom to borrow in capital markets abroad and institutions were allowed to invest their surplus funds abroad. These changes significantly affected corporate finance and led to substantial portfolio diversification on the part of institutional investors.

Official controls on lending abroad by Japanese banks were recently eliminated, though such lending remains subject to prudential guidelines, as it is in other countries, and the access of foreign banks to Japan's financial markets was enhanced. Particularly important with respect to the latter were their increased yen funding sources following the authority given to foreign banks to issue CDs, and their access to the Bank of Japan's discount window. Although bond issues by banks in Japan are not allowed, subsidiaries of Japanese banks are allowed to issue bonds abroad, and remit funds to Japan for lending operations of parent banks.

Furthermore, short-term Euro-yen lending by Japanese banks was completely liberalized. In the foreign exchange market, Japanese residents were given unlimited freedom to exchange yen into foreign currencies for deposit with Japanese banks, and the limits on the foreign-currency swaps that both Japanese and foreign banks could undertake, though remaining in effect, were increased several times.

As a result of the fundamental strength of the Japanese economy and the removal of formal restrictions on international movements of funds, capital flows into and out of Japan have increased dramatically. Outflows of Japanese capital, which averaged $5.1 billion per annum during 1973-77, increased to an average of $18.4 billion per annum during 1978-82, and reached $32.5 billion in 1983. During the corresponding periods, net inflows of long-term foreign capital averaged $1.5 billion, $8.9 billion, and $14.8 billion, respectively. These changes have made Japan's capital market the world's second largest, excluding the Euromarket. Furthermore, the yen's role as an international currency has increased substantially during the past decade.

The liberalization of capital flows has also increased the role of market forces of international origin in the Japanese financial system. In the past, there was heavy reliance on capital controls and exchange market intervention as instruments of exchange rate management. Without capital controls and with the growing size of the exchange market, greater interest rate flexibility in the management of the exchange rate became necessary. The integration of domestic and international financial markets has thus added momentum to the movement toward interest rate liberalization and the associated diversification of financial instruments in the domestic market.

Market forces will continue to exert strong pressures for further progress in capital market developments and interest rate liberalization. The most important pressure is likely to come from the completion of the maturity structure in the secondary market for government bonds with the large-scale maturing of long-term government debt due to begin in 1985. The increase in government bonds with short remaining maturities could cause substantial disintermediation if deposit rates remain subject to controls. Also, refinancing needs are likely to lead to a wider array in the maturities of new government bonds, and could necessitate changes in marketing mechanisms to facilitate these issues. One of the institutional constraints on the liberalization of deposit rates has been the postal savings system, an important source of financing for the Government's fiscal investment and loan program. Therefore, though the liberalization of deposit rates is inevitable in the future, the process is likely to be gradual, starting with liberalization of rates on large deposits held primarily by institutional investors.

Efforts are continuing to enhance Japan's role as a major capital center and to promote further internationalization of the yen by providing a wider array of yen assets. In April 1984, guidelines on Euro-yen bond issues by residents were eased, the requirement of underlying trade

or securities transactions for forward exchange transactions by residents was eliminated, ceilings on CD issues by Japanese and foreign banks were increased, and sales of foreign CPs and CDs in Japan were allowed. Consideration is also being given to the establishment of a bankers' acceptance market in yen and to the reform of current statutory requirements which limit foreign investment in certain industries. These measures are consistent with forces for further liberalization of domestic financial markets and are likely to enhance their efficiency, as well as their integration with markets abroad.

Summary of Bond Issues in Japan

	Maturity (years)	Method of Issue	Other Requirements
Government bonds			
Long-term	10)	Underwritten by a syndicate consisting of major financial institutions and securities houses, these institutions take the portions they have underwritten. 1/	Issued through a fixed calendar issue system.
Discount	5)		
Medium-term	2-4	Competitive auction system whereby investors purchase the securities directly.	
Government-guaranteed bonds	10	Underwritten by a syndicate of banks and securities houses with a bank acting as a commissioned bank.	The amount of bond issues by public corporations is determined every year by the MOF.
Local government bonds	10	Public offerings are underwritten by a syndicate of banks and securities houses with a bank acting as a commissioned bank. Local government bonds are usually privately placed by the issuer to city banks, regional banks, and local financial institutions.	
Bank debentures with semiannual interest payment	3,5)	Issued directly by six banks. Certain amount sold directly by banks and the remainder through securities houses.	(1) Range in maturities from 1-5 years; (2) Ceilings on issue amounts are set by the MOF based on a multiple of banks' capital and reserves.
Discount debentures	1)		

Sources: Bronte, S., Japanese Finance: Markets and Institutions; and Ministry of Finance.

1/ Since early 1983, banks have been allowed to make over-the-counter sales of new issues during the specified issue periods. New issues which are not sold to the public by the end of the issue period are taken into banks' own portfolios and must then be held for a minimum of 100 days before being traded.

Summary Characteristics of Japanese Short-Term Money Markets

	Call Market	Bill Discount Market	CD Market	Gensaki Market
Nature of the market	Interbank	Interbank	Open market	Open market consist of a conditional pu chase of a governme or corporate bond f a fixed period with resale agreement at specific date.
Participants	Financial institutions. Six specialized money dealers act as middlemen.	Financial institutions. Six specialized money dealers act as middlemen.	All financial institutions can issue CDs.	Market is open to any institution, bu not to individuals. Major borrowers are securities companie and financial inst: tutions, and major lenders are privat corporations.
Maturities of transactions	1) Half-day money payable within the day; 2) unconditional money repayable in the next business day; 3) fixed maturity money repayable in 2-7 business days.	Bills are available in four maturities: 30-45 days, 46-75 days, 76-105 days, and 106-120 days.	CDs are issued with maturities of 3-6 months.	Repurchase agreeme with maturities of 1-364 days are available.
Amounts of transactions	Minimum transaction amount is ¥ 100 million.	Minimum transaction amount is ¥ 10 million.	Minimum denominations of ¥ 300 million. 1/	Minimum trading amount is ¥ 100 million.
Interest rates	Posted rates have been removed. The Bank of Japan has a major influence on the call money rate.	Posted rates have been removed. The Bank of Japan has a major influence on the call money rate.	Freely determined.	Freely determined The differential between the purch and resale prices reflects the cost funds or the yiel to the investor.

Summary Characteristics of Japanese Short-Term Money Markets

	Call Market	Bill Discount Market	CD Market	Gensaki Market
Taxation			Final holders of CDs are subject to 20 percent withholding tax at maturity. Foreign governments are exempt from the withholding tax. No transactions tax in secondary trading.	Investors in Gensaki market are subject to transactions tax. Interest from Gensaki Gensaki investments are not subject to withholding tax as securities houses remain the registered holders of bonds during the repurchase agreement.
Other requirements	Unconditional fixed maturity loans require collateral, such as government bonds, government-guaranteed bonds, or bank debentures, of 100-125 percent of the transaction amount.	1) Only short-term bills issued by the BOJ and accommodation bills 2/ are traded; 2) Investors are allowed to sell bills, except one-month bills, without restriction 30 days after they have been issued.	1) Banks cannot buy back their own CDs before they mature; 2) Japanese banks can issue CDs up to 75 percent of their capital and reserves, and foreign banks in Japan up to 50 percent of their yen assets, subject to a limit of ¥ 8 billion. 3/	Securities companies can sell bonds from their own inventories (a dealing transaction) or they act intermediaries between two outside parties (a brokerage transaction). There are no commissions on the former; securities companies earn a spread between the bid and offer yields on the latter (they earn about 0.5 percent or less, depending on the maturity).

Sources: Bronte, S., Japanese Finance: Markets and Institutions; and Hayden, E., "Internationalizing Japan's Financial System," in Okimoto, D. (Ed.), Japan's Economy Coping With Change in the International Environment.

1/ The minimum denomination was reduced from ¥ 500 to ¥ 300, effective January 1984.

2/ When Japanese companies borrow money, they issue promissory notes to the banks. Banks in turn issue accommodation bills, to which they attach the promissory notes as collateral. The value of the accommodation bill equals the sum value of the promissory notes.

3/ The ratio for Japanese banks will be increased 5 percentage points each quarter, starting in April 1984, and will reach 100 percent after April 1985. The ratio for foreign banks was increased from 30 percent to 50 percent in April 1984.

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