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Report to Congressional Requesters

June 1986

# INTERNATIONAL FINANCE

## Implementation of the Yen/Dollar Agreement



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**National Security and  
International Affairs Division****B-222898**

June 3, 1986

The Honorable John Heinz  
Chairman, Subcommittee on International  
Finance and Monetary Policy  
Senate Committee on Banking,  
Housing and Urban Affairs

The Honorable Sam M. Gibbons  
Chairman, Subcommittee on Trade  
House Committee on Ways and Means

On May 29, 1984, the United States and Japan signed the yen/dollar agreement, in which Japan's Ministry of Finance agreed to take steps to liberalize Japan's capital market and to internationalize the yen. The U.S. Secretary of the Treasury and Japan's Minister of Finance described the agreement as "an historic document which contains significant, far-reaching actions which will have a lasting, positive effect on the yen/dollar rate, the Japanese and U.S. economies, as well as the world economy." This report discusses Japan's implementation of the yen/dollar agreement and the extent to which U.S. objectives for the agreement are being achieved or are likely to be achieved in the future. It is a follow-up to our April 20, 1984, report, entitled Floating Exchange Rates in an Interdependent World: No Simple Solutions to the Problems (GAO/NSIAD-84-68), which was requested by your Subcommittees.

The yen/dollar agreement is in the form of a report to the U.S. Secretary of the Treasury and Japan's Minister of Finance from an ad hoc working group on exchange rate issues chaired at the under-secretary level. In negotiating the agreement, the U.S. Treasury sought to increase the use of the yen as an international currency, promote development of the Euroyen market, and liberalize the Japanese capital market by deregulating interest rates, expanding market instruments, and improving foreign access. Treasury believed that Japan's heavy regulation of its capital markets had prevented the yen/dollar exchange rate from reflecting the underlying strength of the Japanese economy. Under the agreement, Japan committed itself to (1) removing barriers to entry of foreign institutions into the domestic financial services industry, (2) liberalizing its domestic capital market, and (3) facilitating the development of a Euroyen market. While the agreement is not formally binding, the Japanese government gave its assurance for the prompt and thorough implementation of the measures announced in the report.

The Japanese government has completed or is working on all of its commitments under the agreement. However, the U.S. Treasury would like internationalization of the yen and liberalization of Japan's domestic capital markets to proceed more rapidly in the expectation that this will, over time, result in a stronger yen. We agree with Treasury Department officials who told us that the agreement will have an impact on the yen's value only in the medium to long run. In any event, such institutional changes will generally be less important in determining the yen's value than will economic fundamentals, like Japan's savings surplus and low inflation rate.

The most progress under the agreement has been made in increasing access to Japan's financial services sector and developing a Euroyen market. Now that non-Japanese banks can engage in trust banking—nine foreign banks now have this right compared with eight Japanese banks—and in trading government securities, the general consensus of the bankers and other financial specialists we interviewed is that equal or national treatment has been achieved for foreign banks in Japan. Treasury officials continue to be concerned, however, over the application process for trading government securities, which they contend is discriminatory and causes unnecessary delays. A number of technical measures have also been taken which have increased the foreign banks' yen-funding opportunities, and the general regulatory climate has improved. Six foreign securities firms also joined the Tokyo Stock Exchange at the start of 1986.

Although a license from the Ministry of Finance is required for all Euroyen bond issues and the first Euroyen certificate of deposit issue, approval appears to be routinely granted. However, maturities of instruments and allowable instruments continue to be restricted, largely due to the Ministry's interest in maintaining a balance between Euromarket liberalization and liberalization of Japan's domestic capital market. These restrictions may be a factor limiting the development of the Euroyen market, but a more important one is the unfamiliarity and relative lack of interest in the yen by both borrowers and investors. Only a limited number of entities, such as national governments and multilateral development banks, appear to be interested in borrowing yen and using the proceeds to fund their operations. Corporations issuing Euroyen bonds have generally swapped the proceeds as a means of getting low-cost dollars; very few are willing to hold the proceeds of such bond sales in yen. Investor interest has also been limited, in part because of unfavorable yields relative to other investments, exchange rate risk, and the limited use of the yen as a transaction currency in world trade.

Increased investment and borrower interest in the yen will result from broader familiarity with yen investments and Japanese financial markets and will also be influenced by how quickly the yen develops as a transaction currency, a process likely to be slow and evolutionary.

The least progress under the agreement has been made in domestic capital market deregulation. There is continuing debate over the overall pace of interest rate deregulation. The Treasury contends that Japan should be proceeding at a faster pace than it has been, while the Ministry of Finance contends that the pace is dictated by the rigidities of the Japanese financial system and depositor safety considerations. Another factor slowing down the process is the Japanese government's concern over the cost of financing its budget deficit.

A timetable for removal of all interest rate regulation has yet to be established. The Ministry of Finance deregulated interest rates on time deposits of about \$2.8 million or greater in April 1986 and has expressed its intention to reduce the minimum denomination to about \$555,000 by spring 1987. Deregulation of small-scale deposits is expected to follow at a yet to be determined date. Deregulation of interest rates on smaller deposits will probably proceed gradually, with a major hurdle being how to deal with Japan's postal savings system, which accounts for about 30 percent of total domestic deposits and is under the control of the Ministry of Posts and Telecommunications and not the Ministry of Finance. The system has a number of competitive advantages over commercial institutions and will likely resist any efforts to reduce or appreciably alter its role as a financial intermediary.

There has also been little progress in enhancing the attractiveness of Japan's money market, which is widely perceived to be underdeveloped in terms of instruments and aggregate size. Growth of the bankers acceptances market after its introduction in June 1985 has been disappointing, in part because of Japanese government policies. Also, a short-term government bill market, a potentially attractive instrument, is only in the initial stages of being established with government auctions of 6-month bills taking place for the first time in early 1986. Unfortunately, current restrictions severely limit participants in the market. Movement has been slow, in part due to the Ministry of Finance's concern over possible shifts of funds from bank deposits with regulated interest rates to short-term government bills with unregulated rates.

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Since we had no recommendations in the report, the U.S. Treasury Department did not provide official agency comments on it (see app. III) but we did discuss the contents of our report with Treasury staff.

More detailed information is presented in the appendices. Appendix I discusses the events leading up to the agreement and appendix II reviews developments since the agreement was signed. Copies of this report are being sent to the Secretary and other Treasury Department officials and to other interested parties.



Frank C. Conahan  
Director



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**Abbreviations**

CD        Certificate of deposit  
GAO       General Accounting Office  
GNP       Gross national product

# Events Leading Up to Yen/Dollar Agreement

As U.S. trade deficits with Japan began to mount in the early 1980's, various U.S. manufacturers raised questions about the exchange rate policies of the Japanese government. Concern was expressed because of the difficulties that U.S. firms were having in competing against the Japanese, both in U.S. and overseas markets. It was generally felt that these difficulties were due in significant part to a misaligned exchange rate between the dollar and yen.

Frequent allegations were made that Japan was actively manipulating the yen for competitive purposes. In the fall of 1982, several congressional committees asked us to look into the allegations of yen manipulation and other questions involving the effects of government policies upon exchange rates. Our report, issued in April 1984, found that there was no support for charges that the Japanese government in the 1980's pursued a policy of deliberately undervaluing the yen relative to the dollar. Increases in the dollar's value against the yen during 1979-82 were comparable with its increases against other currencies, such as the West German mark, the British pound, and the Swiss franc. Market-determined exchange rates can adversely affect firms that engage in international trade. Because exchange rates react to many variables, the market-determined rate can diverge from a hypothetical exchange rate that depends only on relative trade flows and national inflation rates. Our report pointed out that capital flows, one such variable, have recently been taking on increasing importance for the yen/dollar exchange rate. For example, during 1981 and 1982, Japan's aggregate current account balance amounted to \$11.7 billion. Other things being equal, this positive balance in the current account would tend to put upward pressure on the yen. This positive balance, however, was overwhelmed by substantial net long-term capital outflows amounting to \$24.7 billion during the same period (see table II.6), reflecting Japan's savings surplus.

The gradual deregulation of controls during the 1970's may also have contributed to these substantial capital outflows.

During 1982 and 1983, major U.S. exporters continued to put intense pressure on the administration, believing they were being unjustifiably penalized by an overvalued dollar, particularly with regard to the yen. Pressure was being exerted to reduce the U.S. budget deficit, which many believed to be a major cause of the overvalued dollar, and to force Japan to take steps to strengthen the yen.

The President's visit to Japan in November 1983 was the impetus for the establishment of a joint ad hoc group of government financial authorities on yen/dollar exchange rate issues on November 10, 1983. A working group, chaired at the under-secretary level, was tasked with monitoring progress in implementing the agreement made at the November meeting and developing and implementing additional steps to be reported to the Secretary of the Treasury and the Minister of Finance in the spring of 1984.

The basic outline of the Japan-U.S. commitments in the yen/dollar agreement was set out at the time of the President's visit—Japan would continue efforts to liberalize its capital markets and internationalize the yen while the United States would pursue efforts to reduce the U.S. budget deficit as quickly as possible.

The yen/dollar agreement was issued on May 29, 1984, and basically reflects what both the U.S. Treasury and Ministry of Finance believed to be reasons for the perceived misalignment in the yen/dollar rate and measures to deal with it. In negotiating the agreement, Treasury took the view that because of Japan's many regulations in its capital markets, the yen/dollar exchange rate did not reflect the real value of the yen, given the underlying strength of the Japanese economy. Besides liberalizing the domestic capital market and increasing foreign access to Japan's financial services sector, the agreement provides for the establishment of a Euroyen investment and banking market. Reflecting the Ministry of Finance's belief that the U.S. budget deficit was the primary cause of the perceived misalignment in the yen/dollar rate, the United States agreed to continue to try to reduce the budget deficit while at the same time disputing any link between budget deficits, interest rates, and the dollar's strength.

## Liberalization Began in the 1970's

Some observers of the Japanese economy believe the yen/dollar agreement, although an important factor in the liberalization of Japan's capital markets, is serving only to accelerate a process which began during the 1970's. Japan's post-war financial system, based upon artificially low interest rates, strict separation of financial institutions into commercial or investment banking and long versus short-term lending, and a high level of financial intermediation through the banking system, was becoming increasingly outmoded, given international and domestic economic developments. The factors pushing Japan to liberalize its financial system include (1) changes in the flow-of-funds pattern resulting from the dramatic slowdown in economic growth rates during the 1970's

and 1980's, (2) the increasing integration of Japan with the world economy, in part a result of advancements in communications and transportation, (3) the shift from fixed to floating exchange rates during 1971-73, and (4) the growing consciousness of the Japanese public in interest rates in a slower growth economy.

Perhaps the most important factor is the change in the flow of funds resulting from a generalized slowdown in economic growth rates. As the economy slowed from the 10-percent-plus growth rates of the late 1950's and 1960's to the 3 to 5 percent rates in the late 1970's and 1980's, corporate investment demand decreased and the government deficit expanded. Public sector deficits as a percentage of gross national product (GNP) more than tripled during the 1970's and the banks, which were expected to purchase the debt, became increasingly reluctant to absorb the fast growing debt at what were artificially low interest rates. The volume of government bonds outstanding rapidly grew to about 40 percent of GNP by 1983. At the same time, corporate loan demand was declining, in part because of the fall-off in private investment. Exacerbating this situation was the increasing corporate reliance upon internally generated funds and direct borrowings. Due to these developments, the Ministry of Finance met with increasing bank resistance and was forced to make a number of concessions to market forces, including allowing banks to sell government bonds in the secondary market at market-determined interest rates.

Other important liberalization measures of the 1970's include formal acknowledgement of the short-term repurchase agreement market (gensaki market) based upon freely determined interest rates in 1976; establishment of a certificate of deposit (CD) market with freely fluctuating interest rates in 1979; access extended to non-residents to the repurchase agreement market in 1979; relaxation of restrictions on overseas capital market issues by Japanese corporations; and liberalization of the interbank market, i.e., call and bill discount rate market. Finally, an important liberalization measure was introduced in 1980 with an amendment to the foreign exchange control law which established the principle of the free flow of capital in and out of Japan unless specifically prohibited, reversing the previous principle of a general disallowance of capital movements unless specifically authorized.

The liberalization process therefore was already underway when the yen/dollar agreement was signed. Liberalization is believed to be in Japan's long-term interest. In addition to the fact that many Japanese believe the old system must respond to domestic and international

developments, many see liberalization as reacting to the need for (1) a more efficient capital allocation process, (2) more alternatives in funding and investments, (3) new monetary control instruments based upon freely fluctuating interest rates, and (4) an effective response to increased consumer demands for market-determined interest rates. There is also a recognition that unless Japan liberalizes, its financial institutions, which are already increasing their overseas activities, may be barred from foreign capital markets. Because of these considerations, some believe that elements in Japan's bureaucracy who favor liberalization are using U.S. pressure to help speed up the pace of capital market deregulation.

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## **Objectives, Scope, and Methodology**

Our objectives were to analyze Japan's progress in implementing the yen/dollar agreement and assess the likely benefits expected from the agreement.

We reviewed documents from the original yen/dollar negotiations and the minutes and documents in Treasury's files related to the three follow-up meetings between the U.S. Treasury Department and Japan's Ministry of Finance. We also interviewed government officials and private sector specialists in the United States, Japan, and Hong Kong. We did not evaluate the implementation of commitments made by the United States under the yen/dollar agreement with respect to domestic U.S. issues. Our review was made in accordance with generally accepted government audit standards.

# Implementation of the Yen/Dollar Agreement

Japan has completed or is still working on its commitments under the yen/dollar agreement. Pre and post-agreement liberalization measures have eliminated many institutional impediments to the yen's internationalization. Although these changes may contribute to a stronger yen in the medium to long-term, macroeconomic factors, such as the savings surplus and low inflation rate in Japan, will be more important determinants.

## Domestic Capital Market Deregulation

In the yen/dollar agreement, the Ministry of Finance affirmed its intention to liberalize Japan's capital markets, but in a manner which would avoid undesirable side effects for the domestic economy. The Japanese government has thus far met its timetable for commitments made under the agreement, including introducing money market certificates and yen bankers acceptances, expanding the CD market and reducing the minimum denomination, and lifting quotas on converting foreign currencies into yen. (See table II.1.) However, no progress has been made in the overall goal of deregulating interest rates on small deposits for which there is no timetable.

As can be seen in table II.1, the agreement provided only for relaxing and removing interest rate ceilings on large denomination deposits in 2 to 3 years. The Japanese deregulated interest rates on time deposits of approximately \$2.8 million or greater in April 1986 and indicated that rates on deposits of approximately \$555,000 will be deregulated by spring 1987.

**Appendix II  
Implementation of the Yen/Dollar Agreement**

**Table II.1: Implementation of Domestic Capital Measures\***

<b>Commitment</b>	<b>Measures taken</b>	<b>Future measures</b>
Greater flexibility in CD issues; reduce minimum denomination and issue maturity by April 1985.	April 1985 Minimum denomination reduced from about \$1.7 million to about \$555,000 and minimum maturity from 3 months to 1 month. (Maximum maturity extended to 1 year in April 1986).	Minimum denomination to be lowered to about \$278,000 in 1987.
Permit banks to sell new large denomination deposit instruments with market-determined interest rates by April 1985.	March 1985 Money market certificates introduced with minimum denomination of about \$278,000 and maturities of 1 to 6 months. (Maximum maturity extended to 1 year in April 1986.)	Minimum denomination will be lowered to about \$111,000 and maximum maturity extended to 2 years by spring 1987.
Establish yen bankers acceptance market. (No date given).	June 1985 Yen bankers acceptance market initiated.	•
Relax and remove interest rate ceilings on large denomination deposits in 2 to 3 years.	April 1986 Interest rates on time deposits of about \$2.8 million or greater deregulated and now market-determined.	Interest rates on deposits of about \$1.7 million or greater and \$555,000 or greater will be liberalized by Sept. 1986 and spring 1987, respectively. No timetable established for small denomination deposits.
Limits on financial institutions' conversion of foreign currencies into yen to be removed by June 1984.	June 1984 Limits removed.	•
Study the possibility of establishing a short-term government debt market.	February 1986 First auction of 6-month government bills took place.	•

\*Currency translations made at an exchange rate of 180 yen to \$1.00.

The U.S. Treasury Department would like to see the timetable for deregulating interest rates speeded up as well as greater development of Japan's money market. It contends that the yen would have a tendency to appreciate, due to a worldwide portfolio shift, if the Japanese money market were better developed and if more attractive money market instruments at freely fluctuating interest rates were available.

At a meeting of the Group of Five (United States, Japan, United Kingdom, France, and West Germany) in New York on September 22, 1985,<sup>1</sup> Japan said that it would intensify implementation of financial market liberalization and internationalization of the yen. A statement

<sup>1</sup> Participant countries at the meeting agreed to cooperate to encourage further appreciation of the main non-dollar currencies.

issued by the Treasury Department subsequent to that meeting indicates that it continues to be dissatisfied with the pace of market liberalization

A number of organizations, such as Data Resource Incorporated and the Organization for Economic Cooperation and Development, have cited the relative lack of domestic investment alternatives in Japan as a factor accounting for recent substantial capital outflows. For example, Japan's money market is underdeveloped compared with those of other industrialized countries. Although Japan's GNP and population are approximately twice the size of West Germany's, the aggregate size of Japan's money market at the end of 1983 amounted to \$91.25 billion in outstanding securities compared with \$214 billion in West Germany. Similarly, while Japan has a little over 50 percent of the population and nearly 40 percent of the GNP of the United States, Japan's money market equals only 10 percent of the size of the U.S. money market. (See table II.2).

**Table II.2: Comparison of U.S.-Japan Money Markets (December 1984)**

Market	Amount outstanding (billions)	Percent of total
<b>Japan:</b>		
Call	\$ 20.3	20.1
Bill discount	32.2	31.9
CD	34.1	33.8
Gensaki (Repurchase agreements)	14.4	14.2
	<b>\$101.0*</b>	<b>100.0</b>
<b>United States:</b>		
Treasury bills	\$ 374.4	36.0
Commercial paper	239.1	23.0
CDs and other time deposits in excess of \$100,000	160.6	15.4
Bankers acceptances	75.5	7.3
Other	191.5	18.4
	<b>\$1,041.1</b>	<b>100.0</b>

\*Yen translated into dollars at 248 yen to \$1.00 which was the average exchange rate for the month.

Aside from the aggregate size of the money market, the variety of investment instruments is also narrow. For example, prior to the recent development of money market certificates and the bankers acceptances market, Japan had only four money market instruments, only two of which (the gensaki and CD market) were open to investment by non-financial institutions; the other two, (call and bill discount markets)



were and are limited to financial institutions and, since they are currently used by the Bank of Japan for monetary policy, are not entirely free of official influence.

The absence of a well-developed money market has also been cited as one reason why the yen's use as a reserve currency is not commensurate with its economic standing.

Table II.3 shows that the use of the yen as a share of total foreign exchange reserves has increased but still remains far behind the currencies of the United States and West Germany.

Table II.3: Yen as a Reserve Currency

Percent	Share of world foreign exchange reserves - end of year			
	1977	1980	1983	1984
U.S. dollar	78.0	66.8	68.5	65.1
German mark	9.1	15.0	11.2	12.0
Japanese yen	2.4	4.4	4.7	5.2
Pound sterling	1.8	3.0	2.6	2.9
Swiss franc	2.2	3.2	2.3	2.0

A key element of the agreement was to develop the money market through the establishment of a yen bankers acceptances market to (1) enhance the attractiveness of Japan's money market and (2) increase the amount of yen-denominated trade.<sup>2</sup> Without a yen bankers acceptances market, Japanese importers were obliged to depend on the New York-based dollar acceptances market. This reduced the use of the yen in trade transactions and is a factor accounting for the lack of yen internationalization. Both objectives, however, are being frustrated. The bankers acceptances market got off to a bad start in June 1985 and by the end of that month amounted to only \$236.7 million compared with \$2.6 billion for money market certificates one month after being introduced in March 1985 and \$44.1 billion for CDs as of June 1985. There was no growth in the bankers acceptances market through late 1985 and bank officials continue to be pessimistic about its future prospects. The poor showing can be accounted for by (1) interest rates in the yen bankers acceptances market being higher than other short-term interest rates, giving no incentive for exporters or importers to use the market,

<sup>2</sup>Recent estimates are that only 34 percent of Japan's exports and 2 to 3 percent of its imports are denominated in yen. In contrast, in the United States and major European countries, 60 to 90 percent of exports and 36 to 85 percent of imports are denominated in their respective currencies.

(2) marketability in secondary market being temporarily hindered by failure to allow security firms to trade bankers acceptances until April 1986, (3) stamp tax on transactions reducing attractiveness of the market, and (4) banks reported reluctance to participate for fear of market evolving into a commercial paper market, which would compete for bank financing and further reduce the need for short-term bank lending. Although establishment of the yen bankers acceptances market is consistent with the letter of the agreement, a major objective of the agreement is not being realized because of the Ministry of Finance's failure to address these issues.

Another instrument considered by many to be integral to a well-developed money market and the internationalization of the yen is a short-term government bill market. In the United States, the Treasury bill market accounts for about 36 to 40 percent of the total money market. The Ministry of Finance has been issuing short-term government bills only as a cash management device to balance revenues and expenditures. Virtually all of the bills are purchased by the Bank of Japan at artificially low interest rates. In the yen/dollar agreement the Ministry of Finance agreed to study the issue of establishing a short-term government bill market, and in early 1986, it began government auctions of 6-month government bills to a limited number of participants. Two concerns have been holding up its development: the Ministry (1) fears that the banking system could be weakened by depositors shifting funds from bank deposits at controlled interest rates to the government bill market and (2) is reluctant to exchange a short-term funding device based on artificially low interest rates for one based upon market rates.

The Bank of Japan favors the early development of a short-term government bill market, which it would use as a monetary policy tool. In fact, the Bank is already reselling a portion of the bills at market rates to absorb excess liquidity in the market. These investments have been very popular with domestic and foreign investors because of their safety and liquidity and because they are exempt from securities transfer and withholding taxes and stamp tax. These sales by the Bank do not constitute the establishment of a true secondary market for short-term government securities, because the sales have been highly sporadic rather than public placements at frequent intervals.

The Ministry of Finance's program for a short-term government bill market provides for infrequent sales in denominations of at least about \$555,000. They are subject to withholding tax and only financial institutions or corporations are allowed to participate. Given these restrictions,

the market does not have the characteristics which have given U.S. Treasury bills such wide appeal as investment instruments. For example, U.S. Treasury bills are sold weekly to all investors for minimum denominations of \$10,000 and are not subject to withholding tax.

The large portion of government bonds maturing after 1985 and the need for refinancing is expected to increase the pressure on the Japanese government to liberalize issue rates on short-term government securities.

The Ministry of Finance's cautious approach to liberalizing the domestic financial system relates to its concern over the health and stability of the financial system as well as to political difficulties in liberalizing a system in which many participants have a powerful interest in resisting any change that threatens their exclusive rights.

Ministry authorities are concerned that deregulating domestic interest rates threatens the smaller, less efficient institutions, in part by narrowing the spreads between deposit and lending rates. Japan has not experienced bank failures since World War II, but recognizing the possibility, the Financial Systems Research Council (an official advisory body to the Ministry) recommended several steps to deal with bank failures. These include strengthening Japan's insurance deposit system and encouraging mergers among financial institutions.

Political pressure resisting change is also an important factor slowing down liberalization. According to one Japanese authority, many Americans, not fully understanding the consensus nature of decisionmaking in Japan, overestimated the clout and authority of the Ministry of Finance. Failure to develop such a consensus thus far has delayed liberalization. This authority believes that the consensus now exists.

A particularly difficult political and bureaucratic issue that is slowing down the process is how to treat the postal savings system in a deregulated environment. Under the authority of the Ministry of Posts and Telecommunications, the postal savings system accounts for about 30 percent of total savings deposits in Japan. Favorable tax treatment and a wide branch network account for the popularity of postal savings. Private banks fear that in a deregulated environment, as the margin between interest rates on deposits and loans shrinks, it will become increasingly difficult to compete against the postal savings system. The system has the advantages of not having to pay dividends to shareholders and freedom from reserve requirements and corporate tax. It

also enjoys considerable political support and will likely resist any efforts to reduce or appreciably alter its role as a financial intermediary.

It should be noted that Japan's low level of inflation, current high real interest rates, and large capital surplus may mitigate any upward pressure on domestic interest rates from market liberalization.

## Establishment of Euroyen Investment and Banking Market

The Treasury Department believes that the establishment of a completely free Euroyen market is the cornerstone of progress toward internationalizing the yen, largely due to the new investment and borrowing opportunities it would create. Unlike countries' domestic capital markets, the Euromarket is characterized by freedom from official regulations, such as interest rate controls, reserve requirements, and withholding taxes. In the yen/dollar agreement, the Ministry of Finance agreed to the development of a Euroyen market while indicating that care would be taken in implementing liberalization measures to avoid adverse effects upon Japan's economy and domestic financial system.

The Japanese government has met its timetable for commitments made in this area, as it has for liberalizing its domestic capital market. Effective December 1, 1984, private corporations, state and local governments, and government agencies were authorized to issue Euroyen bonds. A foreign security firm also could act as a lead manager, which would not be allowed in the equivalent German mark or Swiss franc market. Banks were authorized to issue Euroyen CDs from their offices outside of Japan, and the Ministry of Finance went beyond its commitments in the agreement by authorizing Japanese banks to extend medium and long-term Euroyen bank lending to non-residents. (See table II.4.)

Treasury Department officials told us that they are generally pleased with Japan's commitment to establish a Euroyen market and believe that the government has not interfered with those segments of the market which have been liberalized. Our discussions with market participants confirm this view. Nevertheless, Treasury has several concerns over how the Ministry of Finance is allowing the market to develop.

One area of contention, which has now been resolved, was the Japanese government's intention to maintain a withholding tax on Euroyen bonds issued by Japanese residents and held by foreigners. That government considered this necessary to maintain the integrity of its withholding

tax system. It became readily apparent that such a policy was not feasible in a market where withholding taxes are not the rule, since no Japanese residents issued Euroyen bonds after the liberalization. The Japanese government, demonstrating its commitment to develop a Euroyen market, finally agreed to eliminate the withholding tax on bonds held by foreigners in April 1985, and almost immediately resident Japanese firms started issuing Euroyen bonds.

Also, the Ministry of Finance continues to require a license, a requirement of the Foreign Exchange Control Law, for all Euroyen bond issues and the first issue of Euroyen CDs, i.e., a bank need apply only one time. Thus far, there are no indications that the Ministry has used this authority to prevent the market from developing. Market participants are satisfied that the Ministry has kept a hands-off attitude, with the licensing requirement appearing to be little more than a formality. However, its presence raises a concern that the Euroyen market is not as free as the Eurodollar market, which has no such requirement.

**Appendix II  
Implementation of the Yen/Dollar Agreement**

**Table II.4: Liberalization Measures in Euroyen Investment and Banking Market**

<b>Commitment</b>	<b>Date Implemented</b>	<b>Comment</b>
On Dec. 1, 1984, private corporations, state and local governments, and government agencies will be able to issue Euroyen bonds. All Japanese and non-Japanese firms will be able to lead or co-lead issues.	Dec. 1, 1984	•
Relax qualification standards by Apr. 1, 1985.	Apr. 1, 1985 Effectively qualifies corporation with credit rating of AA or better and about half the universe of A-rated corporate bonds.	Ministry of Finance is hopeful that credit ratings will replace qualification standards in the future. (Credit ratings for nonresident issues of Euroyen bonds were introduced in Apr. 1986.)
Euroyen issues by Japanese residents eased before yen/dollar agreement on Apr. 1, 1984.  Study issue of withholding tax on interest earnings by non-residents.	Apr. 1, 1985 Withholding tax on bonds issued by Japanese residents and held by non-residents removed.	•
Authorize foreign and Japanese banks to issue short-term negotiable Euroyen CDs from their offices outside of Japan by end of 1984.	Dec. 1, 1984 Banks authorized to issue Euroyen CDs of 6 months or less. (Maximum maturity extended to 1 year in Apr. 1986.)	Ministry of Finance advisory committee recommended in March 1985 that issue of medium and long-term CDs be liberalized.
Effective June 1984, banks can make Euroyen loans of less than 1 year to Japanese residents (loans to non-residents already authorized).	June 1, 1984	•
Ministry of Finance will ask an advisory committee for recommendations on liberalizing Euroyen lending with maturity in excess of 1 year.	Apr. 1, 1985 Going beyond commitments in agreement, Euroyen lending with maturities in excess of 1 year to non-residents is now permitted.	Advisory committee report of March 1985 recommends continuing study on liberalizing medium and long-term loans to residents because of concerns over impact on domestic financial system.

Euroyen bond activity appears to have increased rapidly as a result of the liberalization. (See table II.5). Before the December 1, 1984, liberalization only international organizations and national governments could issue Euroyen bonds. From 1977, when the first Euroyen bond was issued, to September 1984, 29 such bonds were issued; in the first 6 months after the December liberalization, about 30 were issued, over two-thirds by private corporations, state and local governments, and government agencies. Table II.5 shows that the dollar value of newly

issued Euroyen bonds is catching up with Euromarks and has passed Eurosterling but still lags far behind new Eurodollar issues. However, as discussed below, much of the increase does not represent a genuine increase in the foreign demand for yen because most borrowers have converted the yen proceeds into dollars. Moreover, during early 1985, many issues were unsold.

Table II.5: Eurobond Issues, by Currency

Millions				
Currency	1982	1983	1984	1985
U.S. dollar	\$43,959	\$38,428	\$63,593	\$97,782
Japanese yen	374	212	1,212	6,539
German mark	2,588	3,817	4,604	9,491
British pound	748	1,947	3,997	5,766
European currency unit	1,980	2,019	3,032	7,038
Other	1,996	2,078	3,020	10,129

Although progress has been made in establishing a Euroyen bond and banking market, the Japanese government is proceeding cautiously because of its concern over possible negative effects on the domestic financial system. To prevent commercial banks from taking advantage of the greater freedom in the Euroyen market and possibly upsetting the competitive balance between them and long-term credit banks in the domestic market, certain segments of the Euroyen market have not been liberalized. As in the domestic market, banks in the Euroyen market cannot issue debt instruments of greater than 1-year maturity and, while medium to long-term Euroyen loans can be made to foreigners, they cannot be made to Japanese residents. The medium and long-term funding limit on banks in turn limits medium and long-term Euroyen lending. In addition, the attractiveness of Euroyen bonds is restricted by limiting their original maturity to 5 years or more.

To protect the domestic issue bond market which is currently collateralized, i.e., domestic bond issues are secured by assets of the borrower, the Japanese government is limiting the number of Japanese firms that can issue non-convertible Euroyen bonds. Over 1,000 Japanese firms can issue bonds in Japan, but only about 60 of these firms can issue non-convertible Euroyen bonds. This policy serves to limit the Euroyen market's growth by reducing the potential number of participants.

Although these policies have slowed the Euroyen market's development, internationalization via the Euroyen market is being hindered by a more

basic problem. On the borrowing side, most of the proceeds of the Euroyen bond issues by foreign corporations have been swapped, i.e., exchanged for dollars with Japanese companies who have issued Eurodollar bonds. From December 1984 to May 1985, 77.7 percent of all issues were swapped. In this way, foreign companies have used the Euroyen bond market as a means to acquire low-cost dollars. The swapping of proceeds and liabilities has occurred basically for two reasons. First, non-Japanese companies have little need for the yen since most of their business is transacted in non-yen currencies, such as the dollar; second, these companies are reluctant to take on yen liabilities, because in many cases they do not have yen earning assets with which to hedge their liabilities.

According to one source, 60 to 70 percent of Euroyen issues remained unsold in early 1985. A substantial amount of bonds are not being held by foreign investors but are being warehoused for eventual sale into Japan after the mandatory 90-day waiting period. Because of Japanese investors' tendencies to hold investments until maturity, there is virtually no secondary market for Euroyen bonds.

Two basic problems that reduce both investor and borrower interest in the yen is unfamiliarity with yen investments and Japanese financial markets and the continued low use of the yen as a transaction currency in international trade. It has been estimated that the yen accounts for only about 1 to 2 percent of total world trade transactions, compared with 55 percent for the U.S. dollar, 14 percent for the German mark, and 7 percent for the pound sterling. The proportion of yen-denominated transactions is expected to increase in the future, but a primary vehicle for the increase, the yen bankers acceptances market, is slow in developing.

## Foreign Access to Japan's Financial System

The yen/dollar agreement, besides reaffirming Japan's commitment to equal treatment for foreign financial institutions, has opened up several new areas of business to foreign firms.

The concept of equal treatment was espoused prior to the yen/dollar agreement; Japan's 1982 Banking Law embodied the principle that foreign bank branches should be accorded equal treatment with Japanese banks. Our discussion with market participants and others indicates that the yen/dollar agreement has been instrumental in achieving what is now generally believed to be national treatment for foreign banks.



While the Treasury Department broadly concurs with our finding that, in general, national treatment has been achieved for foreign banks in Japan, it continues to express reservations over the application process for trading government securities which it believes continues to cause unnecessary and discriminatory delays. Specifically, the Treasury Department objects to the 1-year waiting period before government securities with maturities of over 2 years can be traded and the Ministry of Finance's apparent tendency to batch new requests for trading securities, which delays the processing of applications.

In the wake of the agreement, nine foreign banks were licensed to trade government bonds of less than 2-year maturities as of June 1985; in the same month, the Ministry of Finance announced the list of foreign banks eligible to participate in trust banking. Only eight Japanese banks are authorized to perform trust banking, which reflects Japan's highly segmented financial system. The Japanese originally took the position that the same number could be made available to foreign banks, fearing that a larger number would result in pressures to expand the number of Japanese participants and upset what they consider to be the domestic competitive balance. When nine foreign banks applied for trust licenses, all nine applications were approved and the banks have begun starting up operations.

Also at the start of 1986, the Tokyo Stock Exchange accepted 10 new members, reportedly the maximum possible because of limited floor space; six of the new seats went to foreign firms, including four firms controlled by U.S. interests.

Closely related to the issue of equal treatment is the question of transparency of rules and regulations for entry and operation in the Japanese capital market. In the agreement, the Ministry of Finance expressed its commitment to continue to promote transparency in the execution of its policies. Our discussions with cognizant officials in Japan indicate that transparency has improved. Rulings are sent to all foreign banks, and special meetings are held to explain more complicated issues. Problems still arise, but they appear to be more a result of misunderstandings, sometimes the fault of the banks, rather than any deliberate attempt to mislead. For example, some foreign banks recently complained about the lack of consultation on the new yen bankers acceptances market; according to one source, part of this problem was the lack of Japanese language ability among the foreign firms and the time pressures to get the market started. Contributing to the problem is the fact that in the absence of a unified organization representing all foreign banks, the

Ministry of Finance has to disseminate rulings and get feedback on proposed policies from the foreign banks on an individual basis. The creation of the Institute of Foreign Bankers in November 1984, comprising foreign banks with offices in Japan, may help to improve communications provided that the membership expands from the current 31 members. As of July 1985, there were 112 branches and 117 representative offices of foreign banks in Japan.

Over 80 percent of U.S. banks responding to the Japan Center for International Finance survey published in April 1985 believed that they would, on balance, benefit from domestic liberalization. Our discussions with market participants generally confirm this belief.

## Benefits Expected From Japan's Implementation of the Agreement

Increased access to Japanese savings is a major benefit to other countries of Japan's implementation of the agreement and deregulation of its capital markets. International bank lending from Japan increased steadily from \$2.6 billion in 1980 to \$11.9 billion in 1984 and accelerated rapidly after April 1984 when Japan removed all non-prudential limits on overseas yen lending from Japan. In 1984 as a whole, the yen was second only to the U.S. dollar as a loan currency. Approximately one-half of direct investments and loans by Japanese banks are directed to less developed countries.

Foreigners also gained greater access to Japanese savings through the bond market. As the Euroyen bond market was liberalized under the agreement, the samurai bond market (foreign bonds issued in Japan) was also liberalized in order to prevent a major shift of such financing to the Euromarket. The result has been an increase in samurai bond market activity. The value of foreign bonds issued in Japan exceeded comparable offerings in all other countries in 1984 except for the United States and Switzerland, and in 1985 exceeded the value of those issued in the United States. In this area, Japan is proving to be a reliable low-cost source of funds for borrowers.

Other major benefits stem from the increased access accorded foreign institutions to the potentially profitable Japanese financial services sector and apparent improvement in the operating environment for foreign institutions in Japan. Foreign financial institutions are already trading Japanese government securities and, at the start of 1986, six foreign security firms had acquired seats on the Tokyo Stock Exchange. Removal of limits on swapping foreign currencies for yen increased the flexibility of foreign banks for yen funding, which is a problem due to

the lack of a deposit base in Japan. In addition, elimination of the real-demand rule for foreign exchange transactions, i.e., that foreign exchange transactions must reflect trade transactions, expanded the foreign exchange market where, according to a Treasury representative, foreign banks account for about 20 percent of total market activity.

Foreign banks are also being given the opportunity to participate in trust banking, which has the potential of being very profitable the future. Japan's trust market is the fastest growing of any in the world and is second only to that of the United States in terms of fund volume.

Overall, discussions with market participants revealed an increased level of awareness and interest by the Japanese government about the needs and concerns of foreign banks in Japan. According to representatives of one major U.S. bank, the Japanese government has become much more accommodating and now often seeks out their views and opinions on policy issues affecting their operations.

According to several experts on the Japanese economy, the Japanese themselves should also benefit from the agreement in the following ways: (1) the Japanese public, particularly small savers who have borne a disproportionate share of the burden of regulated interest rates, should benefit by increased access to a greater variety of investment alternatives at market-determined rates when interest rate deregulation is complete, (2) economic efficiency of capital markets should increase due to a greater reliance on market forces and increased competition, and (3) Japanese financial institutions stand to gain domestically and internationally as the major intermediaries of Japan's capital outflows and as the primary suppliers of yen.

In the view of some experts, a major result of Japanese financial liberalization may be to make the Japanese as competitive in the financial services sector as they are in the industrial sector. In 1984, Japanese financial institutions already accounted for 5 of the 10 largest banks in the world in terms of assets. According to a survey of foreign banks in Japan performed by International Business Information, 15 of 17 respondents believed that Japanese securities firms or city banks benefited the most from the liberalization process while none believed that either foreign banks or securities houses benefited the most. A representative comment by a foreign bank official was that Japanese financial institutions are competing primarily among themselves in the domestic market and therefore stand to gain the most from liberalization. Similar

sentiments about the effects of liberalization on the international competitiveness of Japanese banks were expressed to us by foreign bankers in Hong Kong.

According to one of these bankers, Japanese financial institutions are more powerful than any in Euroyen financing and will become even more so with the yen/dollar agreement. According to this banker, Japanese banks have better access to yen deposits and borrowers will usually go to a Japanese institution if they want to borrow yen. Another speculated that by opening up Euroyen activity and promoting the international role of Japanese banks, the Ministry of Finance is compensating the banks for the limited domestic opportunities for growth. All of these foreign bankers found increasing interest throughout Asia in yen financing and investments, especially among the central banks.

Much attention has been focused on how the yen/dollar agreement will affect the exchange rate of the two currencies. Treasury Department officials expect that a greater array of yen investment opportunities at market-determined rates will increase the demand for yen and therefore its value.

The agreement may help the yen to reflect more fully its underlying value; however, this will likely be a long-term process as the Euroyen and Japan's money market develop. Furthermore, while opportunities for investing in yen will grow, increased interest will depend on continued strong economic fundamentals in Japan, such as stable growth and prices, and on a stable world trading environment. While both conditions may be expected, they are by no means guaranteed. For example, being the most internationalized currency and having a wide array of investment alternatives domestically did not prevent the U.S. dollar from undergoing a prolonged period of depreciation during the late 1970's, a period of high inflation in the United States.

For the foreseeable future, any effect of financial liberalization upon the yen's value will likely be overshadowed by other macroeconomic factors, such as the savings surplus and low inflation rate in Japan. Many market participants in Japan with whom we spoke, including economists, senior government and bank officials, and other financial experts, concurred with this conclusion.

The Japanese are among the most prolific savers in the industrialized world. Their savings rate continues to run around 17 to 18 percent, despite the fact that domestic growth rates decelerated from 10 percent

and higher in the late 1950's and 1960's to about 3 to 6 percent in the early 1980's.

With a decline in private investment demand for funds and liberalization of international capital flows, part of the savings surplus was absorbed by a large increase in long term capital outflows during 1979-85. (See table II.6.) These capital outflows helped to depress the yen's value. There are no apparent prospects for a significant reduction of either the savings surplus or net capital outflows.

**Table II.6: Long Term Capital Flows**

Billions			
Year	Capital outflows	Capital inflows	Net Inflow (+) or outflow (-)
1979	\$-16.29	\$ 3.32	-12.98
1980	-10.82	13.14	+ 2.32
1981	-22.81	13.14	- 9.67
1982	-27.42	12.45	-14.97
1983	-32.46	14.76	-17.70
1984	-56.77	7.12	-49.65
1985	-82.10	17.29	-64.81

# Letter From the U.S. Treasury Department



DEPARTMENT OF THE TREASURY  
WASHINGTON

APR 15 1986

Dear Mr. Conahan:

Thank you for the opportunity to comment on the draft of your report on the implementation of the yen/dollar agreement. We appreciated the chance to discuss the report informally at the staff level, and we hope that discussion was helpful. However, as the report contains no recommendations, the Treasury Department will have no formal comment on it.

Sincerely,

A handwritten signature in black ink that reads "Thomas J. Berger".

Thomas J. Berger  
Deputy Assistant Secretary  
International Monetary Affairs

Frank C. Conahan, Director  
National Security and  
International Affairs Division  
General Accounting Office  
Washington, D.C. 20548

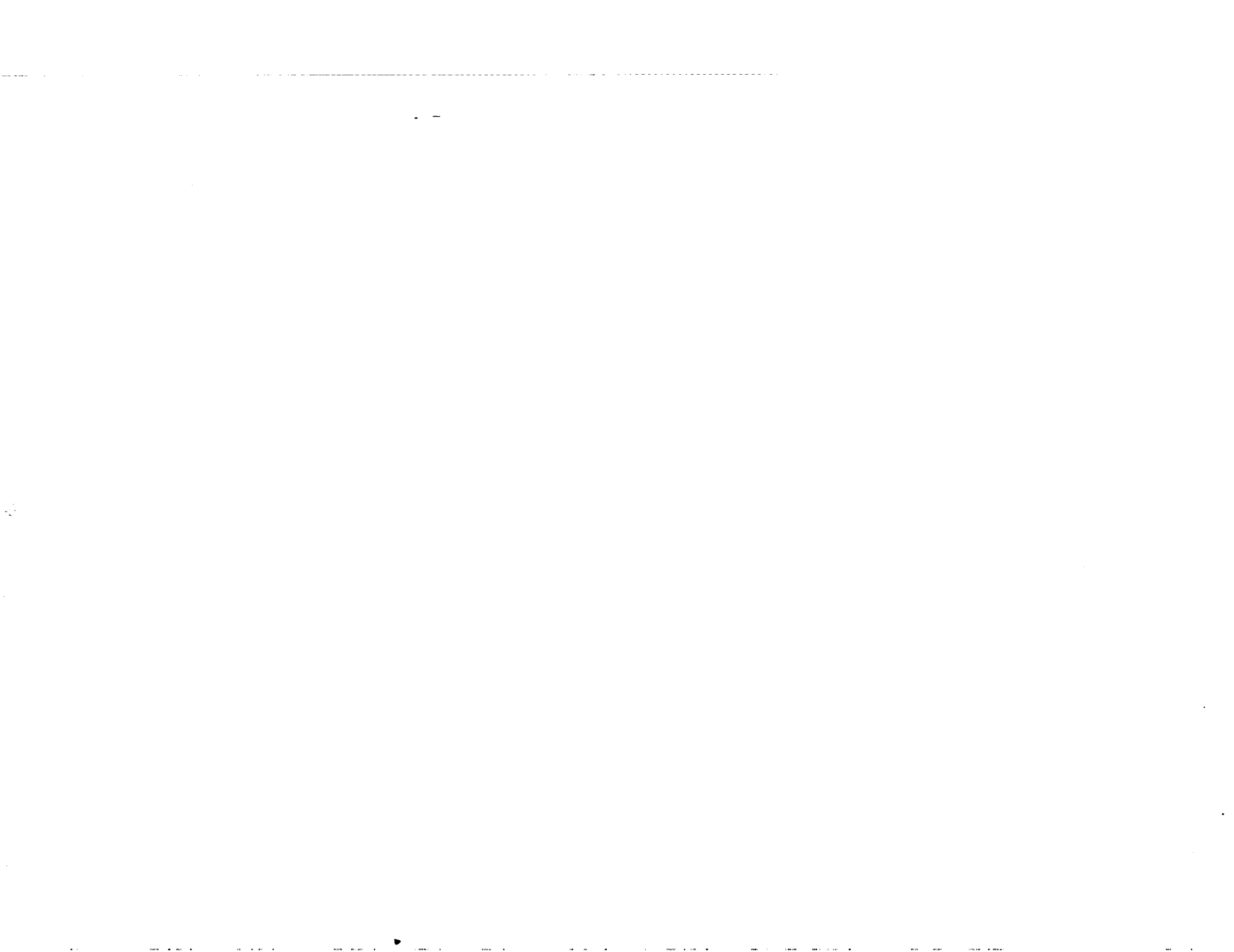
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# Glossary

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<b>Bankers Acceptance</b>	An order in the form of a draft addressed by one party (drawer) to a bank (drawee) and accepted by the bank to pay a third party (payee) a certain sum at a specified future date. The underlying commercial transaction in such financing is typically between exporters and importers. An exporter who receives a bank's commitment or "acceptance" of a draft can sell it at a discount to other investors.
<b>Bill Discount Market</b>	A market in which written orders to pay a sum of money are purchased or sold before maturity at a reduction based on the interest still to be earned. The participants in the market are limited to financial institutions in Japan, including the Bank of Japan which uses the market for implementing monetary policy.
<b>Call Market</b>	Similar to the federal funds market in the United States, in which banks make short-term, often overnight, loans to one another. As with the bill discount market, participants are limited to financial institutions.
<b>ECU</b>	Short for European currency unit, which is a unit of account developed from an arithmetical average of the exchange rates of a number of European currencies.
<b>Gensaki Market</b>	Japanese repurchase agreement market (see below).
<b>Non-Coverible Bond</b>	A bond which cannot be converted into shares of stock of the issuer.
<b>Repurchase Agreement</b>	Conditional purchase (or sale) of a government or corporate bond for a fixed period of time with a resale (or repurchase) agreement at a specified price.
<b>Secondary Market</b>	Market in which previously issued securities, such as government and corporate bonds, are purchased or sold.
<b>Trust Banks</b>	Banks in Japan which have the sole authority to manage corporate pension funds; they are suppliers of long-term funds to industries.

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