

The RISING YEN

The Impact of Japanese Financial Liberalization
on World Capital Markets

RICHARD S. THORN



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ASEAN ECONOMIC RESEARCH UNIT
INSTITUTE OF SOUTHEAST ASIAN STUDIES

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struck to celebrate
the Emperor Hirohito's
Sixtieth Anniversary of Reign
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*To my sister
Judy Bonnie Thorn*



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Statistical Note:

1. The reader should be aware that the data available on international financial flows are less reliable than the corresponding national data. The geographical and transaction coverage has improved over the years so that almost none of the time series data are consistent. There are significant differences between the concepts of international transactions employed by the International Monetary

Fund and the Bank for International Settlements, the two principal statistical sources. I have not burdened the text by listing these qualifications except on rare occasions where I thought it particularly necessary. I have taken pains not to place a burden on the data that it would not bear, in spite of the conventional use of decimal places. It would take a book to detail all the necessary qualifications to what appear to be simple straightforward time series. Fortunately, such a book has been written by Dennis (1984) and is essential reading for those who would gain a full appreciation of the value of the data.

2. At a yen/dollar exchange rate of 150:

¥1 billion = US\$6.67 million

¥1 trillion = US\$6.67 billion

Preface

The Japanese financial district, Marunouchi, is situated directly south of the Imperial Palace, separated from it by a great moat rimmed with the outer gardens of the palace. To the east lie the important government ministries and the Japanese Diet, and to the north and west lie the business and residential quarters of the city. This grand panorama of the Emperor, the symbol of national unity, surrounded by his ministers, prosperous subjects, and bankers, conveys a sense of the harmony comparable to that one experiences on seeing a Japanese garden.

No profound economic study is necessary to inform one that this financial centre is different. In place of the crowded, narrow, littered streets of Wall Street, full of hawkers, office workers, and messengers rushing about, or the strange mixture of old and new of the city in London with its equally bustling streets, one finds in Marunouchi, quiet streets lined with neat, conservative, low, monolithic buildings.

Along its sunlit ways bordered by small hedges and gardens, neatly dressed gentlemen in their dark blue suits stroll briskly to their appointments. It is difficult to believe that one is standing in the midst of the financial heart of the world's second largest economy and largest international lender.

The Japanese Miracle Twice

Japan has risen from what today we call a less developed country, to become a world economic power, confounding not once but twice in this century, those pundits who argue that it is impossible for backward nations to close the gap with the industrialized nations of the West. Not only has Japan closed the gap, but it has also gone to the head of the file; and each time this has brought it in conflict with the West and wrought enormous social and political strains. First, Japan wrenched a feudal economy into the twentieth century after the Meiji Restoration in 1868. It performed the miracle a second time as it arose from the ashes of World War II.

Japan's Imperialist Adventure

Japan's adventure into war in the 1930s may be viewed as a last desperate attempt to counter the imperialist advance of the Western powers, which not only had established a political and economic hegemony over Asia but also attempted to introduce Western values to colonial peoples. Japan in its imperialist initiative emulated the Western powers and attempted to inculcate Japanese values in a much more forceful manner than anything attempted by the Western powers. In the process, Japan alienated the colonial peoples, who instead of welcoming Japan as a liberator, saw it as a worse kind of oppressor. Japan hastened the demise of colonialism in Asia but not in a manner which created any bond of gratitude so that when Japan began its reconstruction it was relatively isolated from its neighbours. Like any people who lived apart for a long period of time, Japan developed its own peculiar set of financial institutions and financial arrangements. These were not always compatible with those of their Western counterparts. To counter its isolation, the Japanese took refuge in their enduring citadel of nationalism.

The Re-emergence of Japan

Today, Japan has re-emerged as a world economic and financial power, but not in a balanced manner. It has taken its place alongside London and New York as a first-tier financial centre. It is in the process of adapting rapidly its institutions to this new international role. However, this swift adjustment in the international sphere has not been matched by an equally speedy adjustment of its domestic financial institutions. This is causing friction as the international transformation causes ever greater strains on domestic financial markets. There is no question either in, or outside of, Japan that Japanese domestic financial institutions will become transformed, at least to the extent that even if they do not fully accept Western norms, they will become compatible with them. How to make this adaptation in a *harmonious* manner is the central problem that faces the Japanese authorities. "Harmony" is a very important word in Japan. The group that was charged with studying the problem of integrating the Japanese economy with the world economy was called "The Advisory Group on Economic Structural Adjustment for International Harmony" ("Maekawa Report"). This goal of achieving change in a harmonious manner without untoward disruption to individuals is a difficult, if not impossible, goal to attain. It explains, however, what seems to outsiders like a great deal of foot dragging on the part of the Japanese. This foot dragging also reflects an insensitivity on the part of the Japanese for the need of Western nations to preserve their own domestic harmony. This book is confined to the financial aspects of the economic restructuring that is taking place in Japan. However, one can only fully understand this restructuring in the context of the larger political adjustment that is taking place as Japan's role in Asia and the world is being redefined and its post-war isolation is coming to an end.

Japan today is searching for an acceptable way to reconcile its nationalistic values with its role as a world power. Japan's leaders are being challenged not only to solve the immediate problems of enormous current account imbalances but also to develop an international financial system that will produce world prosperity. As this is being written, the international trading system is headed towards a crisis with major protectionist legislation directed against Japan almost certain to be passed later this year by the United States and the European

Community (EC). Prime Minister Nakasone's search for a harmonious solution will be severely tested. There is no time for gradual adjustment, but a need for bold, new measures by the three key parties, Japan, the United States, and the European Community to devise not only a new trade relationship among themselves but also a co-ordinated policy towards the Third World. It is in this context that the liberalization of Japan's capital markets is evaluated in the pages that follow.

The organization of this book is as follows: Chapter I presents an analysis of the broad problems faced by the Japanese economy which led it to revise its highly successful post-war economic strategy including a reversal of its attitude towards the control of international capital transactions. It then provides a brief description of the Japanese financial structure which is being deregulated. Chapter II describes the deregulation measures taken thus far and the objectives they hoped to attain. Those not interested in the details need only read the first half of the chapter. This is followed by Chapter III, which examines the progress that has been made in the internationalization of the yen and its implications for the future. Chapter IV looks at the impact of the financial liberalization measures taken thus far on Japanese and world capital markets and how this has affected the flow of capital to the developed and less developed countries, with special emphasis on Asia.

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R.S. Thorn

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