

# The Japanese Financial Diplomacy in the Globalising International Financial Regime

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## Preface

This dissertation is the result of my own work and includes nothing which is the outcome of work done in collaboration except as declared in the Preface and specified in the text.

It is not substantially the same as any that I have submitted, or, is being concurrently submitted for a degree or diploma or other qualification at the University of Cambridge or any other University or similar institution except as declared in the Preface and specified in the text.

I further state that no substantial part of my dissertation has already been submitted, or, is being concurrently submitted for any such degree, diploma or other qualification at the University of Cambridge or any other University of similar institution except as declared in the Preface and specified in the text

It does not exceed the prescribed word limit for the relevant Degree Committee.

This work is heavily indebted to the always great guidance and support given by my two current and past supervisors, Mr. John Forsyth and Mr. Massimo Max Baber, without which I would not be able to accomplish my work. I would like to take this opportunity to thank them for their great support.

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# The Japanese Financial Diplomacy in the Globalising International Financial Regime

## Introduction

1. Regional Financial Cooperation in the aftermath of 1997-1998 Asian Financial Crisis in the globalising international financial regime
  - 1-1 Asian Financial Crisis and Asian Monetary Fund
  - 1-2 Chiang Mai Initiative
  - 1-3 Asian Bond Market Initiative
2. The dominance of US-Japan relationships in the Japan's financial diplomacy
  - 2-1 The Plaza and Louvre Accord era in the late 1980s
  - 2-2 "Awkward partnership" between the US and Japan under the Clinton Administration and the Asian Financial Crisis
  - 2-3 Prolonged deflation and the bad loan problem in the Japanese financial sector in the late 1990s
  - 2-4 Political economy of foreign exchange policy and the increasing tension against China
3. Globalisation of financial and fiscal policies and new form of international policy coordination
  - 3-1 New form of international policy coordination from macroeconomic policy to financial regulation and fiscal codes
  - 3-2 Transcending the regional integration: Transformation of the role of G7 and its role in the new framework of G20 – the meaning of G7 for Japan
  - 3-3 Emergence of the new alliance between the US and Japan?
4. Conclusion

## Introduction

Financial diplomacy has been one of the areas which have reflected the economic and political changes facing the Japanese economy and the Japanese Ministry of Finance. Leading up to the culmination of the development and expansion of the presence of the Japanese economy in the late 1980s, the Japanese financial diplomacy was oriented towards strengthening the relationship with the US. The relationship between Japan and the US was a cornerstone of the financial diplomacy since 1945 in the sense that the US had enjoyed a dominant position in the international financial regime and the US and Japan maintained the special diplomatic relationship under the Japan-US Security Treaty.

In the 1980s, the Japanese financial diplomacy was characterised by the cooperation with the international efforts to coordinate macroeconomic policy and foreign currency policy. The US called for international macroeconomic policy coordination at the G7. Then the Japanese financial diplomacy was oriented towards forming the G2 special relationship between Japan and the US and thereby increasing the presence of Japan in the international financial regime with the G7 a central forum to formulate international financial cooperation.

In the 1990s, especially after the advent of the Clinton administration, the US saw Japan as an economic rival rather than an economic and military ally after the end of the cold war. As it was increasingly clear that the Japanese economy was mired with the bad loan problem, the US attached the less importance on the strengthening of the relationship between the US and Japan. The US looked at China as the new opportunity to expand their business in the Chinese market. When the Asian Financial Crisis hit the South-East Asia, the US was not very keen to take an initiative in rescuing the ailing Asian countries and stabilising the Asian financial markets. They were sceptical about the effectiveness of coordinated efforts to contain the financial crisis and still believed that the ailing Asian countries would need to complete liberal economic reforms including deregulation and opening financial and trade regimes. Faced with the Asian Financial Crisis, the

Japanese Finance Ministry play a proactive role in taking the initiative to strengthen the framework to make the regional financial system more resilient to financial crisis. It could be argued that this was an attempt by Japan to establish the regional hegemony in the regional financial regime, but in fact, this was led by the strong sense of responsibility that Japan would need to contribute to the stability of both the international economy and the Asian economy based on the awareness that Japan would be the only country capable of doing that in Asia.

After the financial crisis in 2008, the G20 has increasingly become a dominant forum to discuss the international policy coordination in the international monetary and fiscal policy. While G7 has played a central role in foreign currency policy, the G7 has been increasingly less influential as a forum to formulate the international policy coordination. The emergence of China as the second largest economy has influenced the relationship between Japan and the US in the financial diplomacy.

The purpose of this dissertation is to examine the Japanese financial diplomacy from the viewpoint of the Japanese Ministry of Finance, which has played a central role in setting out the international economic and financial policy framework in the international financial regime between the late 1980s and now.

## Chapter 1: Regional Financial Cooperation in the aftermath of 1997-1998 Asian Financial Crisis in the globalising international financial regime

### 1-1 Asian Financial Crisis and Asian Monetary Fund

The Asian Financial Crisis represents a watershed in the on-going debate over the role of regional financial cooperation vis-à-vis global financial architecture. The Crisis raised the awareness among the majority of East Asian countries of the need to create and strengthen regional financial cooperation as a means of securing regional financial stability. The momentum of strengthening regional initiative was driven by the awareness of instability of global financial structure and the lack of financial mechanism which sufficiently support the countries in need in Asia.

The creation of an “Asian Monetary Fund” proposed by the Japanese Ministry of Finance was the culminating point of the momentum to promote financial cooperation in the region. The proposal of “Asian Monetary Fund” was not realised mainly due to the opposition of the United States. The concept was to some extent reformulated when the finance ministers of ASEAN countries plus Japan, China and South Korea (ASEAN plus 3) agreed to establish a regional mechanism of bilateral swap arrangements within ASEAN plus 3 countries on May 2000 in Chiang Mai, which is now called “Chiang-Mai Initiative”.

While it was true that there was growing momentum of establishing new regional policy framework to strengthen financial cooperation, it does not necessarily mean that the Japanese financial diplomacy was more oriented towards regional cooperation than globalised financial cooperation. In fact, the Japan’s financial diplomacy was already increasingly oriented towards global cooperation. The Asian Financial Crisis accelerated the momentum towards not only regional financial cooperation, but also global policy coordination such as the creation of the Financial Stability Forum.

The Asian Financial Crisis broke out in July 1997 with the collapse of

Thailand's currency, the baht. It was subject to speculative attack and then did spread to other regional countries including Indonesia, Philippines, Malaysia, and even South Korea. These currency crises led foreign investors to withdraw their money invested towards these countries. The crisis-hit countries were all forced to turn to the IMF for financial support to restore investors' confidence in their respective economies.<sup>1</sup>

The IMF's approach to the crisis was based upon the so-called "Washington consensus" underpinned by a neo-liberal ideological position. According to this view, markets are the most efficient way through which to allocate resources and create wealth. This approach put emphasis on a constellation of virtues of free market, free flow of trade and capital across the borders, macroeconomic policy management characterised by sound monetary, fiscal prudence and limited role of governments. There was a tendency in the IMF to point to some underlying macroeconomic weaknesses such as current account and fiscal deficits, overvaluation of the currency and relative price distortions caused by overvalued currency.

The IMF's programmes had three main components: financing, macroeconomic policies, and structural reforms. In terms of financing, USD 35 billion of IMF financial support was provided for adjustment and reform programs in Indonesia, Korea, and Thailand, with the assistance for Indonesia being augmented further in 1998-99. In terms of macroeconomic policies, monetary policy was tightened (at different stages in different countries) to halt the collapse of the countries' exchange rate and to prevent currency depreciation from leading into a spiral of inflation and continuing depreciation. Finally, in terms of structural reforms, steps were taken to address the weaknesses in the financial and corporate sectors.<sup>2</sup>

The contentious issues were concerned with to what extent structural reforms and macroeconomic policy reforms would be necessary and appropriate as the prescription policy measures to tackle the Asian Financial Crisis then. The IMF was of the view that structural reforms were

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<sup>1</sup> "The Political Economy of the Asian Financial Crisis", Stephan Haggard, Institute for International Economics, 2000, p.47-86

<sup>2</sup> "The recovery from the Asian Crisis and the role of the IMF", June 2000  
<https://www.imf.org/external/np/exr/ib/2000/062300.htm>

clearly needed to restore confidence on a firm basis, by addressing some of the root causes of the crises, especially financial sector and corporate issues. For example, in terms of financial sector report, the IMF tried to implement the policies including the following four elements:

- the closure of insolvent financial institutions, to stem further losses;
- the recapitalization of potentially viable financial institutions, often with government assistance;
- close central bank supervision of weak financial institutions; and
- a strengthening of financial supervision and regulation, to prevent a recurrence of the fragilities that had led to the crisis, the objectives being to restore the health of financial institutions and bring supervision and regulation up to international standards.<sup>3</sup>

In addition, the IMF claimed that the need for corporate debt restructuring, including the establishment of viable workout mechanisms, was also considered to be an essential component for the restoration of the health of the financial system. In addition, other reforms promoted by the IMF included:<sup>4</sup>

- efforts to shield poor and vulnerable sections of society from the worst of the crisis, by deepening and widening social safety nets and (notably in Indonesia) devoting substantial budgetary resources to increasing subsidies on basic commodities such as rice; and
- measures to increase transparency in the financial, corporate, and government sectors.

From the Japanese Ministry of Finance's point of view, the sufficiency of financing is key to the restoring the confidence of investors. As IMF also acknowledged, the Asian crisis countries' estimated financing needs were

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<sup>3</sup> Ibid.

<sup>4</sup> Ibid.



heavily dominated by the capital account and in particular the assumed rollover rate on short-term foreign debt with the denomination of the US dollar. The size of the short-term liabilities was such that it was essential that creditors roll over at least a good part of their positions.

From the IMF's point of view, structural reform packages and tightening macroeconomic policies were intertwined with their financing rescue packages and were intended to restore confidence and limit private capital outflows. In the IMF's assessment, several factors contributed to weak confidence, including hesitant program implementation, political uncertainties, and other factors casting doubt on the authorities' ownership of the programmes. But, the IMF did not change its view that structural reforms in particular were essential.<sup>5</sup>

The Japanese Ministry of Finance considered that the IMF does not have sufficient expertise on all the elements included in the structural reforms. They considered that the IMF's approach was misguided and the IMF pushed a number of policy measures, which were irrelevant to the restoring confidence in the short-term at least and ended up in exacerbating the crisis. For example, while the IMF pressed crisis-stricken countries to raise the interest rate and tighten monetary and fiscal policy, the Japanese Ministry of Finance considered that it was not an appropriate policy response at that time.<sup>6</sup>

However, the Japanese Ministry of Finance did not seek to take a regional initiative at least from an early stage, but rather tried to play a role as mediator between the IMF and the crisis-stricken Asian countries. For example, Prime Minister Hashimoto visited Indonesia March 1998, after the negotiation between the Indonesia and the IMF collapsed. Before the visit by the Japanese Prime Minister, the U.S. also sent Former Vice President Walter Mondale as a special envoy to press the then Indonesian President Haji Mohamed Soeharto to carry out the radical political reform.

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<sup>5</sup> Ibid.

<sup>6</sup> Sakakibara, E. (2005), "Nihon to Sekai ga Furueta Hi" ("The Day that Rocked Japan and the World"), Krugman, P. "Confidence Game – How Washington worsened the Asia's crash" <http://www.pkarchive.org/crises/krugman1.html>; Krugman, P. R. (1998, January). "What Happened To Asia?" from <http://web.mit.edu/krugman/www/DISINTER.html>.

In August 1997, the Japanese Ministry of Finance floated the idea of the Asian Monetary Fund, after the agreement was reached between the IMF and Thailand on 29 July, 1997. On 2 July, 1997, Thailand announced that they would change their currency regime to floating regime, which was followed by the currency attack by international investors and resulted in rapid depreciation of Thai Baht in a short period of time. Thailand asked the IMF and Japan for the provision of liquidity on 28 July, 1997. Japan announced the commitment of USD 4 billion, the same amount as the IMF, on the following day, which was the largest amount as a bilateral aid.

This swiftness of the Japanese Ministry of Finance on Japan's commitment of as much as USD 4 billion was based upon its view that Japan was the greatest stakeholder in the South East Asian economy and the economic turmoil of that region would have serious impacts on the Japanese economy including the Japanese industries. For example, according to the 1998 Trade and Commerce White Paper, the Japanese subsidiary accounted for around 40% of the machine exported from ASEAN 4 countries (Thailand, Malaysia, and Indonesia and Philippines). The importance of the South East Asian economy to Japan was unparalleled with any other country.

The Japanese Ministry of Finance started informally floating the idea of Asian Monetary Fund after the special meeting aimed at discussing the support programme towards Thailand held in Tokyo on 11 August, 1997. The idea of Asian Monetary Fund came from the argument that a similar facility to the ADB as a regional development bank in relation to the World Bank could be effective in Asia also in terms of the facility of providing short-term loan to facilitate the structural economic reform in recipient countries.<sup>7</sup> On 11 August, 1997, the Japanese Ministry of Finance did not invite the U.S. to make a financial commitment to Thailand. According to the book later published by Robert Rubin, there was a discussion internally within the U.S. administration as to whether the U.S. should also make financial commitment. But, the US did not make a commitment then, as they were not sure if there would unforeseen problem at a later stage and

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<sup>7</sup> Sakakibara, E. (2010)

decided that they should preserve that option.<sup>8</sup>

In his book, he described the two types of moral hazards. The first one is the “moral hazard” of the recipient countries to encourage them to borrow unwisely or adopt unsound policies. The second one is the “moral hazard” of investors, who made excessive and undisciplined investment. Robert Rubin saw the second a more serious concern. He described *“Part of the issue in Thailand had clearly been excessive and undisciplined investment from the developed world. “Rescuing” could encourage lenders and investors to give insufficient weight to risk in pursuit of higher yield in other developing countries and undermine the discipline of their market-based system”*.<sup>9</sup>

Eisuke Sakakibara admitted that the idea of AMF assumed that it did not include the participation of the U.S. He guessed that the idea of AMF without the participation of the U.S. was taken as a challenge towards the U.S. leadership or hegemony in the international finance by Japan. At least, the Japanese Ministry of Finance put priority on the need to regain the confidence of market by announcing the sufficient size of financial commitments and the reached agreement between the IMF and Thailand on economic policy reforms on 18 August, 1997.<sup>10</sup>

In fact, the proposal of Asian Monetary Fund by the Japanese Ministry of Finance was made only after they realised that the IMF approach was not appropriate to contain the currency attack waged by international investors. Even before the Thailand made a formal request of financial assistance towards the IMF on 29 July, 1997, Thailand informally requested financial assistance such as establishing the financial commitment lines between central banks to the Japanese Ministry of Finance. However, the Japanese Ministry of Finance found that there was not sufficient disclosure of various information such as the amount of foreign reserves left, how the government agency intervened in the foreign exchange markets to protect their currency so far. Japan had no choice but to rely on IMF to give further

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<sup>8</sup> Rubin, R and Weisberg (2003), J. *“In an Uncertain World”*, Random House, p.220

<sup>9</sup> Ibid. p.218

<sup>10</sup> Sakakibara, E (2005), p.180-185

pressure to the Thailand government authorities to disclose more relevant information.

There was a difference of the sense of imminence between Japan and the U.S. Like the IMF, the U.S. Treasury was of the view that to restore the confidence of international creditors, the Thailand's government would need to address both macroeconomic problems and structural flows in the economy – not just its overvalued currency but also its weak financial sector, which had contributed to a real estate and investment boom financed in foreign currency.<sup>11</sup> On the other hand, Japan was of the view that the Asian Financial Crisis was mainly driven by not so much macroeconomic fundamentals as abrupt movement of short-term capital flows. In the Japanese Ministry of Finance's view, more priority should be given to establishing a framework with financial commitments which would provide short-term liquidity as quickly as possible to restore confidence of international confidence rather than acquiescing even partial default.

The proposal of the so-called Asian Monetary Fund was made only after the Japanese Ministry of Finance realised that the IMF and the U.S. were reluctant to establish a framework with financial commitments which would provide ailing Asian countries with sufficient short-term liquidity. The Japanese Ministry of Finance saw sudden outflow of short-term capital from crisis-stricken countries and contagious impacts on other neighbouring countries across country borders, which resulted from declining confidence of foreign investors, as the major key features of the Asian Financial Crisis. This was especially distinctive from the Latin American Financial Crisis in 1995, which mainly derived from more traditional type of current account deficits problems.<sup>12</sup>

On the other hand, as Sakakibara pointed out in his book, the Japanese Ministry of Finance understood that their proposal of establishing a regional framework with financial commitments to restore market

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<sup>11</sup> Rubin, R. (2003, p.219)

<sup>12</sup> Report of Council on Foreign Exchange and Other Transactions, "Lessons from the Asian Currency Crisis – Risks Related to Short-Term Capital Movement and the 21<sup>st</sup> Century-Type Currency Crisis" Japanese Ministry of Finance, 19 May, 1998  
[https://www.mof.go.jp/about\\_mof/councils/gaitame/report/1a703.htm](https://www.mof.go.jp/about_mof/councils/gaitame/report/1a703.htm)

confidence was taken by the US as the Japan's attempt to take this opportunity to establish itself as a regional hegemony challenging against the U.S. At least from the Japanese Ministry of Finance's point view, the initiative of creating the AMF was rather more defensive in the sense that the major objective was to institutionalise the financial assistance mechanism capable of providing liquidity in a flexible manner and ultimately to reduce spill-over effects of economic and financial turmoil of the stricken countries to the extent possible.

The IMF World Economic Outlook in May 1998 summarised the basic ingredients of the IMF-supported programmes in Indonesia, Korea and Thailand as below:<sup>13</sup>

- *Monetary policy must be kept sufficiently firm to resist excessive currency depreciation, with its damaging consequences not only for domestic inflation but also for the balance sheets of domestic financial institutions and nonfinancial enterprises with large foreign currency exposures. Excessive depreciation, by weakening the competitiveness of partner countries' currencies and contributing to downward pressure on them, also adds to the risk of a downward spiral of competitive depreciations, which bring no benefit to any country and monetary instability to all. As fundamental policy weaknesses are addressed and confidence is restored, interest rates can be allowed to return to more normal levels. Indeed, in Korea and Thailand some easing of monetary conditions has already been possible. But experience—including in the Asian crisis—shows that premature easing can be costly.*
- *Weaknesses in the financial sector are at the root of the Asian crisis and require particularly urgent attention, including a clearly announced reform agenda in each case. These weaknesses have arisen partly as a result of a variety of explicit or implicit government guarantees that encouraged excessive exposure to foreign exchange and other risks by financial institutions and their customers, and contributed to reckless lending. (These problems are*

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<sup>13</sup> IMF (1998), World Economic Outlook May 1998, p.6

*not confined to Asia; they are widespread globally.) In many cases, weak but viable financial institutions will need to be restructured and recapitalized. Insolvent institutions will need to be closed or absorbed by stronger institutions to facilitate the restoration of confidence. Public sector rescue operations should be carried out in the context of comprehensive restructuring strategies that contain costs to taxpayers—partly by ensuring that equity holders, bond holders, and other lenders share losses appropriately—and tighten prudential regulations and oversight.*

- *Improvements in public and corporate governance and a strengthening of transparency and accountability are also essential. Recent difficulties in part reflect extensive government intervention in the economy and widespread political patronage, nepotism, and lax accounting practices. Strong and unambiguous signals from political leaders that such practices will no longer be tolerated, and the adoption of appropriate reforms, are critical to restoring confidence.*
- *Fiscal policies need to contribute to reductions in countries' reliance on external saving and to take into account the significant costs of restructuring and recapitalizing banking systems. While fiscal discipline is maintained, resources will need to be reallocated from unproductive public expenditures to spending that can help to minimize the social costs of the crisis, including the strengthening of social safety nets. The required degree and composition of fiscal adjustment will vary depending on circumstances in individual countries, and in the IMF-supported programs fiscal targets have been adjusted as circumstances have changed and been reassessed. A balance has to be struck between the need to restore macroeconomic stability (and to reassure domestic and foreign investors on that count) and the need to ensure that domestic demand is not unduly compressed.*

The IMF considered that IMF financing could increase incentives for risk taking by both potential borrowers from the IMF and by lenders to

countries without a certain set of conditions. In their view, moral hazard is a concern which has been a key in the design of IMF programmes with countries at the centre of the Asian Financial Crisis and was preoccupied with the risk of moral hazard and how to prevent such moral hazard from prevailing in the borrowing countries.<sup>14</sup>

In order to prevent moral hazard, the IMF stressed structural problems inherent in economic and financial systems. They saw the weaknesses in the financial sector as a key element of the Asian Financial Crisis. For example, they considered that there was not a sufficiently robust financial system underpinned by effective regulation and supervision of financial institutions in Asia. Large private capital flows to Asia were driven to a great degree by an underestimation of risks by international investors who searched for higher yield. Exchange rates pegged to the US dollar contributed to giving investors implicit guarantees and encouraged them to take excessively high risks. From the IMF's point of view, weak management of poor control of risks, lax enforcement of prudential rules and inadequate supervision, and associated relationship and government-directed lending practices led to a sharp deterioration in the quality of banks' loan portfolios. In their view, weakness in the financial sector was closely linked with the underdevelopment of governance structure of the financial supervision, which was susceptible to the intervention by politics such as the inner circle aides of the president and the prime minister.<sup>15</sup>

From the Japanese Ministry of Finance point of view, the implementation of reforms and other confidence-repairing measures in accordance with the IMF's recommendations worsened the crisis by causing currency and stock markets to decline and disrupt industrial activities and the whole economy well beyond what was justified by reasonable reassessment of economic fundamentals. The Japanese Ministry of Finance considered that the IMF's approach stressing structural reforms exacerbated the panic and added to the difficulties in both the corporate and financial sectors by undermining the investors' confidence. In their view, how to restore "confidence" was a

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<sup>14</sup> IMF (1998), World Economic Outlook May 1998, p.6-8

<sup>15</sup> Ibid. p.3.

key point at the time of confidence. On the other hand, in the IMF's view, a wide range of measures described above ranging from tightening macroeconomic policies to overhauling financial systems were necessary to restore confidence and support a resumption of growth. Conversely, the Japanese Ministry of Finance saw the Asian Financial Crisis as a different type of crisis from conventional financial crisis in the sense that investors became much more sensitive to taking the perceived risks and tended to overreact as sentiment changed with the increasing globalisation of financial markets and development of financial technology.

At the time of the crisis, at least until it turned out that South Korea was also caught in a financial crisis, the US overall shared the view with the IMF in the sense that they were more concerned about the possible moral hazard by ailing Asian countries. The US considered that giving the financial support without addressing structural reforms would lead to undermining the discipline of the market-based system by rescuing the investors who gave insufficient consideration to risk in pursuit of higher yield in Asian countries. The difference between the US and Japan is characterised by the choice between swift action of liquidity provision and addressing moral hazard more fundamentally. The latter option would entail encouraging long-term reform and stringent conditionality, while the former would do encouraging short-term reform such as capital controls.

Under these circumstances, the proposal of Asian Monetary Fund emerged as a result of divergence between the Japanese Ministry of Finance and the US Treasury/the IMF.<sup>16</sup> This proposal was not so much the ambition by Japan to seek geopolitical influence as a regional hegemon, as the attempt to present a more practical solution to resolve the Asian Financial Crisis as quickly as possible and contribute to the stability of international financial markets. The IMF's policy advice sought to ensure to the extent possible that the parties to private transactions bear the cost of their transactions. On this basis, the IMF programmes included the closure of insolvent financial institutions. In the Japanese Ministry of Finance's view, requiring private creditors to assume a certain share of the burden at the time of a financial

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<sup>16</sup> Lipsy, P. (2003), 'Japan's Asian Monetary Fund Proposal', 3 (2003) Stanford Journal of East Asian Affairs 93–104.



crisis would not serve to restore the confidence of the international market, but rather deteriorate it.

At the time, the policy stances of the US Treasury on the Asian Financial Crisis were rather a patchwork. On the one hand, the US Treasury expected Japan to play a leadership role in solving the Asian Financial Crisis and called on Japan to put its domestic economic and financial crises in order. The US was increasingly pressing Japan to take more comprehensive and bold reforms to ensure Japan's economic recovery, which they considered was a key to the entire global economy. From the Japanese Ministry of Finance's point of view, the idea of the Asian Monetary Fund was based on their awareness of the role of Japan to take an initiative in preventing the contagion of the Asian Financial Crisis from spreading to other region and contributing to the stability of international financial markets. On the other hand, the US Treasury openly opposed to the idea of the Asian Monetary Fund. In the US view, establishing a regional fund providing liquidity to crisis-stricken countries in Asia would make it even more difficult to ensure that credit loan conditions would be complied with by debtor countries, which would make regional fund less credible to the eyes of international investors. Timothy Geithner raised the issue of lack of transparency such as the information about how much reserves were still left in the government.<sup>17</sup>

Faced with the opposition from the US and lack of support from China, the Japanese Ministry of Finance had no choice but to decide to withdraw the idea of Asian Monetary Fund. For the Japanese Ministry of Finance, the international cooperation among the G7, especially with the US, has been a fundamental elements guiding its financial diplomacy. Under the circumstances, Japan could not make a decision to fight openly against the US.

While Japanese Ministry of Finance were also aware of the lack of transparency, they were equally against the idea of taking no immediate actions until the full information is disclosed. In this vein, the proposal of the Asian Monetary Fund was more pragmatic and solution-oriented idea

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<sup>17</sup> Geithner, T. (2014), "*Stress Test: Reflections on Financial Crisis*", Random House

with the expectation that it would serve to protect Japanese economy from its imminent effects from the Asian Financial Crisis and take a leading role in containing the contagious effects of the Crisis as quickly as possible rather than the idea based on geopolitical or diplomatic considerations seeking to establish Japan as a financial regional hegemony in Asia.

However, the fact of the matter is that the Japan's policy which focused on establishing the mechanism of providing swift financial liquidity and regaining the market confidence. This policy to some extent set aside at least temporarily the risk of moral-hazard at the height of financial crisis. The Japanese Ministry of Finance was aware of the need to address the majority of issues identified by the IMF such as the weakness of financial supervision and regulatory framework and the ability of financial institutions to manage risks. However, the Japanese Ministry of Finance did not link the need to address these issues with the availability of financial assistance to the inflicted countries.

The Japanese Ministry of Finance's policy of focusing on availability of liquidity rather than moral-hazard was heavily affected by the dramatic change of domestic policy circumstances surrounding the Japanese financial system. Within a few months after the Asian Financial Crisis started in Thailand in July 1997, the Japanese Ministry of Finance was caught by a series of bankruptcy of Japanese securities firms and banks which intensified in November 1997 including Sanyo Securities (the seventh-largest brokerage firm), Yamaichi securities (the fourth-largest brokerage firm) and Hokkaido Takushoku Bank. Under these dramatically worsening circumstances, the Japanese Government and the ruling party were forced to take immediate actions to inject public money to strengthen the capital of domestic financial institutions.

In the late 1980s, Japan experienced unprecedented asset bubble characterised by the steep rise of asset prices including land prices and share prices. The unprecedented magnitude of steep and great rise of asset prices and their burst between the late 1980s and the early 1990s in Japan made the financial crisis much deeper than previous economic slumps. The great difficulty facing the Japanese Ministry of Finance in dealing with the

bad loan problem and the resulting financial system crisis gave the Japanese Ministry of Finance an opportunity to learn the lesson on what would be the priority measures to take to prevent the financial crisis from spreading and deepening.

In Japan, the financial crisis characterised by the collapse of a series of financial institutions, occurred in 1997 more than 5 years after the burst of bubble economy in the beginning of 1990. Between the burst of bubble economy and the outbreak of financial crisis, the Japanese Ministry of Finance were faced with the constraints of policy options available partly due to lack of strong political support. When the financial crisis broke out in 1997 in the aftermath of the first symptom of Asian Financial Crisis in Thailand in 1997, the Japanese Ministry of Finance considered that the swift provision of public funds into domestic financial sectors was essential to prevent the confidence among market participants on the Japanese financial system from further deteriorating. The Japanese Ministry of Finance realised that the government had no choice but to inject public funds swiftly into financial institutions.

The view of putting priority on swift injection of public funds was not necessarily consistently shared among the policy-makers of the Japanese Ministry of Finance and the political leaders since the burst of the bubble economy in 1990. It was not formulated until the Japanese Ministry of Finance and the ruling party realised that the depth of non-performing loans problems held by ailing financial institutions was much more grave than could be solved by the steady write-off of non-performing loans using the annual profits of financial institutions.

Before the mid-1990s, the Japanese Ministry of Finance could and did choose to have another healthier financial institution to absorb a nearly bankrupt one without resorting to the implementation of the deposit insurance system, where only JPY 10 million would be safeguarded for each depositor. The priority of the Japanese Ministry of Finance then was how to prevent the confidence of depositors from being lost and avoid bank-runs. In retrospect, it could be argued that the hesitance of the Japanese Ministry of Finance to close the insolvent financial institutions

made the situation further deteriorating. However, the closure of insolvent financial institutions was easy to say, but in fact, it was not such a simple matter. In the first place, generally speaking, financial institutions are solvent as long as they can continue to operate with sufficient liquidity somehow. In the second place, there was no legal framework for the government to force financial institutions to close their business when the top management including the board of directors does not decide to file a bankruptcy. Last but not the least, there was a general belief among many Japanese policy-makers and the financial sector that land price would bottom out at some point soon. The majority of the people concerned considered that the burst of the bubble would need a certain period of adjustment with the substantial decline of land prices. They believed that the Japanese economy would recover from the economic recession as a sort of adjustment period as it did right after the two oil crises hit the Japanese economy in the 1970s.

In 1990-1991, the Japanese Ministry of Finance was faced with the increasing call from the general public and the media on to deal with the high price of land at the unprecedented level. Yasushi Mieno, the then Governor of the Bank of Japan, was hailed by the media then as a hero who took the draconian measure to raise the interest rates rapidly to burst the bubble, with the nickname of “Onihei (a hero of historical drama popular in Japan) of Heisei (the name of the current era)”. However, land price did not bottom out in the way that most people predicted. Yasushi Mieno raised the interest rate from 2.5% to 6% between May 1989 to August 1990 with the interest rate rise for as many as 5 times. While there was already a sign of burst of bubble in 1990, Yasushi Mieno maintained the interest rate of 6% until August 1990. In retrospect, this longer period of financial tightening with high interest rate than necessary was one of the reasons which led to deteriorating burst of bubble economy and subsequent non-performing loan problems.

Since the Tokyo stock market index peaked at JPY 38,195 on 29 December 1989, the trend of the Tokyo stock market index reversed to decline steadily. While the Japanese Government recognised that a sharp fall of stock market would the decline of capital adequacy ratio of financial institutions,

the Japanese Government concluded that the amount of non-performing loans would be much smaller and negligible in view of the amount of net earnings and unrealised capital gains of stocks held by financial institutions.<sup>18</sup> The Japanese Government considered that the Japanese economy was entering into a phase of self-sustaining adjustment after the unprecedentedly rapid pace of asset price bubble based on the assumption that the land price would bottom out at some point. It stated in the 1992 Economic White Paper that the resolution of non-performing loans would not cause any significant problem with the overall health of financial institutions by writing off non-performing loans with the annual net profits.

The Tokyo stock market index continued to drop steadily after it had the highest peak on 29 December 1989, and fell under JPY 15,000 on 18 August 1992 for the first time after it climbed up in the late 1980s characterised by the bubble economy. Then Prime Minister Kiichi Miyazawa indicated the possibility of using public funds along with the self-reliance efforts by each financial institution. Following the instruction from Prime Minister Kiichi Miyazawa, the Japanese Ministry of Finance released the document titled “Policy on Financial Sectors in the immediate future” on 18 August, 1992. The document clearly stated that the Japanese financial system was now much more resilient than before, and was supported by favourable conditions such as high competitiveness of Japanese industries, the accumulated assets, and well-established policy frameworks. It further stated that the Government was sure that we would not see any possibility that the Japanese financial system would suffer dysfunction and cause excessively high burden on the national economy. Following the release of this document, the Tokyo stock market reversed and the Miyazawa’s idea of injecting public funds into the rescue of ailing financial institutions was not seriously considered further at least as an imminent measure to solve the non-performing loan problem.

However, the increased non-performing loans gradually worsened the balance sheets of financial situations, and the Japanese Ministry of Finance was faced with the situation where they somehow need to make ailing

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<sup>18</sup> The 1992 Economic White Paper, the Japanese Government,  
<http://www5.cao.go.jp/keizai3/keizaiwp/wp-je92/wp-je92-00106.html>

financial institutions absorbed by other still healthy financial institutions. In the early 1990s, the traditional style of coping with ailing financial institutions with the initiative of the Japanese Ministry of Finance worked relatively well without causing the concerns about the overall financial system. For example, when the Toyo Credit Union collapsed in October 1992, the Sanwa bank, one of the then biggest city banks, agreed to take over their assets.

But it turned out that this traditional style of rescuing ailing financial institutions was increasingly difficult to continue to implement. Since the bubble economy collapsed, the amount of the necessary money to rescue ailing financial institutions increased dramatically to the level too high for another relatively stable financial institution to absorb ailing financial institutions by merger or acquisition. As the amount of non-performing loans increased and weighed down many financial institutions, the senior managements of Japanese financial institutions were increasingly worried about the risk of being embroiled in shareholder suits and became reluctant to absorb other unhealthy financial institutions even if they received the request from the Japanese Ministry of Finance.

At the same time, there was strong sense of unfairness among the general public about seeing their taxpayers' money used to bail out ailing financial institutions. When the Japanese Ministry of Finance government dealt with housing loan companies, which were established as special companies focusing on providing loans to the Japanese customers who bought houses in the 1970s, there was great criticism against injecting public funds to cover the loss of agricultural cooperatives who lent to housing loan companies. While agricultural cooperatives refused to accept any kind of debt reduction scheme, the injection of public funds were considered by the general public as the rescue of some financial institutions who established housing loan companies as a part of their subsidiaries. There were also some other reasons why the general public were so distrustful against financial institutions. For example, the level of salary of the employees of financial institutions was widely known to be much higher than that of other industries. There was strong mistrust among the general public that financial institutions were generally excessively protected by vested

interests without being exposed to as much competition as other industries. Under these circumstances, the Japanese Ministry of Finance was not able to gain the sufficient political support to use public funds to deal with the non-performing loans until a series of bankruptcies of financial institutions actually happened.

The general public and the media considered that the Japanese financial institutions did not make sufficient efforts to sort out non-performing loans by restructuring their costly business models. However, they were not sufficiently aware of more damaging results which would arise from the leaving the non-performing problems in limbo with the expectation that financial institutions themselves would be able to write off their non-performing loans. In the US, the public funds of as much as USD 90 billion were injected to deal with the saving loan problem in the 1980s. In stark contrast to the US case, there was not sufficient political consensus about injecting public funds for the purpose of protecting financial system and depositors. In Japan, maintaining the stability of financial system was not considered by the general public as the sufficient reason to justify the injection of tax-payers' money.

Since the government completed its work on a set of legislation and budgetary measures necessary for the resolution of housing loan companies and they were approved by the parliament shortly in early 1996, a Japanese economy showed a short period of optimism in the financial system. The Economic White Paper 1997 stated that the Japanese economy was getting out of the economic recession in the early 1990s and gradually back on track of the self-sustained economic growth. The Economic White Paper 1997 also concluded that the non-performing loans were slowly but steadily written off and would be dealt with sufficiently within the annual profits of financial institutions as a whole. The Hashimoto government raised the 6 key reforms with the highest priority attached on financial reform characterised by the overhaul of financial regulations towards radical liberalisation with the aim of making the Tokyo financial market more competitive with the NY and London financial markets. Making the so-called Japanese financial “big-bang” possible was the ultimate aim of the financial reform. The then Japanese financial reform was characterised

by the three principles of free, fair and global. The term “big-bang” is the one commonly used to refer to the financial reform undertaken by the UK conservative government initiated by Margaret Thatcher in the 1980s. The term “big-bang” implicitly contained the intention of the Japanese Ministry of Finance to raise the international reputation of the Tokyo financial market comparable to NY and London.

However, the Japanese economy slipped back into the deeper financial crisis in the late 1997. In November 1997, following the collapse of the Sanyo securities, the Hokkaido Takushoku bank and the Yamaichi securities also fell into the bankruptcy. In the first ever default in the short-term financial market at the time of the collapse of the Sanyo securities in the post-war era, the financial institutions became extremely cautious about lending in the short-term financial markets and it led to the vicious cycle of credit crunch in the short-term financial and the shortage of liquidity available in the inter-bank market. This made financial market participants almost panicked and gave rise to domino effects on some financial institutions already in the brink of bankruptcy. Especially, the collapse of the Yamaichi securities, which was considered as one of the big 4 security companies, along with Nomura, Daiwa and Nikko, gave huge impact on the minds of financial investors both domestically and internationally.

The first default in the inter-bank bank market at the time of the Sanyo securities in 1997 had much greater impact to the market participants than the Securities Bureau of the Japanese Ministry of Finance anticipated.<sup>19</sup> The inter-bank market is the market where financial institutions finance their liquidity needs in the short-term including on a daily basis. The default of JPN 10 billion loan of the Sanyo-securities was not considered as so damaging as it actually was by the Securities Bureau of the Japanese Ministry of Finance. The Securities Bureau took much more radical approach than the Banking Bureau in dealing with ailing financial institutions, which would leave the selection to the market. It was as if the Securities Bureau proclaimed the policy would need to shift from the

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<sup>19</sup>Nikkei-shinbun (2001), “Kensho-Baburu-Haninaki Ayamachi (Analysis of the Bubble, Mistake without criminal intent)”



traditional convoy system. But, it triggered the collapse of the Japanese financial system and gave the damaging effects on the confidence of investors and depositors. At that time, the Securities Bureau of the Japanese Ministry of Finance gave priority to being not so much the guardian of the financial market as the supporter of the judgement of market forces.<sup>20</sup>

In June 1997, the Japanese Ministry of Finance released the new reform plan of the so-called Japanese “big-bang”. This plan was based on 3 pillars: (1) deregulation across and within the sectors, (2) liberalisation of capital transaction, and (3) review of regulation and supervision by the authorities. The review of regulation and supervision included the removal of the traditional convoy system in the Japanese financial system. The traditional convoy system had essentially guaranteed that financial institutions would never collapse and had provided the general public with the confidence about the Japanese financial system as a whole. On the other hand, the traditional convoy system prevented more competitive financial institutions from making dominant profits and restricted the activities of financial institutions of each sector. On a positive side, the traditional convoy system provided a sort of social security network across the country in that even less competitive financial institutions in rural areas made certain profit and continued to play a role of financing local companies. The traditional convoy system played a certain important role in achieving a balanced economic growth without causing much unemployment and economic disparity between regions.

The collapse of the Yamaichi securities triggered the worsening spiral towards the loss of confidence among investors about the Japanese financial system as a whole. It paved the way for the collapse of the Long-Term Credit Bank of Japan and the Nippon Credit Bank in 1998. The collapse of the Yamaichi securities gave the deep impact on the confidence of investors and depositors about not only the Japanese financial system but also about the Japanese Ministry of Finance’s willingness to protect the financial system as a whole. In other words, the general public and investors were increasingly worried about the outright willingness and intention to keep the Japanese financial system as a whole.

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<sup>20</sup> Ibid.

In the right before the deep financial crisis erupted in November 1997, the Japanese Ministry of Finance was faced with the dilemma between whether the Japanese Ministry of Finance should continue to be the guardian of the whole financial market or not. In the Japanese financial “big-bang”, the review of regulation and supervision by the authorities was among the key pillars. What made the Japanese Ministry of Finance most shocked was that it was decided that the role of the financial regulation and supervision would be removed from the Japanese Ministry of Finance and was given to the newly established “Financial Service Authority”, along with the amendment of the Bank of Japan Law designed to give explicit independence to the Bank of Japan. The review of regulation and supervision by the financial authorities included the shift from discretionary approach to rule-based approach. In this process, it was decided that all administrative guidance from the Japanese Ministry of Finance would be abolished and those of real necessity would be stipulated by means of laws and government orders.

The shift to the rule-based approach in the financial regulation and supervision was based on the lessons learned from severe criticism about the lack of transparency of financial regulation and supervision, especially as was observed in the great disorder in the process of resolving the bankruptcy of the two credit unions (the Tokyo Credit Union and the Anzen Credit Union) and the housing-loan companies in 1995-1996. The shift to the rule-based approach was intended to make it clear that the resolution of bankrupt financial institutions was based on the clear criteria by which the authorities could give the final decision about when to close the ailing financial institutions. This was intended to protect the government authorities from any political pressure.<sup>21</sup> However, in the case of the collapse of the Yamaichi securities, the shift to the rule-based approach was taken as the lack of the willingness of the government to protect ailing financial institutions from bankruptcy, irrespective of the size of the financial institutions and the potential impact of the collapse of financial institutions.

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<sup>21</sup> Nishimura, Yoshimasa (1997), “Kinyu-Gyosei-no-Haiin (Causes of the Failure of Financial Supervisory Policies)”

When the Yamaichi Securities was faced with the verge of its collapse, the Securities Bureau of the Japanese Ministry of Finance did not show the willingness to rescue the Yamaichi securities at any cost. When the Moodys announced the possible downgrading the Yamaichi securities on 6 November 1997, the stock price of the Yamaichi securities fell as low as JPY 58 on 19 November 1997. Then the Securities Bureau of the Japanese Ministry of Finance told the CEO of the Yamaichi securities to choose to file for voluntary closure of business with the Ministry of Finance. The Japanese Ministry of Finance did not choose to show its willingness to be the guardian of the financial market, but rather to respect and follow the judgement of the financial market on the stableness of financial institutions.

With the benefit of hindsight, it exacerbated the concerns of ordinary depositors and investors about the Japanese financial system. Just before a series of collapses of financial institutions, there was a strong argument that protecting the confidence about the financial system as a whole was one thing, and preventing ailing financial institutions from collapsing was another thing. However, when the confidence about the whole financial system was weak, it was difficult to make a clear distinction between the confidence about the financial system as a whole and that of each financial institution. The straightforward argument that the mismanagement of the financial institutions should not be compensated by the tax payers' money was prevailing. The traditional convoy approach was symbolised as the pre-modern financial regulatory style of financial regulatory and supervisory policies.

At that time, the pre-modern Japanese financial regulatory style was characterised by the traditional convoy financial supervision, the reluctance of the authorities to implement so-called “pay-off” which protect the deposits only up to the certain ceiling, and the restriction of the types of business activities undertaken by financial institutions. The traditional convoy approach was based on the assumption that the regulatory authorities always make the utmost efforts to save ailing financial institutions at any cost. But, once the government announced that it would undertake a financial reform to promote more liberalisation of business

activities and competition and rule-based administrative approach, the Japanese Ministry of Finance found itself in dilemma and constrained with the policy options.

It could be argued that blanket provisions of public guarantees to creditors of financial institutions would unnecessarily raise taxpayer costs, inappropriately shield creditors and equity holders from losses, and exacerbate problems of moral hazard. However, once the confidence of the general public about the financial system as a whole was lost, it was difficult to make a distinction between the financial institutions to be recapitalised with public funds and the other institutions to be closed without the support of public funds. The worsening market sentiment tends to overreact to the news of a mere fact of bankruptcies of financial institutions, irrespective of whether they were still solvent or insolvent. At the time of worsening financial crisis, it was extremely difficult to expect the general public and market investors to be calm and wise enough to make a selective distinction between solvent institutions and insolvent institutions.

However, it took some time for the Japanese general public and the media to stand ready to realise that public funds are necessary to address the heart of non-performing problem. In the early 1990s, there was a mood in the Japanese public that the bubble would need to be burst and that asset prices which had risen to an unprecedented level need to be corrected. As a result of sharp rise of asset prices, notably land prices, it led to the dissatisfaction among the ordinary public about the growing disparity of wealth between those who owned land and those who did not. Just before the burst of the bubble economy, there was growing call for the Japanese government to introduce various measures which would discourage financial institutions to provide funding to the lenders who would invest in the land.

For the Japanese Ministry of Finance, a series of collapses of financial institutions were something unexpected after it seems that the Japanese economy got back to the path of sustainable economic recovery with the modest rate of economic growth partly due to the depreciation of yen against US dollar in the latter half of 1995 and 1996. The capital

investment in 1995 bottomed out for the first time after starting to fall in 1991. The Economic White Paper 1996 stated that the Japanese economy was back on track of the sustainable economy recovery with the increased export helped by the Japanese yen depreciation and the improvement of labour market.

The Japanese financial reform “big-bang” and the fiscal consolidation efforts attempted by the Hashimoto government in 1996 was based on the assumption that the Japanese economy was already getting out of the worst situation of the financial sector problem characterised by the accumulated non-performing loan, especially which incurred in housing loan company problems. The resolution of the housing loan problems with injecting public funds in 1996 was severely criticised by the public for the use of taxpayers’ money, but it was seen as indicating the end of the worst stage of the non-performing problem in the Japanese financial sector. The attempt to shift the priority from protecting the financial stability at all cost to giving respect to the market forces placed constraints on the policy options to be taken by the government when faced with a series of bankruptcies of Japanese financial institutions. The Japanese financial market reform with the emphasis on market discipline market competitiveness was based upon the belief that the market-oriented increased competition and the selection of market forces would limit the risk of a deeper and more prolonged economic recession and promote an early and sustainable recovery. The IMF also stated that “Decisive action to address strains in the financial sector, including the closure of insolvent institutions”<sup>22</sup>. But, in fact, the Japanese financial market was vulnerable to sudden reversal of market sentiments, and this closure of insolvent institutions exacerbated the worsening perceptions by the general public, depositors, and investors about the stability of the Japanese financial system.

Faced with a series of bankruptcies of Japanese financial institutions in 1997, the Japanese Ministry of Finance was aware of the urgent need to avoid the contagious spread of the Asian Financial Crisis to Japan and the responsibility of Japan to do whatever it could to prevent the Asian Financial Crisis from spreading to other regions in the world. This sense of

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<sup>22</sup> IMF (1997), *World Economic Outlook, Interim Assessment, December 1997*

doing whatever the government could do like was based on the two beliefs, i.e. (1) the sense of international policy cooperation that Japanese would need to undertake a significant role in contributing to stable world economy as the second largest economic power after the US and must not cause any economic disorder to other countries, and (2) the sense of urgency to get out of the domestic economic recession as soon as possible and to put itself back on track of stable economic growth by removing the concern of overseas financial crisis.

The Asian Financial Crisis urged the Japanese Finance Ministry to further strengthen its efforts to use the G7 Finance Ministers meeting process as an opportunity to promote their agenda. The Japanese Finance Ministry put special focus on the discussion of international financial architecture. Especially, Japan began to take a proactive role in leading the discussion on international financial architecture. In the G7 Finance Ministers meeting in Birmingham in May 1998, a report of the G7 Finance Ministers to the G7 Heads of State or Government on strengthening the architecture of the global financial system was transmitted to the G7 Heads of State. The Japanese Finance Ministry worked to insert the elements of their arguments on the origin of the Asian Financial Crisis. In the paragraph 12, the report stated that

*“International capital flows enable a better global allocation of capital and foster economic development. However, events in Asia have shown that weaknesses can suddenly be exposed by global capital markets, making countries with weak fundamentals, including weak financial systems, more vulnerable to external shocks. It has also highlighted the dangers of poorly sequenced and unbalanced liberalisation. To ensure that the process of capital account liberalisation is orderly, it is important that sound macroeconomic policies and supervisory and regulatory practices are put in place. Correct management of the liberalisation process is crucial. And the process needs to be accompanied by reforms to strengthen the domestic financial system.”*

While the report called on the IMF to continue to play an important role in this area and providing advice on how best to manage orderly capital

account liberalisation and monitoring countries' vulnerability to capital flows. It explicitly pointed out the risks of the dangers of poorly sequenced and unbalanced liberalisation of capital account, taking into account the danger of short-term capital flows. It is worth noting that the report stated that open access to domestic markets for foreign firms can help with the development of the deep and liquid domestic financial markets, with soundly managed and well capitalised firms. The communique is based on the delicate balance between the argument calling for balanced liberalisation of capital account and that doing for increased access for foreign financial firms, and carefully drafted not to deny the latter argument.

Since the Asian Financial Crisis, the Japanese Ministry of Finance focused on three agenda in the G7 Finance Ministers process: (1) the reform of IMF such as limiting the conditionality to the areas where the IMF has real expertise, the review of quota giving excessively favourable treatment to European countries and underrepresentation of the Asian countries, (2) bailing in the private investors in a transparent manner, and (3) strengthening of regulation towards highly-leveraged institutions including hedge-funds.<sup>23</sup> The Japanese Finance Ministry considered that the Asian Financial Crisis demonstrated the vulnerability of the international financial system rather than just a regional financial system and the real solution need to involve the reform of the international financial architecture and the G7 Finance Ministers process needs to be the cornerstone of this reform.

At least at the early stage of the Asian Financial Crisis, the IMF was reluctant to admit the downside risks of capital account liberalisation squarely. In September 1997, Stanley Fisher, then the first Deputy Managing Director, stated that liberalisation of capital account can bring more benefits than the costs and it would enable residents and governments in recipient countries to borrow and lend more favourable terms, which would lead to better allocation of savings and investments. In this vein, he further stated that controls are generally inefficient and costly for the economy, and prolonged use of capital control would present investors with

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<sup>23</sup> Kuroda, H. (2003), "Tuuka-gaiko (Currency Diplomacy)"

an additional country risk factor and could lead to capital flight.<sup>24</sup> In April 1997, the Interim Committee of the IMF agreed to amend its Articles of the Agreement to make the liberalisation of international capital movements a central purpose of the IMF and to extend the IMF's jurisdiction to capital movements. At least in the immediate aftermath of the Asian Financial Crisis, the IMF did not admit the capital account liberalisation per se was a cause of the Asian Financial Crisis. Rather they considered that the liberalisation of capital account did not cause a risk itself, but should have accompanied by supporting measures which would encourage stronger management and supervision in banking sector as well as avoid moral hazard problems for corporations and banks. They considered that inadequate transparency and information flows also contributed to sharp shifts in market sentiment in response to uncertainties, along with underdevelopment of instruments for hedging and managing risks.<sup>25</sup>

The IMF's approach was to a great extent oriented towards their favour seeking long-term structural reform. For example, the IMF considered that insolvent institutions need to be closed to facilitate an early restoration of confidence and prevent the complete collapse of already weak financial systems, while weak but viable institutions will need to be restructured and recapitalised. In the IMF's view that sweeping guarantees to domestic and foreign creditors of financial institutions would unnecessarily raise taxpayer costs, inappropriately protect creditors from losses, and exacerbate moral hazard. On the other hand, the Japanese Ministry of Finance considered that at the time of financial crisis, it is difficult for private investors to make a clear distinction between insolvent financial institutions and viable financial institutions. In their view, it is not impossible to expect investors to make a reasonable distinction between insolvent financial institutions and viable ones at the time of financial crisis and the announcement of closure of financial institutions would lead to the panic among investors.

As the international discussion on the effectiveness of capital controls, the

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<sup>24</sup> Fisher, S. "Asia and the IMF", 17 September 1997  
<https://www.imf.org/external/np/speeches/1997/091997.htm#1>

<sup>25</sup> IMF (1999), "Exchange Rate Arrangements and Currency Convertibility Developments and Issues"



IMF was gradually accommodating the capital controls in the 2000s. While they still believe that capital controls could not be a substitute for the required adjustments in macroeconomic and exchange rate policies, the IMF displayed a certain degree of sympathy with some countries in the use of capital controls such as Russia and Peru as the second-best instrument.<sup>26</sup> For example, the IMF staff report for the 1999 Article IV consultation with China stated that the capital controls had helped the country reduce external vulnerability. Also in the case of the Malaysia's capital outflow control measures introduced in September 1998, the IMF staff paper in 1999 recognised that the controls were operated effectively and supported them as temporary measures. This is the stark contrast to the IMF's call on Thailand to eliminate their controls on baht sales to non-residents introduced in 1997, which were eventually relaxed by September 1998.<sup>27</sup>

The gradual shift of the IMF's view on capital controls corresponds to the development of the discussion at the G7 on international financial architecture. Taking advantage of the position of the chair of the G7 in 2000, the Japanese Ministry of Finance worked hard to use the G7 as the opportunity to obtain the mandate of pressing the IMF and other forums to reflect their views. For example, in the report of G7 Finance Ministers to the Heads of State and Government in 2000, Japan succeeded in inserting a paragraph recognising the role of regional financial cooperation as a means of improving regional financial stability. It also stated that "*Regional cooperation through more intensified surveillance can help contribute to financial stability by strengthening the policy framework at the national level. Cooperative financing arrangements at the regional level designed to supplement resources provided by the IFIs in support of IMF programs can be effective in crisis prevention and resolution.*" While the effectiveness of regional financial cooperation was recognised the extent to which it is supportive of the IMF's objectives and responsibilities in the global economy, the pursuit of financial cooperation in Asia was clearly given the mandate at the G7 the effectiveness of regional financial cooperation as something which can improve regional stability and thus contribute to the stability of the global economy. It explicitly supported the work in Asia

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<sup>26</sup> IMF (2005), IMF's Approach to Capital Account Liberalization, IEO's analysis

<sup>27</sup> Ibid.

aimed at establishing the frameworks for regional surveillance and cooperation in finance including bilateral swap mechanisms.

As we have seen, the Japanese Ministry of Finance had consistent strategy that the issues raised in the Asian Financial Crisis could be effectively addressed only when they are put on the table of the international agreement. In their view, the Asian Financial Crisis was distinct in that dramatic deterioration of investor sentiment did spread to other economies with large currency depreciations and capital outflows in such a short period of time. The crisis-stricken countries which relied heavily on short-term borrowing,

In the late 1990s, the concerns about the fragilities about the Japanese financial sector were mounting. At the heart of the concerns was the financial stability of the Japanese financial institutions with a large volume of problem loans whose roots were in asset price bubbles of the late 1980s. As a result of the concerns about the health of the financial systems, the so-called “Japan premium” was charged to Japanese banks in international money markets with dollar-financing in 1997. In October and November 1998, several Japanese banks indicated their intention to withdraw at least partially from overseas activities by closing a large number of foreign branches. The deterioration of the Asian Financial Crisis was considered to have further negative impact on Japan of financial turmoil. Therefore, addressing the remaining risks associated with the Asian Financial Crisis is also necessary to restore the confidence about the Japanese economy.

The Asian Financial Crisis was followed by the Russia’s decision in 1998 to devalue the ruble. This led to the reassessment of the risks associated with holding emerging market financial instruments. Some highly leveraged institutions suffered large losses as a result of the Russian debt restructuring and faced higher margin calls. Growing concerns among investors about liquidity adversely affected emerging market economies with large domestic and external refinancing needs. The reduced capacity to undertake risks led to substantial capital outflows and sustained pressure on foreign exchange and domestic money markets in a number of countries, in Asia and Latin America.

In September and early October 1998, there were growing concerns about liquidity and counterparty risks – ultimately led to the near collapse and rescue of Long-Term Capital Management, a US hedge fund, which attempted to profit from discrepancies in the relative value of governments bonds, fixed-income derivatives, equities and equity derivatives. The private capital inflows to the emerging markets surged during the 1990s. The private capital flows accounted for the largest proportion of flows to emerging markets since 1995. Unlike FDI flows, this portfolio flows to emerging markets later turned out to be volatile.

Faced with deepening of the Asian Financial Crisis, the Japanese Finance Ministry had no choice but to change the policy stance of fiscal policy towards more active fiscal policy. In 1997, the Japanese Finance Ministry succeeded in making the Fiscal Consolidation Law passed in the parliament. In addition, the Japanese Finance Ministry announced providing financial support amounting at USD 30 billion for stricken Asian countries. On 4 December 1998, the Finance Minister Kiichi Miyazawa announced that the Japanese government would provide financial assistance to the Asian countries in order to help them to put their real economy on track of substantial recovery in view of the large role of Japan in the risk to the global economy.<sup>28</sup>

The Finance Ministers' speech on 4 December 1998 was significant in two elements. First, it officially announced that the Japanese Finance Ministry suspended the Fiscal Consolidation Law and instead would present fiscal stimulus package to achieve the stabilisation of financial markets economic recovery totalling at JPN 20 trillion (around USD 200 billion) as the urgent economic package. The speech explicitly stated that this urgent economic package is intended to get out of economic sluggishness and restore the confidence about the Japanese economy in the domestic and international market. Secondly, it announced that Japanese Finance Ministry provided financial support for Asian countries, based on the view that Japan and Asian countries are inter-dependent and Japan had a special responsibility

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<sup>28</sup> Finance Minister's Speech at the Parliament, 4 December 1998, [http://www.mof.go.jp/public\\_relations/statement/fiscal\\_policy\\_speech/1e054.htm](http://www.mof.go.jp/public_relations/statement/fiscal_policy_speech/1e054.htm)

for addressing the risks which threaten the global economy. What struck most in this Finance Minister's speech was that it emphasised the special role of Japanese economy to the world economy both in the context of suspending the course of fiscal consolidation once decided by the cabinet and put into legislation and providing financial assistance for the stricken Asian countries.

What was the "special role" of Japan to the world economy and the Asia, which the Japanese Finance Ministry referred to? The "special role" of Japan was classified into two meanings. First, the idea of "special role of Japan to the world economy" dates back to the mid-1980s, where Japan was pressed by the US to undertake more active role in the world economy by opening the market and orienting its economic structure towards more domestic-demand driven economy rather than export-driven economy. The Japan was called upon by the G7, and notably by the US to take the lead in domestic demand. Second, the idea of "special role of Japan to Asia" was based on the view that Asia's stable growth is in the interests of Japan and Japan has special stakes on the economic stability of the Asia.

The idea of "special role of Japan to Asia" was further divided into the three elements. First, there was a strong belief that Asia's recession would have a repercussion with the economic recovery of Japan through the fall of export of Japanese goods to Asia. Second, there was shared recognition that Asia's recession would affect Japanese companies doing business in Asia. Thirdly, at least at the time when the crisis broke out in 1997, Japan considered itself to be the only country capable of providing financial assistance to the Asia.

In terms of the negative effect of Asia's recession on the Japanese economy, the export of Japanese goods to Asia accounted for 5.7% out of the Japanese GDPs in 1997. The Economic White Paper in 1997 concluded that the Asia's recession would lead to the reduction in the exported goods from Japan to the Asia, and it could be a key element contributing to the reduction of the GDP by 0.5%. In the Q1 of 1998, the Japanese exports declined by 12% to Asia and 30% to the ASEAN 4 countries compared with the figures of Q1 of 1997. As the importance of Asia was growing in

the 1990s as the export markets rather than the location of factories supported by cheap labour, the Asia's recession was considered as the threat to the recovery of the Japanese economy.<sup>29</sup>

In terms of the negative effect of the Asia's recession on Japanese companies, Japanese companies, who used to make foreign direct investment to Asian countries to seek cheap labour or secure natural resources, were rather motivated to increase their foreign direct investment to seek the great potential of broadening consumer bases underpinned by rapid urbanisation and increased purchasing power of growing middle-class households. The foreign direct investment from Japan to the ASEAN 4 countries dropped by 27% in the first half of 1997 compared with the same periods of 1996. In addition, the Japanese banks had as much loan as more than USD 110 billion to the Asian countries. Other Japanese ordinary companies such as trading companies than financial institutions had as much claim as USD 10 billion to Asian countries.

In terms of the role of Japan in rescuing the crisis-stricken Asian countries, the Japanese Finance Ministry had no doubt about Japan being the only country to be able to provide financial assistance to the crisis-stricken Asian countries. Faced with the domestic financial crisis culminating in November 1997, the Japanese Ministry of Finance put priority on preventing Japan from being the origin of the world-wide financial crisis and exacerbating the Asian Financial Crisis, which already started in July 1997 as the major member of the G7 countries. The Miyazawa Initiative had 4 key objectives: (1) promoting the restructuring of debts in private sectors and stabilisation of the financial system, (2) boosting domestic demand, (3) rescuing socially vulnerable group of people, and (4) mitigating credit crunch. What is noteworthy in these objectives is that it included not only "promoting the restructuring of debts in private sectors and stabilising of financial system" and "mitigating credit crunch", but also other objectives such as "boosting domestic demand" and "rescuing the socially vulnerable". The latter two objectives were usually the key objectives which domestic expenditures are used for. This showed that the

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<sup>29</sup> Economic White Paper (1998), Government of Japan  
<http://www5.cao.go.jp/keizai3/keizaiwp/wp-je98/wp-je98-000i1.html>

Miyazawa initiative was intended to not only respond to short-term needs of financial liquidity, but also to support the deficit of revenues and enable governments to increase government expenditures for a wide range of objectives including the rescuing the SMEs and improving social safety-network.

For example, in relation to Thailand, the Japanese Ministry of Finance provided a wide range of loans ranging from infrastructure projects which would serve to create a great number of jobs for the unemployed and helping manufacturing companies including domestic local SMEs to modernise equipment, as well as assist local Japanese subsidiaries with capital investment and operating fund. In the World Bank's social investment projects, the loans under the Miyazawa Initiative were also provided to building various infrastructures such as airports, schools, roads, banks, and reservoir. The Miyazawa initiative played a role in boosting the demand when the IMF-led programme had the effect of contracting the domestic economy. In Malaysia, the loans under the Miyazawa Initiative served to rebuild their manufacturing sectors to increase their competitiveness of exporting.

## 1-2 Chiang-Mai Initiative

In spite of the failure of the AMF proposal, it did certainly contribute to continued intensive discussion on closer regional financial cooperation. The development of regional movement of financial cooperation has been undertaken under the framework of original ASEAN 5 (Indonesia, Malaysia, Philippines, Singapore and Thailand) plus China, Japan, and South Korea (so-called "ASEAN plus 3").

The cooperation among the ASEAN plus 3 members started in December 1997 when an informal Summit among the leaders of ASEAN plus 3 was convened at the margin of the Second AEAN Informal Summit in Malaysia. In the Joint Statement of Heads of State/Government of the Member States of ASEAN and the Prime Minister of Japan, in Kuala Lumpur, Malaysia, 16 December 1997, it stated in the paragraph 7:

*7. They noted that the Finance Ministers of ASEAN and Japan at the recent meeting in Kuala Lumpur on 2 December 1997 discussed national efforts and regional and international cooperation to address the present financial situation in the region. They endorsed the Finance Ministers' agreement on the rapid implementation of the Manila Framework as a constructive step towards promoting financial stability in the region. They noted that Japan would convene a meeting of Asian Finance and Central Bank Deputies in early 1998 to carry forward the initiatives under the Manila Framework and work closely with the IMF, World Bank, ADB and international regulatory bodies. The ASEAN member states noted with appreciation Japan's contribution to the recent financing packages in the region and both sides reaffirmed the importance of enhanced cooperation on economic and financial issues between the Finance Ministers of ASEAN and Japan.*

The ASEAN and the President of China released the same statement as that with Japan.

*7. They noted that the Finance Ministers of ASEAN and the People's Republic of China at the recent meeting in Kuala Lumpur on 2 December 1997 discussed national efforts and regional and international cooperation to address the present financial situation in the region. They endorsed the Finance Ministers' agreement on the rapid implementation of the Manila Framework as a constructive step towards promoting financial stability in the region. They encouraged efforts to carry forward the initiatives under the Manila Framework and work closely with the IMF, World Bank, ADB and international regulatory bodies. ASEAN member states noted with appreciation China's contribution to the recent financing packages in the region and both sides reaffirmed the importance of enhanced cooperation on economic and financial issues between the Finance Ministers of ASEAN and the People's Republic of China.*

At the Finance Ministers Meeting of ASEAN states plus 3 on 6 May 2000 at the margin of the annual meeting of the board of governors of the Asian Development Bank (ADB), the finance ministers laid down a broad set of agenda including “Chiang Mai Initiative”, regional surveillance,

capital-flow monitoring and the training of personnel to enhance the value of these exercises.

*3. We appreciated the presentation by the Asian Development Bank on the East Asian economic financial situations and welcomed the stronger-than-expected recovery of our member economies. To further sustain this economic growth, we agreed to strengthen our policy dialogues and regional cooperation activities in, among others, the areas of capital flows monitoring, self-help and support mechanism and international financial reforms.*

*4. On the monitoring of capital flows, our experts met in Manila in late April this year to exchanging views on capital flows monitoring mechanisms and discussed possible approaches to establish a regional monitoring framework in East Asia. We agreed to use the ASEAN + 3 framework to facilitate the exchange of consistent and timely data and information on capital flows.*

*5. As a first step towards establishing a well-coordinated economic and financial monitoring system in East Asia, we agreed to establish a network of contact person to facilitate regional surveillance in East Asia. This would enhance the effectiveness of our economic reviews and policy dialogues.*

*6. In order to strengthen our self-help and support mechanisms in East Asia through the ASEAN + 3 framework, we recognized a need to establish a regional financing arrangement to supplement the existing international facilities. As a start, we agreed to strengthen the existing cooperative frameworks among our monetary authorities through the “Chiang Mai Initiative”. The Initiative involves an expanded ASEAN Swap Arrangement that would include ASEAN countries, and a network of bilateral swap and repurchase agreement facilities among ASEAN countries, China, Japan and the Republic of Korea.*

The Chiang Mai Initiative is composed of two financial arrangements: an expanded long-standing ASEAN Swap Arrangement (ASA); and a network



of bilateral currency swap and repurchase arrangements among the eight member countries of ASEAN plus 3.

The ASEAN Swap Arrangement (ASA) was agreed in 1977 among the central banks of the original five ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) with a view to providing immediate, short-term swap facilities to any member facing temporary liquidity shortage or a balance of payment problems. The total facility was USD 100 million, with each member contributing USD 20 million, which was later increased by twice to USD 200 million and USD 40 million respectively in 1978. While the ASA served as a symbol of ASEAN solidarity, the role of the ASA was limited because this facility was small relative to the volume of trade and capital flows of the countries in the region. During the Asian Financial Crisis, the facility was not implemented.<sup>30</sup>

At the ASEAN Finance Ministers meeting in March 2000, it was agreed that the ASA would extend its membership to include Brunei, Cambodia, Laos, Myanmar and Vietnam. At the same time, the total amount of the facility was increased from USD 200 million to USD 1 billion with a view to responding more effectively to the needs of its members. The original 5 ASEAN countries, together with Brunei, contributed USD 150 million each, while the other new 4 countries contributed various amounts up to USD 60 million. Under the ASA arrangement, the central banks of member countries were allowed to swap their domestic currencies with major international currencies such as US Dollar, Japanese Yen, and Euro, for an amount of up to twice their commitment amount under the facility and for a period of up to 6 months.<sup>31</sup>

The Financial Ministers' meetings of ASEAN plus 3 in May also agreed to establish a regional network of bilateral currency swap arrangements

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<sup>30</sup> Henning, C.R. "*East Asian Financial Cooperation*", Institute for International Economics, 2002, Kuroda, H. Kawai, M. "*Strengthening Regional Financial Cooperation in East Asia*", PRI Discussion Paper Series, May 2003, Ministry of Finance, Japan.

<sup>31</sup> Henning, C.R. "*East Asian Financial Cooperation*", Institute for International Economics, 2002, Kuroda, H. Kawai, M. "*Strengthening Regional Financial Cooperation in East Asia*", PRI Discussion Paper Series, May 2003, Ministry of Finance, Japan.

(BSAs) under the Chiang Mai Initiative. The Chiang Mai Initiative network of bilateral swap arrangements among the eight members of ASEAN plus 3 is designed to provide liquidity assistance mainly in the form of swap of US dollars with the domestic currencies of participating countries. The maximum amount of liquidity available was decided to be negotiated by the contracting parties.

In terms of the relationship between the BSAs the IMF financing and conditionality, the network of BSAs was placed as complementary to the IMF lending facilities. Initially the amount of liquidity available independent of the IMF conditionality was limited to only 10 per cent of the maximum amount of drawing. A member drawing more than the 10 per cent was required to have completed, or be close to completing an agreement with the IMF on the programme for macroeconomic and structural adjustments. 10 per cent of the facility can be drawn with the consent of creditor countries on a 90-day basis, renewable once. The remaining 90 per cent of the swap facility was also based on the maturity of 90 days, renewable seven times at the creditor's discretion.

Given that the momentum of Chiang Mai Initiative arose from mostly the dissatisfaction with the speed of disbursement of the IMF funds and the conditions attached to the IMF lending and the failure of the Asian Monetary Fund, the link between the BSAs and the IMF lending was apparently the most critical issue in terms of the overall operation. This raised the question of whether there are alternative and superior forms of conditionality that would address the problem of moral hazard.

The link between the BSAs and the IMF lending had two meanings. In the first place, it represented that the ASEAN plus 3 countries recognised the central role of the IMF in the international monetary system including the monetary system in Asia. In the second place, it reflected the reality that there was no effective regional surveillance mechanism in Asia. In the meeting in Philippine on 18-19 November 1997, which paved the way for the Manila Framework and the subsequent Chiang Mai Initiative, the finance and central bank deputies agreed that there was a need to establish the regional surveillance mechanism to complement global surveillance

system by the IMF. In terms of regional surveillance, there was no agreement on to what extent the surveillance mechanism would need to be stringent beyond the mere policy dialogue, what kind of penalty would be imposed if one country cannot comply with their commitments about their economic performances, and by which criteria they assess the member countries' economic performances, for example.

Since the initial launch of the Chiang Mai Initiative, there was a strong argument calling for loosening the linkage between the BSAs and the IMF conditionality and increasing the automatic 10% drawing. The heart of the issue is how to address a fundamental issue relating to moral hazard and make sure that an establishment of the independent monitoring and surveillance system among the ASEAN plus 3 members would serve as an institutional framework not only for policy dialogue and coordination among the members but also for imposing structural and policy reform on the countries drawing from the BSAs.

At the ASEAN plus 3 Finance Ministers meeting in April 2004, the ASEAN plus 3 finance ministers agreed to undertake further review of the Chiang Mai Initiative to enhance its effectiveness.

5. *On the Chiang Mai Initiative (CMI), we are pleased to note the continued expansion of its network of bilateral swap arrangements. Since we last met in Makati City in the Philippines, in August 2003, four more Bilateral Swap Arrangements (BSAs) have been concluded. That brings the total number of BSAs to sixteen, and the size of the network to USD 36.5 billion.*
6. *We agreed to undertake further review of the CMI to explore ways of enhancing its effectiveness. A working group will be tasked to conduct the review and report the outcome, by the end of 2004, to our Deputies who will report to us at the next AFMM plus 3.*

Then the above initiative was followed by the ASEAN plus 3 Finance Ministers meeting in Istanbul in May 2005, where the finance ministers agreed to take the measures to enhance the effectiveness of the Chiang Mai

Initiative such as (1) the integration and enhancement of ASEAN plus 3 economic surveillance to the Chiang Mai Initiative; (2) the adoption of collective decision-making system; (3) the increase of the size of the BSAs; and (4) the increase of the disbursement available independently of the IMF conditionality from 10% to 20%.

There were three elements worthwhile noting in the Joint Statement of the ASEAN plus 3 Finance Ministers' meeting in 2005. Firstly, the ASEAN plus 3 Finance Ministers' meeting in 2005 raised the issue of the collective decision-making system. The issue arose from the fact that, under the original Chiang Mai Initiative, a country under financial crisis wishing to obtain short-term liquidity was required to negotiate the activation with all parties of bilateral swap arrangements. Each party was still allowed to choose to opt out. The negotiations with a multiple of contractual parties may take long time and hence may deprive the BSAs of the ability to respond to speculative attacks effectively and promptly at the time of financial crises. The finance ministers agreed to create a collective mechanism which would determine joint activation of all swap contracts of the swap requesting countries as the first step of multilateralisation of the BSAs.

Secondly, the finance ministers made clear the two core objectives of the Chiang Mai Initiative, i.e. (1) to address short-term liquidity difficulties in the region, and (2) to supplement the existing international financial architecture, in particular. This made it clear that while Chiang Mai Initiative was intended to contribute to promoting the stability of the regional financial system, it should play a supplementary role to the existing international financial architecture.

Thirdly, the finance ministers explicitly admitted that multilateralisation of the Chiang Mai Initiative, together with the increase in the drawing limit initially set at 10% of the overall facilities, would not be possible unless they establish a more effective surveillance system.

*5. On the Chiang Mai Initiative (CMI), we reaffirmed our resolution to strengthen our self-help and support mechanism in East Asia by*

*making the CMI a more effective and disciplined framework. As a basic principle for the review, we agreed to firmly maintain the CMI's two core objectives, namely (1) to address short-term liquidity difficulties in the region, and (2) to supplement the existing international financial arrangements.*

*6. Taking into account (i) the improvement in our economic and financial situations and (ii) the advancement in our various initiatives for regional financial cooperation, such as regional surveillance and the Asian Bond Markets Initiative, as well as reflecting the existing vulnerabilities in the global financial markets, we agreed upon the following measures to enhance the effectiveness of the CMI as a self-help and support mechanism:*

- (i) Integration and enhancement of ASEAN plus 3 economic surveillance into the CMI framework to enable early detection of irregularities and swift policy actions, with a view to developing effective regional surveillance capabilities that complements the current undertaking by the International Financial Institutions (IFIs)*
- (ii) Clear-defining of the swap activation process and the adoption of a collective decision-making mechanism of the current network of bilateral swap arrangements (BSAs) as a first step of multilateralization so that the relevant BSAs would be activated collectively and promptly in case of emergency; and*
- (iii) Significant increase in the size of swaps. The size of the BSAs should be increased by (i) increasing the amount of existing bilateral commitment, (ii) concluding new BSAs, for example, among ASEAN countries, (iii) transforming one-way BSAs to two-way BSAs. Member countries favoured an enhancement of up to 100% increase of the existing individual arrangements while noting that the size could be flexibly decided by bilateral negotiations. In this context, the ASEAN*

*Swap Arrangements has been doubled from USD 1 billion to USD 2 billion.*

- (iv) *Improving the drawdown mechanism. The size of swaps that could be withdrawn without the IMF-supported program would be increased from the current 10% to 20% in order to better cope with sudden market irregularities while the current framework to complement the international financial arrangements and other disciplined conditions would be firmly maintained.*

### 1-3 Asian Bond Market Initiative

The Asian Financial Crisis also highlighted the underdevelopment of local currency bond markets at both national and regional levels. The key objectives of the Asian Bond Market Initiative were to (1) to reduce the risks associated with excessive reliance on short-term external financing, thereby mitigating the currency and maturity mismatch problems, and (2) to provide an alternative vehicle for channelling domestic savings into productive investment and reducing dependence on bank lending. This was based upon the view that the Asian Financial Crisis resulted from excessive short-term foreign currency-denominated financing and the “maturity” and “currency” mismatches in the financing structure in East Asia made the region more vulnerable to volatility in short-term capital movements. In the view, relative underdevelopment of domestic bond markets and the absence of efficient regional bond markets exacerbated capital outflows in East Asia during the financial crisis. Developing the local currency denominated bond markets was expected to be an effective means of addressing the “currency” and “maturity” mismatches as well as to make better use of the savings in East Asia.<sup>32</sup>

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<sup>32</sup> Eichengreen, Barry., Luengnaruemitchai, Pipat., “Why Doesn’t Asia have Bigger Bond Markets?”, Paper presented to the Korea University/BIS Conference on Asian Bond Market Research, Seoul, 21-23 March 2004, p.2. Kuroda, Haruhiko., Masahiro Kawai., “Strengthening Regional Financial Cooperation in East Asia”, 2003, Policy Research Institute Paper Series No.3 A-10; Kawai, M., “Asian Economic Integration: Progress, Challenges and Opportunities”, Asian Economic Speaker Series, Asia-Pacific Foundation of Canada, 13 October, 2005. P.2.

On the other hand, well-developed market infrastructures were needed to construct efficient domestic capital markets that were broad and deep in terms of the variety of financial instruments, issuers, and investors. The ASEAN plus 3 Finance Ministers in 2003 agreed to launch a substantive work on the feasibility of creating new and improving existing Asian bond market under the framework of the ASEAN plus 3 Finance Ministers' meeting. They agreed to organise six working groups to conduct detailed studies on the construction of market infrastructure and create new debt instruments including bond denominated in local currencies. The topics dealt with by the six groups include: (1) creating new securitised debt instruments; (2) credit guarantee mechanism; (3) foreign exchange transactions and settlement; (4) issuance of bonds denominated in local currency by Multilateral Development Banks, foreign government agencies and Asian multinational corporations; (5) local and regional rating agencies; and (6) technical assistance coordination.

*10. We agreed to intensify our efforts to develop regional bond markets. This will further strengthen our financial systems by better utilizing the aggregate savings in the region and minimizing the risk of maturity and currency mismatches. Voluntary working groups have been established to further discuss a range of key issues crucial to further development of the domestic and regional bond markets, such as, securitization, credit guarantee, promotion of local currency denominated bonds, credit rating, and foreign exchange transactions and settlement issues.*

At the ASEAN plus 3 Finance Ministers' meeting in 2004, substantial part of the Joint Finance Ministers' statement was devoted to the work on the Asian Bond Market Initiative. It is noteworthy that the Joint Statement explicitly described the purpose of establishing the Asian Bond Markets as assisting in the efficient allocation of the large pool of savings in Asia to fund productive investment in the region. It implied that they shared the view that the underdevelopment of domestic and regional capital markets prevented the efficient allocation of the large pool of savings in Asia.

7. *We are pleased with the substantial progress made by the six working groups under the Asian Bond Markets Initiative (ABMI). We believe that such efforts, in consultation with the private sector, will contribute significantly to the development of deeper and more liquid regional bond markets that will assist in the efficient allocation of the large pool of savings in Asia to fund productive investment in the region. We also noted the establishment of the ABMI Focal Group, which was set up to coordinate the activities of six working groups.*
8. *We appreciated the assistance by the ADB in conducting studies on credit guarantee mechanisms and regional clearing and settlement mechanisms as well as the joint effort by Japan and Malaysia to conduct a study on the impediments on cross-border bond investments and issuance. We supported Korea and China co-chairing the working group to explore ways to further enhance the regional credit guarantee and investment mechanisms. We also welcomed our members' efforts in modifying existing regulations to facilitate the issuance of and investment in local currency denominated bond under the ABMI.*
9. *We recognized the importance of disseminating information about bond market infrastructure as the dissemination of such information will promote market transparency and facilitate the decision-making process by both issuers and investors. In this respect, we welcomed the launch of the AsianBondsOnline Website (ABW) today. The ABW will play an important role in providing the public with information about the bond markets in the region as well as updates on the progress made by each working group under the ABMI. We also noted the importance of active involvement of the private sector in fostering the regional bond market and promoting regional economic integration, and welcomed the initiatives to be taken under the ABMI.*
10. *We also recognised the importance of capacity building efforts for the further development of regional bond markets and welcomed the*



*technical assistance provided by the Japan-ASEAN Financial Technical Assistance Fund (JAFTA) to assist participating members. We appreciated Korea's and Malaysia's offer to provide additional technical support in this area. To enhance the effectiveness of the economic review and policy dialogue process, JAFAT has also provided assistance to strengthen participating and compiling more accurate and timely data. We also welcomed China's offer to continue with training courses and seminars on the regional economy and financial cooperation.*

At the ASEAN plus 3 Finance Ministers' meeting in 2005, each of the six working groups presented progress reports to ASEAN plus 3 Finance Ministers, but did not contain substantive development except agreeing with the general principles, i.e. (1) introducing a roadmap with a view to creating a mechanism to gather, share, and disseminate information on bond markets development in Asia, and (2) launching new studies on Asian Bond Standard, which would identify necessary market infrastructure and market procedures comparable on those of global bond markets. It was worth noting that the ASEAN plus 3 Finance Ministers acknowledged the need to undertake the study of Asian Bond Standards to explore the development of international bond market in Asia through tailoring necessary infrastructure and setting the procedure entrusted by global issuers and investors.

The Asian Financial Crisis highlighted the need to establish the mechanism to prevent future financial crises. The contagious nature of financial crises demonstrated that financial crises in one country should not be considered as the matters of indifference to the rest of the countries in the region. The Chiang Mai Initiative and the Asian Bond Market Initiative purported to be the concerted actions to better safeguard the region from potential future financial crises. While the momentum of the Chiang Mai Initiative and the Asian Bond Market Initiative came from the political will to better protect the financial crises from the region, it was soon realised among the policy-makers in Asia that the substantial degree of harmonisation of various standards, procedures, rules and regulations including accounting standards compatible with the internationally accepted rules was necessary

in order to gain the sufficient confidence of international investors. The harmonisation of the various standards and regulations would require substantial degree of the market liberalisation and opening in each country, but in Asia there is no mechanism to surrender part of sovereignty to a sort of supra-national body like the European Commission.

The lack of enforcement mechanism to stabilise the regional framework was the key feature of the Asian approaches to promote the regional financial integration. While the importance of a regular monitoring and surveillance process including sharing the collected information among the countries in the region was recognised especially since the Asian Financial Crisis, there was not yet a consensus about what issues should be addressed under a monitoring and surveillance mechanism and to what extent a monitoring and surveillance mechanism should have the binding nature in relation to economic and financial policies of each member state.

With regard to the issues to be focused, the coverage of economic monitoring could include: (1) macroeconomic trends and policy changes, (2) financial markets development including cross-border capital flows; and (3) institutional and legal changes relating to financial regulation.<sup>33</sup> As for the extent to which a monitoring and surveillance mechanism has enforceability, there were three different levels depending on the levels of commitments on the part of participating countries: (1) information sharing; (2) peer review and peer pressure; and (3) conditions for contingent credit line. For example, the Manila Framework, which was convened and established in November 1997, would be classified into the first group.<sup>34</sup>

In October 1998, the ASEAN Finance Ministers agreed to establish an ASEAN Surveillance Process based on the principles of peer review. The responsibilities of the ASEAN Surveillance Process include capacity

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<sup>33</sup> Wang, Yunjoing, Woo, Wing Thye., “A timely information exchange mechanism”, an effective surveillance system, and an improved financial architecture for East Asia”, *Monetary and Financial Integration in East Asia: The Way Ahead Volume 2*, edited by Asian Development Bank, Palgrave, Basingstoke, 2004, pp.422-423.

<sup>34</sup> Institute for International Monetary Affairs, “Research Papers and Policy Recommendations on Economic Surveillance and Policy Dialogue in East Asia”, commissioned by the ASEAN Secretariat, March 2005.

building, institutional strengthening, and information sharing. The ASEAN finance ministers were designed to meet twice a year for policy coordination under the ASEAN Surveillance Process. The key objective of the ASEAN Surveillance Process was to strengthen regional cooperation by: (1) exchanging information and discussing economic and financial development of member states in the region; (2) providing an early warning system and a peer review process to enhance macroeconomic stability and the financial system in the region; (3) highlighting possible policy options and encouraging early unilateral or collective actions to prevent a crisis, and (4) monitoring and discussing global economic financial developments which could have implications on the region and propose possible regional national level actions.<sup>35</sup>

The ASEAN Surveillance Process was further developed as the ASEAN plus 3 Surveillance Process, which was formalised in November 1999. The ASEAN plus 3 Surveillance Process has developed as the ASEAN plus 3 Economic Review and Policy Dialogue process. Under the ASEAN plus 3 Finance Ministers' framework, a regional mechanism of monitoring and surveillance was placed as a part of the institutional structure of the Chiang Mai Initiative. The Joint Statement of ASEAN plus 3 Finance Ministers' meeting in 2000 indicated that the key objective of monitoring and surveillance mechanism was to enable early detection of irregularities and swift remedial policy actions, with a view to developing effective regional surveillance capabilities that complements the current undertaking by the international organisations such as the IMF, World Bank, and the BIS. On the basis of the Joint Statement of the ASEAN plus 3 Finance Ministers' meeting in 2002, it was decided that the ASEAN plus 3 Finance Ministers and Central Bank Deputies would meet informally once a year to discuss economic and policy issues and prepare for the ASEAN plus 3 Finance Ministers' meeting. The linkage between the Chiang Mai Initiative and the monitoring and surveillance was considered in terms of how to address the problem of moral hazard. To prevent moral hazard, it was essential to strengthen the surveillance process, improve the capacity to formulate appropriate adjustment policy in the event of financial crises.

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<sup>35</sup> Ibid. pp5

On the other hand, there remain contentious arguments as to what role the regional surveillance mechanism would play vis-à-vis the IMF, to what extent the issues to be discussed in the regional framework should be comprehensive vis-à-vis the IMF, and to what extent regional surveillance mechanism should have enforceability. As the languages of relevant sections in a series of Joint Statement of the ASEAN plus 3 Finance Ministers indicated, the scope of the ASEAN plus 3 Surveillance process was not supposed to be so comprehensive but rather mainly limited to the monitoring of capital flows. It was not designed to exert peer pressure to harmonise or coordinate macroeconomic policies or financial regulations.

The OECD uses a framework of peer review and peer pressure and describes its characteristics.

*“Peer review is a discussion among equals, not a hearing by a superior body that will hand down a judgement or punishment. This makes them a more flexible tool; a state may be more willing to accept criticism, and its neighbours to give it, if both sides know it does not commit them to a rigid position or obligatory course of action. Peer reviews are not intended to resolve differences among states, but they may play some of the role of a dispute settlement mechanism by encouraging open dialogue that can help clarify positions in non-adversarial setting. The key to the effectiveness of the peer reviews is the “peer pressure” exerted by the states carrying out the review, and the willingness of the state concerned to accept it. This pressure can make itself felt in several ways, both public and private.”<sup>36</sup>*

In short, peer pressure can thus be characterised by the influence and persuasion exercised by the peers during the peer review process. Peer reviews can be generated in a number of forms, but the most common form of peer review is to assess a country’s performance in implementing policy recommendations and guidelines. “Peer review and peer pressure” was usually conducted by inducing each country to improve its policy-making, adopt best practices, and comply with established standards and principles, which often take the form of recommendations and best practices.

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<sup>36</sup> OECD (2003), “Peer Review: A Tool for Cooperation and Change”, *OECD Policy Brief*, OECD Observer, December 2003, Paris.

As regional financial cooperation was developing to the creation of an enhanced Chiang Mai Initiative, a moral hazard issue posed a strong case for the due diligence of potential borrowing countries, and for a clear need for specific enforcement mechanism. At present, it remains ambiguous to what extent the member countries in the ASEAN plus 3 were already ready to accept the peer pressure mechanism. At least what seems to be obvious now is that it has a long way to go for the regional monitoring and surveillance to function as an efficient mechanism to induce member countries to adopt best practices.

Among the key challenges was the absence of leadership that can keep participating countries as a coherent group dedicated to achieving a set of common objectives. Japan considered that Japan was the only country able to provide financial assistance at the time of the Asian Financial Crisis, and many countries considered that it is the case. But, Japan did not use the long-term and short term loans as the leverage to encourage each Asian country to surrender their own sovereignty about economic and financial policies. At the time of the Asian Financial Crisis, China was considered as only a military power, but not an economic power. The Chinese government was extremely cautious of liberalisation of capital controls and unwilling to undertake the economic leadership at least at the time of the Asian Financial Crisis, while they avoided giving the impression that they yielded to the Japan's economic leadership.

Japan was aware of the need to represent the Asian countries in the major international financial frameworks including the G7 Finance Ministers processes and a number of Washington-based international financial institutions such as IMF and the World Bank. However, this Japan's awareness of the need for them to represent the interests of the Asian countries was not linked with the desire to be the regional hegemony in the financial diplomacy in the Asia, but rather was more oriented towards policy-driven discussion from the viewpoint of establishing the more resilient international financial system. At least from the Japanese Ministry of Finance's point of view, the Asian Bond Market Initiative (ABMI) was designed to address the excessive reliance on US dollar. In their view, the

Asian economies informally pegged their currencies to the US dollar, and soft dollar pegs made these economies vulnerable to sudden reversal of capital flows and resulting depreciation of their own domestic currencies.

In the aftermath of the Asian Financial Crisis, the Japanese Ministry of Finance promoted the internationalisation of the Japanese Yen as a part of their efforts to correct the imbalance of dominant use of the US dollar. The Japanese Ministry of Finance identified the 3 key objectives of promoting the internationalisation of the Japanese Yen, i.e. (1) contributing to the stability of the international financial system by facilitating the use of the Japanese Yen and helping to diversify the financial risks, (2) contributing to the stability of the Asian financial market by facilitating the use of the savings of Japanese households and corporate sectors for the development of Asia, and (3) contributing to the stability of the Japanese financial system by reducing the financial risks associated with the transactions between the Japanese Yen and other foreign currencies.

The ambition of the internationalisation of the Japanese Yen was compatible with that of the Japanese financial reform, the so-called Japanese “big-bang” in that it aimed at contributing to making the Tokyo financial market one of the core international financial centres, along with London and New York. The advent of Euro made the Japanese Ministry of Finance more aware of the need to promote the competitiveness of Japanese Yen as an international currency. The Japanese Ministry of Finance considered that the increased use of the Japanese Yen in the international financial markets, especially in Asia, could expand the business opportunities for weakening Japanese financial institutions and contribute to their increased profits. To this end, a number of measures were taken with the intention of promoting the internationalisation of Japanese Yen, including the exemption of withholding taxes on the interests deriving from Japanese government bonds received by non-residents, the improvement of clearing system such as the introduction of the real time gross settlement. The Japanese Ministry of Finance expected that the provision of loan to crisis-stricken Asian countries under the “the Miyazawa Initiative” would serve to promote the internationalisation of the Japanese Yen, as well.

In essence, the Japanese Ministry of Finance's strategy in the aftermath of the Asian Financial Crisis was characterised by the strong sense of responsibility that Japan would need to contribute to the stability of both the international economy and the Asian economy based on the awareness that Japan would be the only country capable of doing that in Asia. The awareness of responsibility of Japan of contributing to the stability of the international and Asian economy was associated with the sense shared among the Japanese Ministry of Finance and the political leaders that Japan must not be the origin of the global financial crisis. This Japan's strong sense of their own responsibility for the stability of Asia's economy and international economy were welcomed by Asian countries, as long as it provided them certain comfort and helped to recover their economy. The Japan's approach was particularly welcomed by the Asian countries in comparisons with the IMF, which demanded a number of conditions with a heavy-handed approach. This approach was based on the desire and the sense of responsibility of Japan to contribute to the stability of the Asian economy, ultimately the international economy, by undertaking the role and responsibility proportionate to their economic presence. This was not based on the desire to seek the regional hegemony in Asia, but rather on the combination of economic pragmatism, which took into account the extent to which Japanese economies and companies were affected by the instability of the Asian economy, and the desire and the sense of responsibility of Japan to contribute to the Asian and international economy. On the other hand, at the same time, the Japanese financial diplomacy had been always based on the sense of obligation to maintain the cooperative and constructive relationship with the US. The co-existence of the sense of responsibility to contribute to the international economy and to maintain the cooperative relationship with the US was the key concept characterising the financial diplomacy of the Japanese Ministry of Finance since the 1980s.

## Chapter 2: The dominance of US-Japan relationships in the Japan's financial diplomacy

### 2-1 The Plaza and Louvre Accord era in the 1980s

For the Japanese financial diplomacy, the Plaza Accord in 1985 and the Louvre Accord in 1987 were the turning point in the sense that Japan was under particular pressure to take a leading role in appreciating its currency against US dollar. In the early 1980s, Japan's trade and current surplus increased sharply and this was accompanied by increased external pressure especially in relation to the US. The financial diplomacy of the Japanese Ministry of Finance was driven by how to respond to the political pressure from the United States.

In the mid-1980s, the Japanese Ministry of Finance understood that the world economy has become more interdependent, and this fundamental changes in the world economy that have been evolving over a longer period of time especially since the collapse of the Bretton Woods system, led to the increased interest in international economic cooperation. This was also based on the belief that Japan has become a major economic power, along with the European Community that competes effectively in trade and finance. While Japan pointed out that the biggest reason for the current imbalance in the 1980s was the US economic policy under the Regan administration, which increased their domestic fiscal deficit, Japan accepted the view that policy cooperation was essential to make the exchange rate fluctuation more orderly and stable under the floating exchange rate system. The Japanese Ministry of Finance considered that economic policy coordination was aimed at strengthening the discipline to encourage each government to implement economic policies to achieve sustainable economic growth of the world economy without inflation, with more stable exchange rate under the floating exchange rate system.

In other words, how to control the exchange rate fluctuation and achieve more orderly exchange rate under the floating exchange rate system was



the key consideration for the Japanese Ministry of Finance. In their view, the sudden and great fluctuation of the exchange rate would incur huge cost of the domestic industry (e.g. by requiring domestic industries to adjust their cost mechanism to maintain their competitiveness) and lead to the trends of protectionism (e.g. by demanding the exporting country to constrain the volume of exported goods).

The objective of achieving the objective of controlling the exchange rate fluctuation gave the Japanese Ministry of Finance the justification to pursue the coordination of economic policy among the G7 major countries underpinned by the surveillance mechanism. The 1986 Economic White Paper stated that rising protectionism could risk damaging the free trade system and Japan would need to undertake the responsibility of achieving the domestic-demand economic growth and contributing to maintaining and strengthening free trade system. The 1986 Trade and Commerce White Paper also stated that Japan enjoyed the benefits of free trade system by increasing its exports and would need to play the major role of maintaining free trade system. This assessment reflected that the post-war Japanese economic growth and prosperity was based on its increased exports and Japan would need to pay more costs by itself in order to maintain free trade system and continue to enjoy its benefits in the long-term.

In fact, G7 Summit itself was established in 1975 and was considered as the place for the leaders of the G7 (the US, Japan, West Germany, the UK, France, Italy, and Canada) to discuss the adjustment and coordination of their policies as the collective leadership by major advanced countries on the international economic issues. The background of the establishment of the G7 Summit was the increased uncertainty of the world economy after the shift to the floating exchange rate system and the economic difficulties of a number of major advanced countries after the first oil shock in 1972. Since the mid-1976, there was an increasing argument mainly led by the US that Japan and Germany would need to play a role of “locomotive” of the world economy by expanding their fiscal expenditure and increasing their imports arising from increased economic growth, which ultimately would help other major advance countries with economic difficulties to

recover their economies more quickly.<sup>37</sup>

In the Bonn Summit in 1978, Japan accepted that they would increase additional fiscal expenditures to achieve the annual economic growth of 7%, along with Germany who committed to doing likewise equivalent to 1% of their GDP. Based on this commitment, Japan increased public investment by JPY 2.5 trillion but failed to achieve the annual economic growth of 7%. The US, which committed to strengthening anti-inflationary measures and saved the consumption of oil, could not achieve the commitments and ended up in the further increase of budgetary deficits. The other European countries such as the UK and France also did not show any significant progress in inflation, budgetary deficits, current account deficits, and unemployment. Before the Plaza Accord, the framework of economic policy coordination was essentially on ad-hoc basis and each country did not have specific obligations unless there was no explicit commitment made by each country to achieve the agreed objectives.

Throughout the first Regan administration between 1981 and 1984, the Reagan administration took the stance of non-interventionist policy toward the foreign exchange market. Beryl Sprinkel, the then undersecretary for international affairs of the US Treasury, was a long-time monetarist who studied economics under Milton Friedman. In his view, foreign exchange rate is determined by the market and foreign exchange intervention was necessary only in the case of disorderly movement. In the Japanese Ministry of Finance, the dollar's strength in the late 1970s and early 1980s was driven by its tight monetary policy stance aimed at reducing inflationary pressure and the special status of the US dollar as the major reserve currency which encouraged other countries to increase their portfolio investment in the US dollar-denominated assets including the US Treasury bonds.<sup>38</sup>

In terms of monetary policy, Paul Volker, the then FED chairman, continued its policy of high interest rates to squeeze inflation out of the

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<sup>37</sup> Kuroda, H. (1989), "International Finance under Policy Coordination (Seisaku-Kyocho-ka-no-Kokusai-Kinyu)", Kinyu-zaisei-jijou-kennkyuukai. 1989.

<sup>38</sup> Ibid. .

economy. The Federal Funds Rates were kept over 10% almost throughout the early 1980s. However, while high interest rates helped attract more and more foreign funds from abroad to help finance our deficits and investments, it led to appreciation of the US dollar. By early 1985, the dollar appreciated by about 45% above 1980s levels against the mark. This strong US dollar adversely affected the US business sector and “the question naturally arose as to whether we might back off from our tough monetary targets and attempt to ameliorate the situation by lowering interest rates”.<sup>39</sup>

To some extent, the US dollar’s appreciation were natural consequences of higher interest rates policy as the Reagan won the 1980 presidential election with the emphasis on the need to fight inflation and return to the price stability.<sup>40</sup> The Fed tightened their fund rates by 600 basis points in less than two months immediately after the 1980 presidential election. This monetary contraction pushed the US economy into deep recession with the sharp rise of unemployment rate from 7.5% in January 1981 to 10.2% in September 1982.

The US Treasury stance against Japan regarding international finance showed a dramatic change in the autumn of 1983. The US Treasury started to demand Japan to take concrete measures to address artificially weak Japanese Yen against the US dollar.<sup>41</sup> The US Treasury led by the then Treasury Secretary Don Regan believed that yen’s exchange rate against the US dollar was artificially weak due to the lack of opportunity for overseas investors to invest in the Japanese financial markets and products denominated in the Japanese Yen.

It was also politically necessary for the US administration to be seen attempting to respond to the public and congressional concerns over the rising US trade deficits against Japan, feeling threatened by the increased competitiveness of Japanese counterparts. The US business circle took

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<sup>39</sup> Volker, P. and Gyoten, T. “*Changing Fortunes*”, 1992

<sup>40</sup> Feldstein, M. “*Monetary Policy and Inflation in the 1980s: A Personal View*”, NBER Working Paper No. 4322, April 1993

<sup>41</sup> Takita, Y. (2006), “Nichi-Bei Tuuka-Kosho (Negotiation of Financial Affairs Between Japan and the US)”

increasingly tough approach against Japan. For example, the Caterpillar Report in September 1983 called for correcting the strong dollar by pressing the Japanese authorities to further open their Japanese financial markets. In their view, the artificially weak Japanese Yen led to the excessive bilateral trade imbalance between the United States and Japan. In other words, the United States pressed the Japanese Ministry of Finance to liberalise the Japanese Financial markets to further promote the internationalisation of Japanese Yen. From the US point of view, how to achieve the correcting stronger dollar without losing their face of their traditional doctrine of “strong dollar is in the interest of the US” was a critical issue.

In political terms, there was a good reason for the then US Reagan administration to fear that the US trade deficit against Japan would give the Democrat a potentially good weapon to criticise the Reagan administration leading up to the November 1984 presidential election and the growing frustration in the Congress could lead to protectionist legislation on Capitol Hill. Within the Japanese Ministry of Finance, there was a general view that the Japanese Yen and US dollar exchange rate did not reflect the strength of the Japanese economy, which overcame the second oil-shock in 1979 well. The Japanese Ministry of Finance also considered that the level of Japanese Yen against the US dollar reflected the stereo-type image of the Japanese economy which had been susceptible to the hike of oil prices in view of the reliance of the Japanese economy on the imports of crude oil.<sup>42</sup>

At the margin of the President Reagan’s visit to Japan in November 1983, the US Treasury and the Japanese Ministry of Finance formally agreed to create the Yen/Dollar Committee to discuss the Japanese financial liberalisation. The then US Treasury Secretary Don Regan followed the argument made by Caterpillar Tractor Chairman Lee Morgan in his report compiled late September 1983. Morgan argued that Japanese financial liberalisation would help promote capital flow from the US to Japan, rather than the reverse, and would help reduce the corresponding US trade deficit through yen’s appreciation. At that stage, foreign exchange rate between the US dollar and the Japanese yen was not the direct objective of the

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<sup>42</sup> Ibid.

US-Japan policy dialogue, but merely the consequence of the financial liberalisation.

In response to the US Treasury's requests, the Japanese Ministry of Finance worked hard to avoid the appearance of being forced to open the Japanese capital markets. The Ministry concurrently prepared a report for domestic consumption on financial liberalisation and yen internationalisation. The report titled '*The present status and outlook on financial liberalisation and yen internationalisation*', was released at the same time as the Yen/Dollar Committee report. The measures included the liberalisation of euro-yen market aimed at making it easier for non-resident investors to buy yen as well as liberalisation of Japanese domestic financial and capital markets including interest rates liberalisation.

While the Yen/Dollar committee played a catalytic role of opening up a set of financial liberalisation measures in Japan, it did not lead to the appreciation of the Japanese Yen as the US Treasury expected. The proposition that the highly regulated Japanese financial and capital market discourage the flow of capital into Japan and depressed the value of the yen was more driven by long-termism rather than short-termism. As Beryl Sprinkel admitted in the negotiation, a set of US requests were intended to increase the business opportunities of the US financial firms in the Japanese financial and capital markets as increasingly attractive markets by facilitating their access to the Japanese markets. In terms of Japanese Yen's appreciation, the Yen/Dollar committee did not bring about any result, which paved the way for the Plaza Accord. The Japanese Ministry of Finance did not consider from the beginning of the negotiation that the liberalisation of the Japanese financial market and the internationalisation of the Japanese Yen would lead to Japanese Yen's appreciation. However, it used the negotiation with the US Treasury as the opportunity to persuade the domestic Japanese financial industries to accept the liberalisation.

The pivotal event in the making of exchange rate policy in the 1980s was the inauguration of the second Reagan administration with the replacement of Don Regan and Beryl Sprinkel with James Baker and his aide Richard Darman. The new team of James Baker and Richard Darman leading the

Treasury shifted its policy focus towards the more direct exchange rate adjustment underpinned by macroeconomic policy coordination. They attached the importance on the institutionalisation of macroeconomic policy coordination as a continuous framework rather than an ad-hoc one. At that time, the primary interest of the Japanese Ministry of Finance was to how to make the US commit to the orderly exchange rate fluctuation. The Economic White paper in 1986 stated that the surge of protectionism would risk collapsing the free trade system and Japan need to change the economic structure characterised by export-driven growth to the domestic-demand driven economic growth model, taking into account the status of Japan in the international economy. This was based on the view that Japan enjoyed much more benefits than the US from the free trade system, and if the US takes more aggressive protectionism measures, the Japanese industries and then subsequently Japanese economic growth would be severely damaged.

The perception of the overvalued US dollar was quickly spreading within the administration and the Capitol Hill. In February 1984, the annual Economic Report of the President led by Martin Feldstein, the then chairman of the Council of Economic Advisors clearly stated that the high value of the US dollar in foreign exchange markets is the most important cause of the recent increases of trade deficit. As of December 1983, the dollar had risen 52% against an average 10 trading partners' currencies weighed by their shares in world trade, relative to the average for 1980. It showed that the real appreciation of the dollar as of December 1983 amounted at 33%, if one takes the average over the period of 1973-1979 as the standard of comparison. While Donald Regan came from the Wall Street with the CEO of the giant brokerage firm Merrill Lynch, James Baker practiced law in a legal firm in Texas before switching to a political career. James Baker preferred to take a more direct approach to rebalance overvalued dollar.

In the confirmation hearing of James Baker in the Congress in January 1985, he clearly stated that the dollar was overvalued and the US Treasury would encourage trading partners to adopt the same macroeconomic policies as the US in the Reagan administration. In the Committee, James

Baker stated:<sup>43</sup>

I would rather say that the dollar is very, very strong, Senator. I think the term 'overvalued' has a technical meaning. Since the value of the dollar is set by the market, I suppose one could argue it's not overvalued because it is set by the market. It's obviously very, very strong. I do think there are some things that can be done to help with that situation, and I have already mentioned that one of them, which is getting our fiscal deficit down so that we have less pressure on interest rates, and therefore, perhaps less inclination to invest the dollar. I also think that it's in the interest of this country to encourage our trading partners to adopt those policies that we have adopted in this country which have given us the sustained economic growth that we are now enjoying. That is, freedom from overtaxation, freedom from overregulation. That if we can encourage our trading partners to adopt these policies, their economies will come back just like ours has. And that will help with the value of the dollar.

*On the question of question of intervention, it's been the position of this Government as long as Ronald Reagan has been the president that we would intervene only in instance of disorderly markets. I understand that there have been some discussions between Secretary Regan and the finance ministers of Germany, Japan, Great Britain, and France looking toward the possibility of perhaps a little bit activity in this area. Nothing has been done, as far as I know. And quite frankly, I'm told that there are serious doubts about whether intervention today – whether or not intervention is effective in light of the vast amount of private capital that now flows out of there in the exchange markets. So I should not express, nor do I have, an opinion on whether our policy of intervening only where markets are disorderly should be changed. But that's obviously something that should be looked at because some will argue that that could have a dramatic effect on the value of the dollar.*

(To the question by Senator Bradley of 'Do you believe that the dollar is too high or do you think it should come down?')

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<sup>43</sup> Transcript of the Hearing Before the Committee on Finance of US Senate on 23<sup>rd</sup> January 1985 on the nomination of James Baker to be Secretary of the Treasury

*I think the dollar is very, very strong. And I said in answer to a prior question, I think there are pluses and minuses with respect to that strength of the dollar. And it's not a case of too high or too low. I think we have to look at the consequences of moving it down or permitting it to continue upward.*

(To the remark by Senator Bradley of 'So that when we consider the deficits, we consider not just trade deficits but also capital accounts surplus or deficits in order to get a true picture.')

*That's correct.*

(To the written question by Senator Heinz of 'do you support any change in current law to reduce the independence of the Federal Reserve Board and correspondingly increase the power of the Treasury Department with respect to setting targets for growth in the money supply?')

*My primary concern about monetary policy is that it provide consistent support for solid real economic growth at non-inflationary rates. (in written answer)*

What was worth noting in James Baker's remark at the confirmation hearing at the Senate Committee in January 1985 was that he explicitly stated that the US dollar was very strong, and also expressed the wish to drive down overvalued dollar by seeking more active macroeconomic policy coordination among trading partners. Then James Baker was faced with the dilemma of achieving the two contradicting goals at the same time, i.e. (1) driving down overvalued dollar and (2) securing capital inflows from overseas. The strong-dollar policy aimed at fighting inflation and returning to price stability worked to attract overseas capital inflows to the US and secure capital inflows from overseas.

In order to counter the inflationary pressure in the financial markets, he maintained the stance of containing inflationary pressure. But at the same time, he expressed that the primary objective of monetary policy would be



to provide support for solid real economic growth. Here he clearly signalled that monetary policy should be oriented towards economic growth rather than solely anti-inflation as the primary objective. Macroeconomic policy coordination was needed to enable the US to drive down interest rates to stimulate growth while continuing to secure capital inflows to the US at the same time. If the interest rates of the other major trading partner countries are driven down in parallel with the US, the negative effects of the US interest rates reduction on capital inflows to the US would be minimised. The US demanded to Japan and Germany that both countries adopt monetary easing with lower interest rates and expansionary fiscal policy.

In essence, the US Treasury pursued macroeconomic policy coordination as the means of achieving their domestic agendas such as reducing trade deficits and lowering their interest rates to economic stimulate growth without securing capital inflows to the US. In the first place, even for the purpose of reducing trade deficits, it was politically embarrassing for James Baker to explicitly admit the major policy shift of the strong-dollar policy once proclaimed by their President Donald Reagan. In the second place, the macroeconomic policy coordination was necessary to achieve the both goals of reducing the deficits and securing the capital inflows to the US by ensuring the yield gaps between the US and trading partners to maintain the attractiveness the US Treasury bonds.

Faced with the US's demands for macroeconomic policy coordination, Japan tried to first use coordinated exchange rate intervention to drive down the overvalued US dollar without going so far as macroeconomic policy coordination including as wide a range of policy as fiscal policy and tax policy. The officials in charge of international affairs were always under pressure not to make any commitment for either budgetary policy or tax policy. In view of the administrative structure of the Japanese Finance Ministry where each Bureau has separate authority and duty, it was natural for neither Budget Bureau nor Tax Bureau to give generous mandate to their colleagues in charge of international affairs. Especially in terms of budgetary policy, the Japanese Ministry of Finance was always surrounded by political circle and other ministries putting pressure of expansionary

budget on them and tended to be isolated about its cautiousness about any expansionary budgetary pressure. As a result, foreign exchange intervention was essentially the only tool for the officials of the Japanese Finance Ministry to use within at least some degree of discretion of the officials in charge of international affairs.

However, the then Finance Minister Noboru Takeshita made concession to agreeing with starting the macroeconomic policy coordination at the preparation process to the Plaza Accord in September 1985. Domestically he was considered as one of the three candidates who would succeed Prime Minister Yasuhiro Nakasone, along with Kiichi Miyazawa and Shintaro Abe (the then Foreign Minister). While Noboru Takeshita was leading the biggest political faction in the Liberal Democratic Party, he admitted that his name was not as well recognised internationally as the other two key rivals Kiichi Miyazawa, who was a former Finance Minister official working as a private secretary and interpreter of former Prime Minister Hayato Ikeda in the 1950s before entering into a political career, and Foreign Minister Shintaro Abe. Noboru Takeshita was concerned that if he could not show political leadership as Finance Minister to the US and make James Baker, who was a close ally to Ronald Reagan, see him as a strong and reliable partner with the US, he could be at disadvantage compared with his other two political rivals. In the process leading up to the Plaza Accord in September 1985, Noboru Takeshita finally decided to accept the Plaza Accord as the starting-point of macroeconomic policy coordination as well as coordinated foreign exchange intervention.<sup>44</sup>

While the Plaza Accord was sometimes described as the tipping-point of the macroeconomic policy coordination as well as coordinated foreign exchange intervention, this macroeconomic policy coordination was essentially the rescue of the US economy by the other major trading partners especially Japan and Germany taking the form of international macroeconomic policy coordination.<sup>45</sup> The international macroeconomic policy coordination helped the US administration in two respects: (1) it

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<sup>44</sup> Funabashi, Y., *"Tsu-ka-retsū-retsū (Currency Wars)"*, Asahi-Bunko, 1992

<sup>45</sup> Martin Feldstein stated that "The highly publicised policy coordination meetings of the finance ministers unfortunately served as a substitute for much needed policy changes at home" (*"The Dollar and Trade Deficits in the 1980s: Personal View"* NBER Working Paper No.4325, April 1993)

enabled the US administration to describe it as the adjustment of overvalued dollar through international policy coordination rather than the U-turn or renunciation of the Reagan's strong-dollar policy; and (2) it enabled the US to continue to attract the capital inflows to the US by locking in the monetary policies of Japan and Germany downward in parallel, which eventually served to maintain the attractiveness of the US Treasury bonds to plug the fiscal gap even when the FED shifted its policy stance towards low-interest rate policy. The Japanese government was worried that the bilateral trade imbalances would exacerbate anti-Japanese sentiments especially at the Capitol Hill and cause the protectionist measures to be taken to adversely affect the Japanese manufacturing sectors.

After the Plaza Accord, the Japanese Yen appreciated against the US dollar from around 230 to 150 between September 1985 and September 1986. James Baker's ambition was as extensive as calling on other trading partners to adopt a system of so-called objective indicators. At the Louvre Agreement in February 1987, the Ministers and Governors agreed that the substantial exchange rates since the Plaza Agreement brought their currencies within ranges broadly consistent with underlying economic fundamentals and agreed to cooperate closely to foster stability of exchange rates around current levels. In return for including the languages indicating that the dollar should be stabilised 'around current levels', Japan had no choice but to agree that Japan would follow 'monetary and fiscal policies which will help to expand domestic demand and thereby contribute to reducing external surplus. Between the Plaza and the Louvre Accord, the negotiations of foreign exchange interventions and macroeconomic policy coordination were highly politicised.

The Plaza Accord agreed with the coordinated intervention to drive down dollar to achieve realignment between the dollar and the yen and mark. But from the US point of view, it also paved the way for the international macroeconomic coordination. At the Tokyo Summit of May 1986, it was decided that with the initiative of the US, G7 countries would focus in their meetings on a set of objective indicators: the growth rate of GNP, interest rate, inflation rate, unemployment, ratio of the fiscal deficit to GNP, current

account and trade balances, money growth rate, international reserve holding, and exchange rate. The 1986 Tokyo Summit agreed that G7 finance ministers would meet at least once a year to review the compatibility of their economic objectives.

After the Plaza Accord, the Japanese Yen appreciated against the dollar rapidly, it did not lead to substantive reduction of trade deficit between Japan and the US, as is well understood in the J-curve in trade surplus. In general, it takes a certain period of time for exchange appreciation and depreciation to affect the volume of imports and exports. In the short term, as a result, the Japanese Yen's appreciation resulted in the deterioration of the US trade deficit denominated in the US dollar against Japan. For the US who intended to use exchange rate appreciation as the effective means of readdressing the trade deficit against Japan, it forced the US government to shift their focus on from exchange rate to macroeconomic policy coordination in order to call on Japan to steer its economy towards domestic demand driven economy.<sup>46</sup>

The US initiative to use international policy coordination as a means of pressing other countries to take some actions on domestic fiscal and monetary policies caused the domestic conflict and friction both within the Ministry of Finance and between the Ministry of Finance and the other ministries. In the post-war period, the trade friction between Japan and the US was sorted out by voluntary constraints of the volume of exported goods, which started with textile in the late 1950s and 1960s and extended to steel and television in the 1970s. The trade friction issue was traditionally the one dealt with by the Ministry of Trade and International Trade. In the mid-1980s, the battlefield was extended to macroeconomic policies as broad as budget, fiscal, monetary, and exchange rate policy, which were the territory of the Ministry of Finance.

In Japan, budgetary policies and tax policies are primarily administered by the Budget Bureau and the Tax Bureau of the Ministry of Finance. Budgetary policy and tax policy are by nature domestic process and highly politicised with the engagement of various political stakeholders. Both

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<sup>46</sup> Funabashi, Y., "*Tsu-ka-rets-u-rets-u*", Asahi-Bunko, 1992

budgetary policy and tax policy begin with the submission of budget requests and tax reform requests from all the ministries in September. In Japan, the budget examination process continues until December. The final deliberation of both budget and tax reform plan for the next budget year needs to go through the process of the ruling party. The final negotiation on the budget draft is held between the minister of the Finance Ministry and the requesting ministries with a group of MPs (member of parliaments) and interests groups. The tax reform draft is even more politicised and each item of tax reform request is fully subject to the discussion at the Liberal Democratic Party Tax Commission. As a result, the international finance bureau did not have any mandate to negotiate with the US on either budgetary or tax policies.

As a result, the officials of the International Finance Bureau of the Ministry of Finance saw only exchange policy at their discretion. There was some degree of awareness among some officials in the Ministry that the yen was undervalued and some degree of appreciation could be tolerable. The Japanese business community was so afraid about escalating unilateral protectionist measures led by the US congress that it was of the view that some degree of yen's appreciation was the price they could put up with. However, the pace of the Japanese Yen's appreciation after the Plaza Accord in September 1985 was far faster than the extent the Japanese business community could be ready to accept. This led to the call on the Japanese government to seek the stability of foreign exchange market.

In contrast to the mid-1980s, the Japanese Yen's appreciation was not necessarily considered much negative to the Japanese economy. Between 1977 and 1978, the yen appreciated from the range of 290 yen against US dollar to 182 yen at its peak on 15 August, 1978. This rapid appreciation of the Japanese Yen is mostly due to the growing trade surplus of Japan and trade deficit of the US. The Economic White Paper in 1978, which was written by the Economic Planning Agency and the official analysis of the domestic economy as the Japanese government, pointed out that the Japanese Yen's appreciation would lead to the fall of the price of imported goods and the improved terms of trade. The Japanese Yen's appreciation was more positively seen as a desirable variable appeasing the increased

imported price of natural resources such as crude oil.

But, the decline in oil price in the mid-1980s worked to offset the advantage of currency appreciation as the shock-absorber of price hike of natural resources. The currency appreciation was highlighted as something which brings about the decline in profits through the loss of competitiveness rather than as a shock-absorber. The acceptance of the Japanese Yen's appreciation forced the Japanese Ministry of Finance to take more fiscal stimulus policy and loose monetary policy to absorb its shocks.

When Japan clearly emerged as the second largest economy in the non-communist world, the then Prime Minister Nakasone clearly steered the traditional Japanese passive diplomatic stance towards more pro-active one especially in relation to the US. He attempted to establish the special relationship with the US to leverage the Japan's position in the G7. In terms of the currency, he believed that the Japanese Yen were significantly undervalued and the strong yen should represent the strong Japanese economy and the more proactive role of Japan as the second largest economy next to the US. He saw the Plaza Accord a clear sign for Japan to pursue the G2 in the global financial order.

By contrast, the Japan's pursuit of the G2 in the global financial order was not necessarily shared with the domestic fiscal authorities such as the Budget Bureau and the Tax Bureau in the Ministry of Finance and the monetary authority of the Bank of Japan. The International Finance Bureau, which was in charge of international finance matters, represented the Japanese Ministry of Finance as a whole and tried to shield the autonomy of the domestic fiscal policy from the pressure deriving from the international macroeconomic policy coordination. The International Finance Bureau did not share all the information about the negotiations with the other bureaus within the Ministry in view of the confidentiality of the information.

The US's call for international macroeconomic policy coordination led to the tense relationship between the Finance Ministry and the other ministries.

The international macroeconomic policy coordination called on Japan to undertake more expansionary Keynesian budgetary policy and easier monetary policy with the reduction of discount rate. The Finance Ministry was naturally oriented towards achieving budgetary neutrality and minimising budget deficits. On the contrary, the other ministries were eager to make the best use of the US pressure to demand the Finance Ministry more budget in the interests of achieving their domestic agenda.

Since the Ohira cabinet failed to increase the consumption tax rate in 1979, the first priority of the domestic economic policy of a series of Japanese governments including the Suzuki cabinet and the early years of Nakasone cabinet was to achieve fiscal consolidation and administrative reform without tax increase. Thus, in the early 1980s, the break-away from the dependence of deficit-financing bonds was the first priority for the Budget bureau of the Ministry of Finance.

The rapid Japanese Yen's appreciation and the international macroeconomic policy coordination resulted in the call for Japan to increase government expenditure and promote domestic-demand driven economy, thereby worked to tilt the balance against maintaining fiscal authority in two respects. In the first place, the rapid Japanese Yen's appreciation hurt domestic exporting sectors such as shipbuilding and steel and small and medium-sized enterprises, in particular, this led the politicians of the ruling Liberal Democratic Party to give pressure on the Finance Ministry to take more active fiscal measures to offset the pain by providing fiscal support such as loans at a preferable rates and guarantees. In the second place, the international macroeconomic policy coordination called on Japan to take fiscal stimulus to stimulate domestic demand to address external imbalance.

In the late 1980s after the Plaza Accord, there was a growing tension between the argument stressing the role of Japan in the international economy and the argument stressing the role of government measures to protect the domestic industries that were put at disadvantage by rapid yen appreciation. On the one hand, the Japanese economic diplomacy in the late 1980s was characterised by the sense of a sort of guilt about growing trade

deficits. This posed a fundamental question to the export-led growth of the Japanese economy in the post-war period. The sense of guilt was associated with the reliance of Japan upon the US military forces since the Second World War and the pursuit of economic prosperity without a proportionate burden-sharing about defence policy.

The so-called Maekawa-Report released in April 1986, commissioned by Prime Minister Nakasone to a former Bank of Japan Governor Haruo Maekawa, stressed that the Japanese economy needed to be transformed from export driven economy to domestic demand driven economy. It also further stated that the excessively accumulating current account surplus was threatening the stability of world economy and the orderly reduction of current account surplus should be explicitly placed as the mid-term objective of the government economic policy. There was an underlying belief that current account surplus and deficit determines the economic power game in the world and Japan was disproportionately monopolising the wealth of the world economy and needed to share it with other trading partners. The report called for the Japanese budgetary and tax policies to be more oriented towards increased domestic demand, the consumption of private sector, in particular.<sup>47</sup>

In essence, at the heart of the international macroeconomic policy coordination after the Plaza Accord was the coordinated rescue among the G7 of the US economy without making the US administration lose their faces. From the US point of view of addressing the growing trade deficits, Japan was the primary target in this whole exercise led by the US. Even before the Plaza Accord, the US-Japan trade conflicts dated back to the 1950s with the US's call for Japan on voluntary limitation of textile exports to protect the US textile industry. In response to the rather political responses against Japan highlighting the bilateral trade imbalances, Japan made as much efforts as it could to accommodate their demands by resolving the bilateral trade imbalance with the justification that the US was the most important trade partner, and any restrictive unilateral US actions would have negative impact on the Japanese industries in the long

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<sup>47</sup> Kokusai-kyocho-notameno-keizaikouzouchouseikennkyuukai-houkokusho (Maekawa-report), (available in <http://www.komazawa-u.ac.jp/~kobamasa/lecture/japaneco/maekawarep.htm>)



term.

In the 1980s, Japan played an active role in the debt problems in emerging and developing countries in the international finance. In the early 1980s, Latin American countries were faced with accumulating debt problems. Historically there was not much direct economic or political for Japan in the Latin America, where the US had a dominant presence. But, then Japan made proactive responses to the call from the international community based on the belief that the contribution to the stability of the international economy would ultimately serve the interests of Japan. At that time, the Japanese Ministry of Finance considered that Japan would undertake the role of providing capital as the largest saving surplus country to maintain the stability of the international financial market. It considered that giving more emphasis on providing non-concessional loan including the co-financing with the international financial institutions by the Japan Export-Import Bank and private financial institutions would make it easier for those financing to be used for the development of their domestic industries in developing countries rather than for the simple repayment of the past debts.

In October 1986, Japan announced the USD 10 billion capital recycling programme designed to recycle Japan's trade surplus to developing countries over the following 3 years. This programme was further expanded to USD 30 billion capital recycling programme in May 1987, which included the untied loan provided by the Japan Export and Import Bank amounting at USD 3 billion, the contribution to the international financial institutions such as the World Bank (USD 8 billion), the expansion of co-financing with the international financial institutions by the Japan Export-Import Bank, the Overseas Economic Cooperation Fund, and private financial institutions (USD 9 billion), along with the Japan's contribution amounting at USD 2 billion to Japan Special Fund at the World Bank, the USD 3.6 billion loan to the IMF and the USD 3.9 billion capital provision to the International Development Association and the Asian Development Bank.

Faced with the accumulating debt problem, the Japanese Ministry of

Finance considered that the issue could not be resolved by the traditional approach of forcing the debtor countries to implement tight macroeconomic policies, but rather more important was it to restore the ability of repayment in the medium and long-term underpinned by sustainable economic growth of debtor countries. The Japanese Ministry of Finance considered that it was necessary to provide new money necessary via private financial institutions as well as public funds for the economic growth of debtor countries. The Japanese Ministry of Finance was aware that this forward-looking growth would contribute to alleviating the dissatisfaction of the general public of debtor countries and achieving more political stability.<sup>48</sup> There is much common between the Japanese proposal in the late 1980s for resolving the debt problem and the Japanese proposal in the aftermath of the Asian Financial Crisis, notably in that it attached the emphasis on the importance of providing the new money as a means of restoring the confidence of private investors and achieving the economic growth. In the case of the Latin American countries, the Latin American countries was lacking of sufficiently high level of saving to finance the development of their domestic industries. The provision of new money was an essential component of resolving the accumulating debts in the Latin American countries. In terms of the accumulating debt problem, Japan worked to play a certain role of providing new capital as the current account surplus country. The Japanese government considered that while the US needed to address domestic fiscal deficit and had difficulty in providing new capital from the public sector, Japan would need to undertake a certain responsibility of providing new capital using their abundant capital in private sector.<sup>49</sup> This sentiment reflected the view that Japan was expected and able to undertake the leadership role to fill in the vacuum created by the situation where the US had difficulty in managing their domestic economic agendas including the domestic fiscal deficits and current account deficits.

When the Bush administration started in 1989, the US-Japan bilateral relationship continued to focus on the bilateral trade imbalance problem.

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<sup>48</sup> Kuroda, H. (1989), "International Finance under the International Policy Coordination (Seisaku-kyochou-ka-no-kokusaikinnyuu)"

<sup>49</sup> The Trade and Commerce White Paper 1989, Government of Japan

What differed from the Regan administration was that the Bush administration focused on more specific policy issues such as land policy and vertical distribution practices. President Bush proposed to then Japanese Minister Uno to establish the US-Japan Structural Impediments Initiatives to discuss more specific policy issues. The background of this proposal was the US administration's view that the coordination of macroeconomic policy pursued since the Plaza accord did not lead to the expected result of declining trade imbalances between the two countries.

The proposal of establishing the US-Japan Structural Impediments Initiative was based on the increasing US's frustration about the continued trade imbalance between the two countries. Strengthening of the so-called Super 301 act of the Trade Act 1974, which authorised the President to take all necessary measures including unilateral retaliation, created the anxiety among the Japanese government. While Japan was critical of the US's move to use unilateral measures as the negotiation strategy to coerce the other country to the US's demands, Japan accepted the establishment of the US-Japan Structural Impediments Initiative on the fear that unless Japan did not accept the establishment of the US-Japan Structural Impediments Initiatives it would give the US administration the excuse to implement the Super 301 earlier than otherwise.<sup>50</sup> From the Japanese Ministry of Finance's point of view, the macroeconomic imbalance and the US's call on Japan to increase public expenditure for public works was the most difficult topic. The US administration pressed the Japan to increase the amount of fiscal expenditure for public works for the next 10 years and specify it in the bilaterally agreed document. The US administration focused on the macroeconomic balance and the lack of public investment to offset the current account surplus.<sup>51</sup>

Faced with the escalating demands from the US administration, the Japanese Ministry of Finance tried to make the bilateral commercial negotiations as the major issues to be discussed between the bilateral negotiations. However, the US Treasury adamantly insisted that the explicit

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<sup>51</sup> Takita, Y. (2006), "Nichi-Bei Tuuka-Kosho (Negotiation of Financial Affairs Between Japan and the US)"

figure of the amount of public expenditure for public works need to be filled in in the agreement. The US administration knew that there were the ministries who would benefit from the increase in the public expenditure for public works and the politicians of the ruling party would welcome the US pressures as the justification of the increased public expenditure for public works.<sup>52</sup>

In the Japanese sides, there was clear difference of interests among the Ministries. For example, the Ministry of International Trade and Industry was reluctant to admit that the trade imbalances were due to anti-competitive industrial behaviour and structural impediments in the Japanese markets such as the legal and administrative constraints. The Ministry of International Trade and Industry insisted that the core problem of the Japanese current account surplus was due to the macroeconomic imbalance between savings and investments in Japan. From the Japanese Ministry of Finance's point of view, the commitment of fiscal expenditures for public works will constrain the future flexibility and autonomy of the budget planning, which was the last thing for the Japanese Ministry of Finance to accept. The 1990 Trade and Commerce White Paper stated that the multilateral trade system was a key pillar of the Japanese economy, and the pursuit of domestic-demand led growth and improvement of standard of living would contribute to addressing the trade imbalance through increased imports of foreign goods. The Trade and Commerce White Paper raised the concern about the risk of regional integration in the North American and the European countries becoming regional trade blocks and overriding the multilateral free trade system, and underscored the need of Japan undertaking the certain responsibility of maintaining the multilateral free trade system. The Trade and Commerce White Paper hailed the rise of the Japanese economic power in the 1980s as the success of export-led growth policy and post-war industrial policy, but at the same time, admitted that the rise of the Japanese economic power was taken by other countries as the threat and expressed the concern about the increasing trend towards protectionism in some countries calling for sometimes even the numerical target. In other words, there was a sort of confidence that a rise of Japan as a major economic power in the international economy would require more

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<sup>52</sup> Ibid.

domestic-demand driven economic growth, and recycle the benefits which the Japanese enjoyed to other countries as the contribution to the international common goods such as the free trade system.

In the Structural Impediments Initiatives negotiations, the US called for the Japanese government to commit to JPY 500 trillion over the next 10 years as for the fiscal expenditure for public works. Apart from a discussion on whether there was any economic rationale for the US to call on Japan to reduce the trade surplus, the US government assumed that their economic malaise was most due to the Japan's trade surplus. From the Japanese Ministry of Finance's point of view, what the US would need to call upon to address was the business practices of the Japanese companies and the legal and administrative regimes by the Japanese Ministry of International Trade and Industry, as well as the strengthening competition law and enforcement mechanism of anti-monopoly law. The Ministry of International Trade and Industry stressed that the trade imbalance between the US and Japan was due to the macroeconomic imbalance between savings and investment, with the intention of shifting more attention to macroeconomic imbalances rather than the closedness of the Japanese market.

At the end of the negotiations, the Japanese Ministry of Finance agreed that the Japanese government would commit to JPY 430 trillion over the next 10 years as the public expenditure for public works. During the negotiation, the Japanese Ministry of Finance insisted that the commitment of the increase of public expenditure for public works would be the breach of the budget authority. Apparently there was no link between the increase of public expenditure for public works and the reduction of trade account imbalances between the two countries. However, in the end, the Japanese Ministry of Finance conceded that they would commit to JPY 430 trillion over the next 10 years. Then Vice Minister for International Affairs of the Japanese Ministry of Finance, Makoto Utsumi was internally severely criticised by the budget bureau's colleagues of the Japanese Ministry of Finance colleagues for his failure to carve out the budgetary commitment in the US-Japan Strategic Impediments Initiative. However, the Japanese Ministry of Finance eventually accepted the explicit figure of the amount in

order to avoid the political damage of the break-up of the US-Japan Strategic Impediments Initiative.

In the late 1980s and early 1990s, Japan took a rather proactive stance on the financial diplomacy, responding to the demands from the US about the Japan's continued expansionary macroeconomic policies. The Prime Minister Nakasone took this opportunity to raise the international profile of Japan among the G7 by establishing the special personal relationship with the US Ronald Regan and taking an initiative in steering the Japanese economy towards a domestic-demand driven economy. The Prime Minister Nakasone was convinced that Japan should be aware of the need to undertake the corresponding responsibility to the second largest economy in the international community in both economic and military terms within the constraints of the current constitution prohibiting the exercise of military forces in general. While Japan made utmost efforts to avoid making the US lose their faces in their negotiations, the Japanese Ministry of Finance took advantage of the stronger G2 cooperation as the means of promoting the interests of Japan in financial diplomacy in other relevant financial diplomacy issues such as the increase of Japan of the quota share in the multilateral development banks including the World Bank.

In the process of establishing the strong G2 cooperation between Japan and the US, the Japanese Ministry of Finance worked hard by go so far as even sacrificing a part of budgetary authority to avoid causing severe political damage with the US administration. This is based on the growing confidence by the Japanese Ministry of Finance that the Japanese economic power dramatically increased in the 1980s in the international economy and finance while the US economy had difficulty of the twin deficits of fiscal and current account balances, and the sense of responsibility underpinned by that confidence that the Japan would need to undertake the greater responsibility of maintaining the sustainable growth of the international economy.

2-2 “Awkward Partnership” between the US and Japan under the Clinton Administration in financial diplomacy and the Asian Financial

## Crisis

In the early 1990s, the US-Japan relationship was still driven by the trade imbalance problem between the two countries. In the early 1990s, the Clinton administration pressed Japan to take even more aggressive stances against Japan to address the bilateral trade imbalances. The end of the cold war between the US block and the Soviet Union (USSR) also worked to reduce the urgent need for the US to take into account the strategic importance of Japan as a military ally.

The Clinton administration can be divided into the two phases. In the first phase, the trade-centric view was prevalent in the first two years of the Clinton administration until the advent of Robert Rubin. In second phase, the trade-centric view was replaced by the finance-centric view in support of strong dollar. In the trade-centric view, exchange rate was considered to be a tool for addressing trade imbalances. This was promoted by the trade negotiator group who believed that talking down US dollar and resulting strong Japanese yen would work to reduce the US trade deficits against Japan.<sup>53</sup>

In the early days of the first Clinton Administration, they were pressing Japan to give way to setting the quantitative targets in each sector such as automobile in a designated timing to show the political commitment. In their process, the US administration was not hesitant to say that the Japanese yen appreciation is a one of the tools for addressing the US trade deficits. For example, in the joint-press conference of Clinton and Miyazawa on 15 April, 1993, Clinton stated that Japanese yen appreciation was the number one priority policy action along with expansionary budgetary policy and the improved market access of the US goods and services towards the Japanese market through the discussion the US-Japan Framework Talks focusing on specific sectors.<sup>54</sup> The market received this message as the US's willingness to see further Japanese yen appreciation to address the US-Japan trade imbalances, and the Japanese Yen further

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<sup>53</sup> Sakakibara, E. "Nihon to Sekai ga Furueta Hi" ("The Day that Rocked Japan and the World")

<sup>54</sup> Joint statement of Clinton and Miyazawa at the White House on 16 April 1993  
<http://www.ioc.u-tokyo.ac.jp/~worldjpn/documents/texts/JPUS/19930416.O1E.html>  
<http://www.c-spanvideo.org/program/39740-1>

appreciated above 110 yen/dollar on the following day.

In the early days of the Clinton Administration, the Japanese Ministry of Finance considered that the US democratic administration's financial diplomacy was oriented towards the bilateral trade imbalances. The US administration continued to press Japan to increase fiscal stimulus measures to change the economic structure towards a more domestic-demand driven growth and open the Japanese market with specific sectors with numerical targets. The Japanese Ministry of Finance took this pressure as the US's populist response to the traditional supporting groups of the democrat such as the trade unions affected by the trade imbalance between the two countries.<sup>55</sup> As the 1992 Trade and Commerce White Paper stated, the then Japanese government took this as the lost confidence of the US due to their declining leadership coming from the loss of the dominant position in the international economy and finance. The 1994 Trade and Commerce White Paper further stated that the GNP of Japan was likely to surpass that of the US within the next 10 years.

The US strategy of using the yen appreciation as a means of addressing the trade imbalances was gradually modified by Robert Rubin and Larry Summers. Robert Rubin was of the view that strong dollar helps to attract from abroad to the US and it would lead to lower costs to consumers and producers and ultimately lower inflation, lower interest, higher standard of living and greater productivity.<sup>56</sup> The shift of the US exchange rate policy towards "strong dollar" had another implication for emerging and developing countries, especially the East Asian countries which relied on shorter-term cross-border capital inflows denominated in the US dollar.<sup>57</sup>

While the arrival of Robert Rubin brought about a policy change in the previous US policy of using the exchange rate as a means of correcting the bilateral trade imbalance, the yen-dollar exchange rates appreciated dramatically in the first half of early 1995. As the 1995 Economic White

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<sup>55</sup> Sakakibara, E. (2005).

<sup>56</sup> His (Robert Rubin's) view is well articulated in, for example, [http://www.banking.senate.gov/01\\_07hr/072501/rubin.htm](http://www.banking.senate.gov/01_07hr/072501/rubin.htm)

<sup>57</sup> Eatwell, J. and Taylor, L (2000), "*Global Finance at Risk - The case for International Regulation*", Polity Press



Paper stated, the Japanese Ministry of Finance considered that the yen's appreciation in the early 1995 was driven by speculative forces in the market which tried to link the yen's appreciation with the accumulating trade imbalances between Japan and the US. The Japanese Ministry of Finance considered that the excessive Japanese Yen's appreciation would prevent the Japanese economy from going back to the path of sustainable growth and getting out of the recession due to the collapse of the bubble economy. Therefore the Japanese Ministry of Finance attempted to intervene in the foreign exchange markets in the coordinated way with the US to give the message to the markets that the US government would not seek the weaker dollar as the markets had predicted. The G7 Finance Ministers' statement 24 April 1995 explicitly admitted that the pace of fluctuations was unjustified, stating that *"The ministers and governors expressed concerns about recent developments in exchange markets. They agreed that recent movements have gone beyond the levels justified by underlying economic conditions in the major countries. They also agreed that orderly reversal of those movements is desirable, would provide a better basis for a continued expansion of international trade and investment, and would contribute to our common objectives of sustained noninflationary growth. They further agreed to strengthen their efforts in reducing internal and external imbalances and to continue to cooperate closely in exchange markets (underlined by the author) "*.

The G7 Finance Ministers' statement marked the watershed in terms of correcting the excessively speculative movements of the foreign exchange markets. The US-Japan coordinated intervention at the foreign exchange markets worked successfully to send the clear message that both the US and Japan considered that the current level of Japanese Yen against the US dollar was not justified by the market fundamentals and either of the countries did not seek. The Japanese Ministry of Finance was aware of the need for the two countries to work in a coordinate way to send more effective messages to the markets.<sup>58</sup> The G7 Finance Ministers' statement in October 1995 reaffirmed the line agreed by the previous one in April 1995, stating that *"Ministers and Governors welcomed the orderly reversal in the movements of the major currencies that began following their April*

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<sup>58</sup> Sakakibara, E. (2005).

*meeting. They would welcome a continuation of these trends consistent with underlying economic fundamentals. They reaffirmed their commitment to reduce imbalances and to cooperate closely in exchange markets”.*

The G7 Finance Ministers’ framework also played a major role as the forum of coordinating the G7 positions on the rescue of Mexico. The February 1995 statement showed the support for the IMF package for the Mexican economy, stating that *“We agreed that Mexico must pursue vigorously its economic program, which the IMF has described as strong, coherent and credible. The decision by the International Monetary Fund to join the international package assembled recently with an exceptionally large standby agreement for Mexico of up to some 17.8 billion dollars represents an important source of support. The great stride that the Mexican economy has made in recent years provides a sound basis for our confidence in the ability of the Mexican authorities to fulfil their commitments under the new economic program. We also reviewed the broader implications of volatility in Mexico’s financial markets”*. This G7 Finance Ministers’ statement showed the coordinated support by the G7 for the US action to provide the US-led support including the IMF on 31 January 1995 just before the G7 Finance Ministers meeting. This G7 Finance Ministers’ support was also explicitly shown in the G7 Finance Ministers’ statement in April 1995, which stated *“In preparation for the annual Economic Summit, the ministers and governors reaffirmed their strong support for the Bretton Woods Institutions, and discussed how their role could be adapted to meet the challenges of today’s global economy. In this context, they reviewed the lessons that can be drawn from Mexico’s recent financial problems and had an extensive discussion of approaches which may be desirable to facilitate continued progress toward sustained growth and employment, the maintenance of financial stability, and the promotion of sustainable development.”*

The reversal of the exchange rate markets also worked better for the US economy. From the US Treasury perspective, the appreciation of the US dollar contributed to attracting more capital from the overseas to the US and containing the inflation risks by reducing the increase of the prices of

imported goods. The decrease of the budgetary deficit led to lower interest rates, which helped private sector to finance their investments.

In the mid-1990s, the recovery of the US economy was clearly observed, and the bilateral trade imbalances was no longer the political issues between the US and Japan. Instead, as the Japanese economy was mired in the financial sector crisis, the US Treasury called on Japan to address the non-performing loans problem and stimulate the Japanese economy. Just before the Asian financial crisis erupted in Thailand in July 1997, the Japanese Ministry of Finance considered that Japanese economy was getting back on the path of economic recovery. The Economic White Paper 1997 stated that the Japanese economy was now finally heading towards the path of self-sustainable recovery after the long period of adjustment of the collapse of the bubble. At the same time, the Economic White Paper raised a concern about the rapid pace of the Yen's depreciation from around 80 yen to 127 yen against a US dollar between mid-1995 and mid-1997, pointing out that this depreciation could be interpreted as the selling Japan rather than the adjustment of exchange rates based on the fundamentals. The Japanese Ministry of Finance kept an eye of the capital inflow from overseas investors to the Nikkei Index and considered that Japan was under attack from overseas investors in November 1995 when it was revealed that a series of Japanese financial institutions collapsed.<sup>59</sup> The Nikkei Index, which was stable above 20,000 until June 1997, fell below 16500 at the end of October 1997.

As the financial crisis deepened in Japan, the US called on Japan to address its economic problem. In the US Treasury view, the Japan's economic difficulty had a spill-over effect on the Asia and Japan's economic trouble led to the deteriorating financial crisis in Asia.<sup>60</sup> The US Treasury considered that the then Japanese monetary and fiscal policies were too tight and urged to take more aggressive measures to soften the damages caused by accelerating the resolution of non-performing loans at the Japanese financial sectors. From the Japanese Ministry of Finance's point of view, the deteriorating Asian financial crisis was the problem of the lack

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<sup>59</sup> Sakakibara, E. (2005)

<sup>60</sup> Rubin, R. (2004)

of resilient Asian financial markets and regulatory regimes against the speculative short-term movements of capital on their own, rather than the problem caused by the Japanese economic difficulty.

The Japanese Ministry of Finance regarded the Asian Financial Crisis as the problem caused by short-term speculative capital movements and the weak financial system in the Asia, well before a series of financial institutions collapsed in November 1997. Japan proposed the creation of “the Asian Monetary Fund” in September 1997 as a means of ensuring financial stability and preventing the financial contagion in Asia at an as early stage as possible. The key element in this proposal was the creation of the networks of providing liquidity within a more flexible framework than the IMF to give more confidence to international investors. The proposal was well received by a majority of East Asian countries, but opposed by the objection by mainly from the US and China. The concept of “Asian Monetary Fund” was inherited by a regional mechanism of bilateral swap arrangements within the ASEAN plus 3 countries on May 2000 in Chiang Mai, which was called as “Chiang Mai Initiative”.

The Japanese Ministry of Finance proposed the creation of the AMF at the G7-IMF meetings in Hong Kong during September 20-25, 1997. The proposed was drafted by Eisuke Sakakibara (then Vice Minister for International Affairs of the Ministry of Finance) and Haruhiko Kuroda (then Director of the International Finance Bureau of the Ministry of Finance, later Vice Minister for International Affairs succeeding Eisuke Sakakibara). The key concept of the AMF was pooling reserves held by each Asian state could be effective in dealing with financial crises by providing liquidity assistance when financial crises strike. In the original plan drawn by the Japanese Ministry of Finance officials, the AMF was envisioned as a USD 100 billion fund composed of ten members, i.e. China, Hong Kong, Japan, South Korea, Australia, Indonesia, Malaysia, Singapore, Thailand, and Philippines.

The desire to create the AMF as an alternative to the IMF was based upon the Japanese Ministry of Finance’s view that the IMF prescriptions were not effective but rather deteriorating the financial crisis. The IMF’s

approach to the crisis was based upon the so-called “Washington consensus” underpinned by a neo-liberal ideological position.<sup>61</sup> According to this view, markets are the most efficient and productive way through which to allocate resources and create wealth. This approach put emphasis on a constellation of virtues such as free markets, free flows of trade and capital across the border, macroeconomic management characterised by sound fiscal and monetary prudence. The IMF initially applied their usual prescriptions including tight fiscal and monetary policies as the standard prescription, demanding that the governments need to raise interest rates and reduce government spending. But these policies were abandoned by mid-1998 when it became clear that they worsened rather than ameliorated the crisis.

In the Japan’s assessment, it was clear that the measures prescribed by the IMF were not effective but rather misguided. The Japanese Ministry of Finance considered these was growing awareness of the need to create a new solution to prevent future crises from threatening the region again. Against this background, Japan proposed the creation of the Asian Monetary Fund (AMF) as a framework for multilateral liquidity provision and policy co-ordination as a vehicle of a sort of Asian version of the IMF taking into account the specific needs and conditions of the Asian countries.

In the IMF’s view, the liberalisation of financial transactions, including the deregulation of financial markets, the removal of controls on international capital movements, and the liberalisation of trade and exchange controls is one of the principal forces driving the growth of international trade and investment. IMF acclaimed that a rapid liberalisation of exchange controls on transactions and controls on capital movements outstripped the growth of international trade in the 1990s. In their view, the forces of globalisation, liberalisation, and technological and financial innovation exerted an important influence on the exchange arrangements and led to the trend by IMF member countries to adopt more flexible market-based exchange rate

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<sup>61</sup> Williamson, J., “*What Washington Means by Policy Reform*”, <http://www.iie.com/publications/papers/paper.cfm?researchid=486>

arrangements.

In contrast, the Japanese Ministry of Finance considered that the IMF's package of policies were not effective but rather deteriorating the Asian Financial Crisis. In their view, the IMF policies pay insufficient attention to the need to provide liquidity promptly than necessary and were preoccupied with promoting liberalisation of capital controls. They considered the benefits of liberalisation of capital movement are not so self-evident in Asia and more cautious approach with the emphasis on sequencing is appropriate. They also considered that the IMF's prescriptions of tight macroeconomic policy focusing on interest rate hike and budgetary consolidation worsened the economic situation in ailing Asian countries.<sup>62</sup>

When the IMF provides financial assistance to member countries to solve a problem of balance of payment adjustments, the IMF negotiates with national governments the arrangement (or programme) specifying the conditions in return. The negotiated arrangement (or programme) requires the aided countries to accept and undertake a certain set of policy packages as prior conditions for financial assistance from the IMF. In addition, the actual provision of financial assistance is not lump sum payment but rather available over the certain period of time in several tranches and the disbursement of each tranche is dependent on the extent to which such agreed policy packages as prior conditions are duly implemented. This mechanism was intended to make sure that the governments receiving the IMF assistance duly implement a set of policy packages and adopt sound policies.

The AMF proposal was intended to address the two major drawbacks of the then existing IMF programme, i.e. the lack of the mechanisms of providing necessary liquidity promptly, and the shortage of funds necessary funds necessary to cure financial crises.<sup>63</sup> When the IMF provides financial assistance to member countries to solve a problem of balance of payment

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<sup>62</sup> Sakakibara, E. (2005)

<sup>63</sup> Sakakibara, E. (2002), "*Kawase ga wakareba sekai ga wakaru (Understanding of exchange rates and the international affairs)*", Bungei-shunju, 2002, pp.168-169

adjustment, the IMF negotiate with national governments the arrangement or programme specifying the conditions governing financial assistance. The negotiated arrangement or programme requires countries to undertake a certain set of policy packages as prior conditions for financial assistance from the IMF. The actual provision of financial assistance is not lump sum payment but rather available over the certain period of time in several tranches and the disbursement of each tranche is dependent on the extent to which such agreed policy package as to prior conditions are duly implemented. In addition, when the meeting was held in Tokyo to discuss the Thai rescue package in August 1997, the amount of necessary financial liquidity was not provided by the IMF and other international organisations. In fact, IMF provided only USD 40 billion while it estimated USD 140 billion as the necessary to rescue the Thai baht. More than half of the total aid came from other Asian governments.<sup>64</sup>

The proposal of AMF was not realised mostly due to the opposition of the US and China, but was followed by a different framework for regional co-operation called “Manila Framework” at a meeting of the Finance and Central Bank Deputies in Manila on 18-19 November, 1997. 14 countries (Australia, Brunei, Canada, China, Hong Kong, Indonesia, Japan, Malaysia, New Zealand, Philippines, Singapore, South Korea, Thailand, and the US) attended the meeting, along with the international organisations including the IMF, the World Bank, and the ADB as observers. The statement titled “A New Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability” stated that *“This framework, which recognizes the central role of the IMF in the international monetary system, includes the following initiatives: (a) a mechanism for regional surveillance to complement global surveillance by the IMF; (b) enhanced economic and technical cooperation particularly in strengthening domestic financial systems and regulatory capacities; (c) measures to strengthen the IMF's capacity to respond to financial crises; and (d) a cooperative financing arrangement that would supplement IMF resources.”*

The Manila Framework was far less ambitious than the AMF in that the Manila Framework was designed to play a supplementary role to the IMF

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<sup>64</sup> Ibid.

in respect of regional economic surveillance and regional financial arrangement. It was not designed to pool a part of reserves of member countries, but rather provide the opportunity to exchange the information on economic outlook and financial sector reforms among members. But, the Manila Framework statement showed, the Asian countries agreed to call on the IMF to strengthen the IMF's capacity to respond to financial crises. While the original idea of establishing the AMF was abandoned, there were a group of like-minded Asian countries led by Japan who pressed the IMF to take a new approach focusing on the provision of short-term liquidity which would be more flexible and different from the conventional IMF approach.

The initiatives taken by the Japanese Ministry of Finance during the Asian financial crisis was based on policy-driven arguments rather than political hegemony-driven arguments. The prevailing argument at that time was so-called "crony-capitalism". The Japanese Ministry of Finance took a rather different view from that stereo-type argument and considered that more fundamental solutions would be needed including establishing a network of providing liquidity to ensure the confidence of investors in the international financial markets supported by regional policy dialogues and surveillance and developing Asian bond markets. This policy-driven argument was oriented towards fundamental reform of the international financial architecture. The Japanese Ministry of Finance took the Asian financial crisis as the wake-up call for the need of correction of excessive liberalisation of international financial markets.<sup>65</sup> In this process, the Japanese Ministry of Finance always endeavoured to work with the other G7 countries, most particularly with the US.

On the other hand, this policy-driven argument was domestically distorted by political pressure to justify excessively expansionary fiscal measures. After the Hashimoto cabinet stepped down, the Obuchi cabinet, which came into being in June 1998, changed the course of fiscal policy completely. The Obuchi cabinet aborted the Fiscal Structure Reform Act approved by the cabinet in 1997 and took the unprecedented amount of expansionary measures. The Hashimoto cabinet originally included fiscal

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<sup>65</sup>Sakakibara, E. (2005)



consolidation as one of the key reforms along with the financial market reform so-called “Big-bang”. This fiscal consolidation effort reflected the strong views held by the Budget Bureau of the Japanese Ministry of Finance. As the Economic White Paper 1997 stated, this fiscal consolidation was based on the views that (1) the deteriorating fiscal balance would lead to the absorption of the savings held by private sectors and would prevent necessary capital from accumulating as ageing of society brings about the reduction of saving; (2) the accumulating fiscal deficit would reduce the budgetary flexibility and lead to efficient resource allocation; (3) the accumulating fiscal deficit would lead to increased taxation to repay the debt in the future generation and result in the inequality between generations; and (4) the deteriorating fiscal balance would undermine the confidence of the market about governments debts and result in the increase in the interests rates and could have negative impact on the economy. In December 1996, the Hashimoto cabinet finally approved the principles of reducing the annual budgetary deficit under 3% of the Japan’s GDP.

It was apparent that this fiscal consolidation effort was heavily influenced by the trend of fiscal consolidation in other countries, notably in the EU and the US. The 3% of the GDP was the same threshold set by the Maastricht treaty to join the currency union. Behind this strong sense of urgency held by the Budget Bureau of the Japanese Ministry of Finance derived from a series of expansionary budgetary measures taken in the early 1990s designed to stimulate the demand in the economy after the collapse of the bubble economy. The expansionary budgetary measures were taken as the ones to boost the economy as the recession after the collapse of the bubble economy deepened in the early 1990s. The US administration also pressed Japan to stimulate the economy with a different reason of reducing the trade imbalances from what the political heavy-weight of the ruling party intended. In the early 1990s, priority was given to the public works for the construction of information and telecommunication network infrastructure and research and development facilities, which were called then “new social infrastructure capital”. The Economic White paper 1994 raised the issue of whether a series of stimulus measures were as effective as expected, and concluded that a series of

stimulus expenditure for public works was offset by the decline in capital spending in private sectors and did not contribute to the overall increase in demand in the Japanese economy.

The fiscal consolidation effort in the Hashimoto cabinet was a drastic attempt to contain the conventional argument of using public expenditure as a measure to boost the economy. It was placed as one of the structural reforms led by the Hashimoto cabinet. This was based on the view that the success of the various structural reforms would remove the regulatory obstacles and create additional business opportunities in private sectors including financial services, in particular. This was compatible with the view that the non-performing problems should be resolved by financial institutions themselves. For example, the Economic White Paper 1997 stated that the financial asset held by the Japanese household were biased in favour of safe assets such as cashes due to the lack of investment opportunities and the financial market reform would ensure that a greater number of investment opportunities would be given to investors. In the report, the development of the Japanese securities market was a key to encouraging investors to take more risks and ensuring that their savings would be channelled to be used as the capital for innovative business activities.

From the viewpoint of the Budget Bureau of the Japanese Ministry of Finance, it was a blessing that a prime minister took the initiative of fiscal consolidation. However, the financial turmoil in November 1997 showed that it was difficult to rely on the assumption that the non-performing problems could be resolved by financial institutions themselves. The Hashimoto cabinet's ambition to undertake structural reforms were preoccupied with the strong belief of self-responsibility of financial institutions and the principles of market-discipline with minimum intervention by the government. The fiscal consolidation act compiled by the Hashimoto cabinet did not include any clause of taking into account a possible temporary repeal of the implementation of the law. After the collapse of the Yamaichi securities, the Hashimoto cabinet completely changed the policy course and worked to make it possible for the government to inject public money to ailing financial institutions. In

February 1998, the deposit insurance act was amended to enable the government to inject as much as JPY 30 trillion including JPY 13 trillion intended to inject financial institutions even before their final collapse. The Hashimoto cabinet made it clear that the new policy measures would be aimed at restoring the stability of the Japanese financial system and the confidence of international investors in the Japanese financial market. The Hashimoto cabinet tried to respond to the concerns that the Japanese financial crisis could trigger more global financial crisis along with the Asian financial crisis.<sup>66</sup>

Faced with the sharp depreciation of the Japanese Yen, the Japanese Ministry of Finance worked with the US Treasury to take the coordinated intervention in the foreign exchange markets. The US Treasury called on Japan to take the stimulus fiscal measures to boost the demand. In June 1998, the US Treasury proposed to Japan that Japan would make it clear that the government would commit to the restoration of the stability of the Japanese financial system and boosting the domestic demand in return for agreeing to make coordinated interventions, in the bilateral meeting over phone between the US Treasury secretary and the Japanese Minister of Finance. The injection of public money to financial institutions including the ones which were not as bad as ailing financial institutions were intended to achieve a quick and forceful recapitalisation and restricting the financial health and profitability of the Japanese banking system. The macroeconomic policy was expected to play a major role in stimulating domestic demand and facilitate the resolution of non-performing loans.

Before the Asian financial crisis was contained, the financial crisis in Russia in mid-August 1998 resulted in a drying up of private financial flows to emerging economies and encouraged financial investors to act more in risk aversion. This concern quickly spread to Latin American countries as well. With the concern about a global credit crunch spreading among investors, the turbulence in world financial markets led the US Treasury to take more coordinated action to reduce uncertainty about global prospects of financial markets. In Japan, the Japanese financial crisis further escalated into the nationalisation of Long-Term Credit Bank

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<sup>66</sup> Sakakibara, E (2005)

(LTCB). In the package approved by the Japanese parliament in October 1998, the funds available to the banking sector were raised to JPY 60 trillion, with 25 trillion targeted to the recapitalisation of “viable banks” and JPY 18 trillion mainly targeted to failure resolution schemes including public bridge banks and the nationalisation of failed banks. JPY 17 trillion was reserved for guaranteeing deposits at failed banks. The package also included the creation of a new high-level body (the Financial Revitalisation Commission, FRC) within the Prime Minister’s Office, which will be responsible for drafting and implementing the regulations necessary for bridge banks and carrying out the nationalisation of failed banks, and also responsible for overseeing the recapitalisation of banks, and centralising all financial supervisory activities. The package of the new laws were intended to reduce the risk of a collapse of the Japanese banking system and provided some institutional and financial mechanisms that could help to accelerate the restructuring and consolidation of the banking system. The provisions allowed Japanese banks to receive funds in order to facilitate realignments or consolidation in the sector. In this package, it was clear that the government considered that a quick and forceful injection of public funds were given more priority than leaving the resolution of non-performing loans completely to the market-discipline and the self-responsibility of financial institutions.

In October 1998, the Long-Term Credit Bank (LTCB) filed for temporary nationalisation, about four months after its market valuation had dropped markedly, on rumours that the bank was faced with the difficulty in raising funds. The Banking Bureau of the Japanese Ministry of Finance originally planned to merge the LTCB with the smaller Sumitomo Trust Bank. But, this plan was abandoned due to the reluctance of the Sumitomo Trust Bank to take over the LTCB substandard loans. In September 1998, after one of the main affiliates of LTCB with more than JPY 1.5 trillion in debts failed, the LTCB failed for nationalisation and declared a negative net worth of JPY 350 billion, including unrealised losses on securities holding.<sup>67</sup> The Nippon Credit Bank, one of the three long-term credit banks, also failed for nationalisation in December 1998.

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<sup>67</sup> IMF (1998), “*World Economic Outlook and International Capital Market Interim Assessment*” December 1998.

The turbulence in global financial markets in 1998 showed even more explicitly that the volatility of financial market could lead to a sudden heightened perception of, and aversion to, risk following Russia's effective debt default in August 1998 and an associated flight to quality. Emerging markets were particularly seriously affected as interest rate spreads on their external debt increased significantly and new private external financing virtually ground to a halt. The process of deleveraging and portfolio rebalancing in response to heightened risk aversion triggered a massive global reassessment and re-pricing of emerging market risk and generated severe strains, sharp increases in credit and liquidity spreads, and extreme price movements in not only emerging markets but also the markets of developed countries including the US market, especially in the wake of the near-collapse of LTCM (Long-Term Capital Management), a private hedge fund.<sup>68</sup>

Long-Term Capital Management (LTCM) was a hedge fund that attempted to profit from discrepancies in the relative value of governments bonds, fixed income derivatives, equities and equity derivatives primarily in the US, Japanese and European markets. The LTCM also invested in a few markets outside the G7 countries. In the week of 21 September 1998, following the rumours in the market about insolvency of the LTCM and some of its major creditors and counterparts over potential liquidity problems, the Federal Reserve Bank of New York helped to organise and coordinate USD 3.6 billion private rescue of the LTCM by a consortium of 14 major international financial institutions. All of these institutions were either counterparties, creditors, or investors of the LTCM. At that time, there were the two major reasons as the necessity of the rescue package of the LTCM: LTCM's financial condition deteriorated to the point where it might not be able to make either loan repayments or margin calls on its highly leveraged positions in the US, Japanese, and European bond markets, and might require either recapitalisation or liquidation; and immediate closure of LTCM would have worsened the financial condition of some already weakened international financial institutions and could have triggered a massive simultaneous sale of LTCM's collateral securities by

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<sup>68</sup> IMF (1998), Ibid.

creditor institutions. LTCM's trading book was "long" in relatively illiquid, low-quality securities and "short" in liquid, high-quality securities such as the US securities. Contrary to LTCM's judgement, interest rate spreads widened throughout most of 1998 in most of their operations, as the intensification of the financial crises in Asia encouraged a flight to quality in the G7 government securities markets, and later in the year, as the credit spreads of Russian ruble-denominated discount debt instruments widened. The rescue package of the LTCM was led by the US Treasury and the Federal Reserve. Their main concern was that with LTCM's large balance sheet exposures and additional large off-balance-sheet positions, a bankruptcy filing could have triggered the instability of financial market and a liquidation of collateral would have had repercussion in the underlying repo and swap markets, which would make liquidity dry up. These concerns encouraged the Treasury and the Federal Reserve Bank New York to arrange the rescue in order to avoid a panic and the potential for systemic problems.<sup>69</sup>

The Russian financial crisis had its origins in the large fiscal deficit and the associated increase in holdings of Russian government debt by domestic and foreign investors. The Russian government was relatively successful in selling ruble-denominated debts, with non-resident investors holding about one-third of domestic treasury securities by May 1998. However, a series of domestic political events and external shocks including weak oil prices in the first half of 1998 led to increased difficulties in selling ruble-denominated debt. As investors' confidence fell, selling pressures mounted in debt, equity, and foreign exchange markets, and liquidity dried up in the interbank market as fears of bank failures led to the increased withdrawal of deposits from banks.<sup>70</sup> On 17 August, 1998, the Russian government announced a package of measures aimed at dealing with the currency, debt, and banking crises. The exchange rate band was devalued, a 90 day moratorium was placed on principal payments on private external obligations including payments on forward contracts, and it was announced that a compulsory restructuring of the domestic government debt would take place.

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<sup>69</sup> IMF (1998), Ibid.

<sup>70</sup> IMF (1998), Ibid.

Shortly after the Russian government's announcement of moratorium, the Malaysian government announced that they would impose capital controls to try to protect the domestic economy from international financial volatility, to curb capital flight and speculation against the ringgit, and to eliminate offshore transactions in the domestic currency. Bank Negara Malaysia announced that proceeds from the sale or maturing of local currency securities must be placed in local currency deposits for one year from the date of the transaction and cannot be converted into foreign exchange. In addition, domestic credit to non-resident banks and brokers was prohibited, and general payments and transfers between external accounts required official approval for any amount. Domestic residents were not allowed to invest abroad more than MYR 10,000 without official approval. These measures did not contravene Malaysia's commitments under the IMF's Article VIII and they differentiate foreign direct investment from portfolio investment. Foreign direct investors were still free to repatriate interests, dividends, capital gains, and capital at any time.<sup>71</sup>

The financial market turmoil that followed the Russian debt restructuring led to a sharp deterioration in the terms and conditions under which many emerging market economies, including Latin American countries such as Brazil and Mexico with the perception of large domestic currency denominated debt heavily dependent on foreign investors, could access global financial markets. As a result, issuance of new emerging market debt and equity instruments virtually collapsed in the period July-October 1998. From the Japanese Ministry of Finance's point of view, there was clear double standard between what the US argued at the beginning of the Asian financial crisis and what the US did in the aftermath of the Russian financial crisis followed by the near-collapse of the LTCM. The Japanese Ministry of Finance was unhappy with the US Treasury's attitude to leave the prescriptions of the Asian financial crisis to the IMF based on the view that the Asian financial crisis was caused by the reasons specific to the Asian countries characterised by crony capitalism. In the Japanese Ministry of Finance's view, the US Treasury did not argue the necessity of strict

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<sup>71</sup> IMF (1998), Ibid.

conditions attached to a rescue package when speaking of the Russian financial crisis and the near collapse of the LTCM. The Japanese Ministry of Finance considered that the roots of the financial crises is the same and that the impact of the simultaneous rush of many investors to close out positions and deleverage could result in a sort of panic spreading to even in the mature financial market. In their view, the turbulence of financial markets would need to be understood as a systemic problem of financial system. This was the reason why the Japanese Ministry of Finance argued for the need to discuss the international financial architecture. In the financial crises between 1997 and 1998 revealed that financial markets could be adversely affected by the manner in which individual financial institutions react to market pressures, stresses and turbulence, particularly when many of them hold similar highly leveraged positions. The highly integrated and complex nature of financial position taking, institutions, and markets and the linkages of financial positions across national and international markets could impair the ability of the mature financial markets to smoothly and efficiently facilitate the closing out and deleveraging of positions and exposures.<sup>72</sup>

The Japanese Ministry of Finance gave a positive assessment to the temporary introduction of capital controls such as the ones the Malaysian government announced at a rather early stage shortly after they were introduced.<sup>73</sup> In the process of formulating the rescue package for Brazil, the Japanese Ministry of Finance and the US Treasury basically agreed that Japan would not ultimately block the rescue package for Brazil, while the US would not block the bilateral rescue package of the “Miyazawa Initiative” announced in October 1998. The terms of a USD 41 billion IMF-led financial assistance package for Brazil were finally announced on 13 November 1998. Of the total amount, USD 18.1 billion was provided by the IMF in the form of a three-year Stand-By arrangement, about USD 4 billion each from the World Bank and the Inter-American Development Bank, and USD 14.5 billion from 20 governments channelled through, or provided in collaboration with, the Bank for International Settlement (BIS). The US agreed to provide the largest bilateral contribution with a credit line

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<sup>72</sup> Sakakibara, E. (2005), and IMF (1998)

<sup>73</sup> Sakakibara, E (2005)



of USD 5 billion. The financial package for Brazil was significantly front-loaded, with about USD 37 billion available, if needed, in the first 13 months, with a view to responding to the financing needs immediately.<sup>74</sup> In the process of preparing the rescue package for Brazil, Russia and Asian countries, there was a sort of consensus between the Japanese Ministry of Finance and the US Treasury that the provision of liquidity was essential to counter the effects of the deleveraging of investors' financial positions and on-going withdrawal of commercial bank lending seen evidently in the emerging and mature markets in the world.

In the Obuchi cabinet, at the same time as the government used the budgetary policy as a measure to boost the demand giving the priority to economic recovery, the Obuchi cabinet was not hesitant to provide the bilateral aid package called "Miyazawa Initiative" for the five afflicted countries by the Asian financial crisis including South Korea, Thailand, Indonesia, Malaysia and Philippines totalling USD 30 billion for the 2 years. This was intended to help to provide financial flows to these countries when the liquidity of the emerging markets dried up in the aftermath of the financial crisis in Russian and many Latin American countries. After the Japanese Yen hit the record high at JPY 79.75 against US dollar in mid-1995, the yen depreciated by some 40 percent during the past three years and reached an eight-year low at JPY 147.26 against US dollar on 11 August, 1998. Yen-carry trades, which were tempted by low borrowing costs in Japanese Yen, helped to accelerate the trend of the Yen's depreciation until the August 1998 partly due to the lack of confidence in the stability of the Japanese financial system. Major financial institutions and hedge funds had borrowed in Japanese Yen to invest in US, European and emerging market assets, thereby shorting the Japanese Yen. This long-running appreciation of the dollar and the depreciation of the Japanese Yen was abruptly and sharply reversed in the wake of financial turbulence in Russia and Latin American countries. The "Miyazawa Initiative" announced in October 1998 was designed to address the shortage of liquidity when the pool of liquidity especially to emerging markets was dramatically shrinking when leveraging of investments magnified losses by urging investors to simultaneously sell assets to liquidate positions as

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<sup>74</sup> IMF (1998), *ibid.*

quickly as possible. The “Miyazawa Initiative” was based on the view that Japan had the responsibility of preventing global financial crises from undermining the stability of the Asian financial markets and the Asian economies.

At that time, there was essentially no argument that China could replace Japan with the role to provide the bilateral financial assistance package to the crisis-stricken Asian countries. China did not take a proactive action to undertake the role of providing liquidity to the neighbouring Asian countries, either. The Japanese Ministry of Finance had no doubt that it was Japan who would undertake the primary responsibility of maintaining the stability of Asian economies and financial markets. More generally, this sense of responsibility was also closely linked with the idea that Japan must not be the source of an international financial crisis and must take any possible measure to restore the economic growth and the confidence of international investors. This sense of responsibility was further combined with the argument that restoring economic growth must be given more priority than fiscal consolidation and fiscal consolidation would not be achievable without sustainable economic growth.

At that time, Japan still provided the official development assistance (ODA) to China, making China the destination of the greatest amount of the bilateral ODA. The key reasons why the Japanese government considered that they needed to provide ODA to China were that (1) the stable development of the Chinese economy based on market mechanism would contribute to the economic prosperity of the Asia as a whole region; (2) the economic development of Japan would benefit Japanese, and (3) the ODA would contribute to improving the sentiment of the Chinese public to Japan and the Japanese.<sup>75</sup> The ODA White Paper 1998 stated that Japan needed to undertake a role proportionate to the economic power in the international society and remember that Japan benefited from ODA in the early years of economic restoration in the 1960s and 1970s.<sup>76</sup> China accounted for the largest portion of the then Japanese ODA as much as

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<sup>75</sup> <http://www.mofa.go.jp/mofaj/gaiko/oda/files/000072239.pdf>

<sup>76</sup> ODA White Paper (1998), Government of Japan  
[http://www.mofa.go.jp/mofaj/gaiko/oda/shiryo/hakusyo/nenji98/front\\_1.html](http://www.mofa.go.jp/mofaj/gaiko/oda/shiryo/hakusyo/nenji98/front_1.html)

12%. This reflected the increasing economic link between China and Japan mainly through the increased foreign direct investment of Japanese industries towards China to seek cheaper labour forces and the great potential of the Chinese market as a consumption market. In such a period of time, there was essentially no argument on which country was capable of providing economic support to other Asian countries other than Japan. At that time, China was not yet even a member of the WTO. The Japanese government welcomed the accession of China to the WTO as the opportunity to encourage China to comply with the international standards and contribute to the increased business opportunities for the Japanese companies. As the Trade and Commerce White Paper 2001 pointed out, the Japanese companies and the Ministry of Economy, Trade and Industry considered that the accession of China to the WTO would promote the liberalisation of the Chinese markets in various sectors and contribute to making China comply with the internationally accepted rules of the protection of intellectual property rights.<sup>77</sup> Japan expected China to be one of the leading “manufacturing bases” in the international economy and commerce.

At that time, the Japanese government considered that faced with the increasing trends towards strengthening the regional trade relationship via free trade agreements (FTA), Japan attached the priority on the launch of a new round negotiation process at the WTO. Japan was concerned about lagging behind the increasing number of concluded FTAs and undermining the competitiveness of Japanese industries and put them in a disadvantageous position. They fear that the proliferation of FTAs would undermine the role of WTO as the multilateral framework. Japan considered that the accession of China to the WTO would contribute to giving better conditions to Japanese companies rather than giving huge economic opportunities eventually as much as exceeding Japan in the GDP. The Japanese government was aware of the great potential of the Chinese market as the growing consumption markets for the Japanese companies and the manufacturing bases for them to take advantage of cheaper labour force and growing demands. But, then the Japanese government did not

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<sup>77</sup> Trade and Commerce White Paper 2001, Government of Japan  
<http://warp.da.ndl.go.jp/info:ndljp/pid/8296268/www.meti.go.jp/report/tsuhaku/index.htm>

seriously call into question the dominance of Japanese economy in Asia.

### 2-3 Prolonged deflation and the bad loan problem in the Japanese financial sector in the late 1990s

In the prolonged deflation and the bad loan problems in the Japanese financial sector since the burst of the bubble in the 1990s, the power balance between Japan and the US has completely changed. The Economic White Paper in 1998 analysed the reasons why the US booming economy continued for such a long period of time in 1990s. It pointed out that the lower interest rate underpinned by appropriate macroeconomic policies such as better fiscal balances and shrinking government deficit gave the resilience and flexibility of economic policy, thereby giving the confidence to the market. It also pointed out that the productivity growth of the US industry increased especially in the sectors relating to high-technology industries.

When there were strong concerns about the deflation and the health of the Japanese financial system, the US increased the pressure on Japan to call on them to address the non-performing loans problem and increase the domestic demand by taking more aggressive fiscal measures and monetary policies. This caused a complicated domestic problem between the Japanese Ministry of Finance and the Bank of Japan. Since the advent of the Obuchi cabinet, the Japanese government expanded the budgetary expenditure to ensure that the level of stimulus would be maintained as long as the recovery in private demand did not firmly take hold as the short-term requirements.

The Japanese Ministry of Finance was faced with the increased pressure from the political circle including the Obuchi cabinet about the increase of the public expenditure. At that time, the Japanese Ministry of Finance felt that the political pressure to stimulate the economy was too more heavily put on fiscal policy than monetary policy and considered that the Bank of Japan did not take as much proactive measures as should do. In July 1998, the Bank of Japan Act was amended to increase the independence of the

Bank of Japan as a central bank. The purpose of this amendment was to make the independence of the Bank of Japan clear in the legal framework based on the belief that the strong independence of a central bank should be guaranteed to shield the Bank of Japan from the political pressure put on monetary policy and the subsequent risk of inflation out of control. This was based on the lessons learned from the bubble economy in the late 1980s. Apparently this amendment was based on the lessons learned in the causes of the bubble economy in the late 1980s.

As Haruhiko Kuroda pointed out, the Japanese monetary policy in the late 1980s after the Plaza Accord in 1985 was too accommodative for a longer period of time than necessary. At that time, the sharp appreciation of Japanese Yen after the Plaza Accord hit the Japanese exporting industries and there was increasing political pressure to ease monetary policy and take additional stimulus measures. The Bank of Japan lowered the interest rate from 3% to 2.5% immediately after the Louvre accord in February 1987. The Bank of Japan already lowered the interest rate from 3.5% to 3.0% on October 1986. The Japanese Ministry of Finance wanted to avoid the risk of disproportionately heavy burden being put on fiscal policy and accepted to allow a certain degree of further appreciation of the Japanese Yen. The US Treasury pressed Japan to lower the interest rate as a Japan's contribution based on the Louvre Accord. The then Bank of Japan governor Satoshi Sumita was a former Administrative Vice Minister of the Japanese Ministry of Finance, equivalent to a Permanent Under-Secretary in the UK Treasury. In the 1990s, when there were various discussions on the causes of the bubble economy in the late 1980s, there was almost the consensus view that monetary policy was put behind the international policy coordination and as a result of it monetary policy was excessively accommodative for a longer period of time than necessary.<sup>78</sup>

Even in the late 1980s the Bank of Japan was not satisfied with the way in which the Bank of Japan was subject to the increased pressure from the Japanese Ministry of Finance and the political circle including the prime minister's office. The Bank of Japan considered that the international

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<sup>78</sup> Economic White Paper 1993, Government of Japan,  
<http://www5.cao.go.jp/keizai3/keizaiwp/wp-je93/wp-je93-000i1.html>

policy coordination was disproportionately biased against monetary policy and that excessive burden was put on monetary policy. As the discussion on the origins and causes of the outbreak of the bubble economy in Japan in the late 1980s drew increased attention and became a topic of heated discussion in the mid-1990s, the Bank of Japan considered that the increased independence of the Bank of Japan was indispensable to more autonomy of monetary policy-making.<sup>79</sup>

The Bank of Japan restructured their governance system in 1998. The new Governor Masaru Hayami did not take as bold actions as the Japanese Ministry of Finance expected. He believed that deflation would not cause as much harm to the economy as others claim and the appreciation of the Japanese Yen reflected somehow the strength of the Japanese economy. He considered that the fall of prices was mainly due to the reduction in distribution costs and more competition derived from deregulation in various commercial sectors.<sup>80</sup> He stressed the concerns about the risk of inflation getting out of control and the risk of Japanese Yen's depreciation of leading to the depreciation of other Asian countries rather than the risk of deflation from taking hold in the Japanese economy. He understated the role of monetary policy to boost the Japanese economy, but rather stressed the role of stimulus fiscal measures and financial regulatory measures to encourage financial institutions to write off the non-performing loans from their balance-sheet. He even pointed out the risk of further decline in interest rate leading to the decrease in interest revenue and subsequent contraction of household consumption.<sup>81</sup>

In a few years leading up to the Great Intervention, the Bank of Japan was under increased pressure to take a series of aggressive monetary easing policies to address deepening deflation. The first commitment was made in February 1999 when the Bank of Japan introduced the so-called

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<sup>79</sup> <https://www.boj.or.jp/about/outline/expdokuritsu.htm/>

<sup>80</sup> For example, Bank of Japan Governor Masaru Hayami's remark at the Finance Committee at the Lower House of the Japanese Parliament, on 18 July 2000, [http://www.shugiin.go.jp/internet/itdb\\_kaigiroku.nsf/html/kaigiroku/000614820000718003.htm](http://www.shugiin.go.jp/internet/itdb_kaigiroku.nsf/html/kaigiroku/000614820000718003.htm) and also his remark at the press conference on 10 March 2000, [http://www.boj.or.jp/announcements/press/kaiken\\_2000/kk0003a.htm/](http://www.boj.or.jp/announcements/press/kaiken_2000/kk0003a.htm/)

<sup>81</sup> Masaru Hayami's remark on 29 July 1998, [http://www.boj.or.jp/announcements/press/koen\\_1998/ko9807c.htm/](http://www.boj.or.jp/announcements/press/koen_1998/ko9807c.htm/)

zero-interest rate, where it decided that it would initially aim to guide the overnight call rate to move around 0.15%, and subsequently induce further decline in view of the market developments.<sup>82</sup> There was further heated discussion on what other measures the Bank of Japan could do including quantitative easing policies such as the purchase of government bonds. At this time, the Bank of Japan kept taking conservative attitudes on monetary policy and was afraid of being seen to have given way to the pressure from the government and the political circle.

In mid-September 1999, the Japanese yen appreciated from 120 yen against dollar in June 1999 to around 100 yen in September. The Japanese Ministry of Finance worked with the US to insert a sentence indicating the concerns shared by the G7 countries about the recent appreciation of Japanese Yen in the G7 Finance Ministers' statement on 25 September 1999. The Japanese Ministry of Finance urged the Bank of Japan to send a clear signal to further easing of monetary policy including the informal bilateral meeting between the then Finance Minister Kiichi Miyazawa and the Bank of Japan Governor Masaru Hayami.

The US Treasury pressed the Bank of Japan to at least indicate further monetary easing in return for the insertion of the sentence about the appreciation of the Japanese Yen. In the G7 Finance Ministers' statement on 25 September 1999, it stated *"We shared Japan's concern about the potential impact of the yen's appreciation for the Japanese economy and the world economy. We welcomed indications by the Japanese authorities that policies would be conducted appropriately in view of this potential impact. We will continue to monitor developments in exchange markets and cooperate as appropriate"*. The Japanese Ministry of Finance considered that while the stability of the Japanese financial system was not yet fully restored, the Japanese Yen's appreciation could have negative impact on the profits of the Japanese industries and retard the economic recovery.

The Bank of Japan Governor Masaru Hayami had a strong conviction that the zero-interest rate was abnormal and it needed to be terminated as

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<sup>82</sup> "Change of the Guideline for Monetary Market Operations", 12 Feb 1999, Bank of Japan [https://www.boj.or.jp/announcements/release\\_1999/k990212c.htm/](https://www.boj.or.jp/announcements/release_1999/k990212c.htm/)

quickly as possible to regain the normality of monetary policy. However, the Japanese Ministry of Finance was severely opposed to the idea of terminating the zero-interest rate policy. From the Japanese Ministry of Finance's perspective, the Japanese economy was still fragile and did not show sufficiently strong indication of getting back to the path of economic recovery. The Japanese Ministry of Finance considered that the stability of the Japanese financial system was still called into question by the market participants and there was no rationale to run the risk of weakening the Japanese economy while there was little sign of improvement of business confidence.<sup>83</sup>

The IMF also pointed out in the World Economic Outlook 2000 that the Japanese monetary and fiscal policies needed to continue to be directed towards encouraging a lasting recovery in domestic demand when the Japanese Yen rose by over 10% in nominal effective terms between July 1999 and mid-March 2000 and this rise tended to reduce external demand. At least in 2000, the IMF was in favour of the policy stance of the Japanese government putting self-sustaining recovery as the chief economic policy goal in the belief that it in turn would provide a supportive environment for restructuring. The IMF clearly stated that growing concerns about the fiscal situation, the need to prevent deflation, and the continued strength of the Japanese yen, underlined the need to keep monetary policy as accommodative as possible. The IMF firmly believed that when the Japanese economy was faced with fragile recovery, additional steps to ease liquidity to the "zero-interest rate" seemed appropriate to provide further support to activity.<sup>84</sup>

In spite of strong opposition from the Japanese Ministry of Finance, the Bank of Japan lifted the zero-interest rate policy in August 2000. The IMF had a different view from that. They took the view that where consumer confidence remains weak and deflationary pressures persisted in Japan, monetary policy should be highly accommodative until clear signs that the recovery became self-supporting emerge. But, the Bank of Japan Governor

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<sup>83</sup> Karube, K. (2004) "Zero-interest rate – why Bank of Japan and the Japanese Government conflict with each other"

<sup>84</sup> IMF (2000), IMF World Economic Outlook, April 2000, <http://www.imf.org/external/pubs/ft/weo/2000/01/pdf/chapter1.pdf>



Masaru Hayami stuck to the belief that zero-interest rate policy should be removed as early as possible to the normal state of monetary policy. He described “dispelling the concern about the deflation” as the criteria for lifting the zero-interest rate policy. He rephrased it as self-sustainable recovery of demands in private sector. In the aftermath of the bankruptcy of the Sogo Group, one of the major retail group companies in Japan, there were increasing calls from the Japanese Ministry of Finance and political circle to continue the zero-interest rate policy.<sup>85</sup>

Since the Bank of Japan was reformed and given more degree of independence in 1998, the Bank of Japan was preoccupied with how they were seen by the general public through the media. They were too much sensitive about how they were seen to make a decision-making without the interference of the government, notably the Japanese Ministry of Finance. The Japanese Ministry of Finance tried to give influence on the decision-making on the Bank of Japan directly or indirectly. Sometimes, the Finance Minister Kiichi Miyazawa made phone calls directly to the Bank of Japan Governor Masaru Hayami to urge him to take more proactive monetary policy measures and refrain from sending a wrong message of tightening the monetary policy prematurely to the market at a wrong timing.<sup>86</sup>

Apparently there was lack of communication between the Bank of Japan and the Japanese Ministry of Finance during the office of Masaru Hayami between 1998 and 2001 due to the strong preoccupation by the Bank of Japan about its independence as a central bank and the personal belief by Masaru Hayami himself that more priority should be given to preventing inflation in monetary policy based on his personal experiences in the 1970s and 1980s after the oil shocks. The Bank of Japan was preoccupied with not being seen succumb to the political pressure to ease monetary policy. On the other hand, the Japanese Ministry of Finance considered that while the Bank of Japan needed to be politically neutral, there should not be a difference about how they see the Japanese and overseas economy and

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<sup>85</sup> The remarks by Masaru Hayami at the Finance Committee at the Lower House in Japan on 18 July, 2000

<sup>86</sup> Karube, K (2004)

what monetary policy would be needed at a given time. The Bank of Japan tried to show their independence by making their own decision on the basis of their own view on how they saw the state of the Japanese economy.

In the disagreement between the Japanese Ministry of Finance and the Bank of Japan, the Japanese Ministry of Finance tried to make the Bank of Japan exposed to the pressure from the US Treasury and the US Federal Reserve Board. At that time, the Japanese Ministry of Finance considered that the G7 Finance Ministers and Central Bank Governors meeting was the most important and primary forum to send a signal to the market and coordinate economic policies when necessary. Especially, the Japanese Ministry of Finance attached particular importance on the bilateral meeting between Japan and the US, which already became the tradition essentially institutionalised as a part of the G7 Finance Ministers and Central Bank Governors meeting. The bilateral meeting between the Japanese Minister of Finance and the US Treasury Secretary was the highest level meeting between the two economic and financial authorities in Japan and the US. The Japanese Ministry of Finance was concerned about the risk that the effects of expansionary fiscal policies could be offset by tighter monetary policies.

The Japanese Ministry of Finance had a strong wish to end the expansionary fiscal policies as soon as they can and return to the policy of fiscal consolidation. They were aware of the pressure from the Japanese and overseas financial markets to undertake fiscal consolidation in the long term. Faced with growing fiscal deficits since the advent of the Obuchi government in 1998, the Japanese Ministry of Finance was increasingly aware of the need to return to the trends towards fiscal consolidation. They felt increasingly frustrated about the lack of willingness of the Bank of Japan to cooperate with the Japanese Ministry of Finance and their inclination to stress their independence as a political posturing. To the eyes' of the Japanese Ministry of Finance, the Bank of Japan did not care about so much sending the coordinated messages to the market as a political posturing to refuse the interference from the Japanese government. The inconsistency of macroeconomic policies and the perceived lack of communications between the Japanese Ministry of Finance and the Bank of

Japan increased the doubts among the market participants as to whether the Japanese government and the central bank really took the still weak economic recovery seriously enough. The Japanese Ministry of Finance considered that this uncooperativeness of the Bank of Japan contributed to much less effects of various fiscal stimulus measures on the Japanese economic recovery than expected and resulted in sharp deterioration of fiscal imbalance in the late 1990s and early 2000s.

Although the zero-interest rate policy was lifted in August 2000, the Bank of Japan was forced to return to essentially zero-interest rate policy by adopting aggressive monetary easing in March 2001, as they were faced with the burst of the IT bubble in the US economy.<sup>87</sup> Then the Bank of Japan was severely criticised for its misjudgement about the timing of lifting the zero-interest rate policy in August 2000 in spite of there being no clear sign of the Japanese economy getting back to on the path of self-sustainable recovery.<sup>88</sup> The Bank of Japan attributed the weaker recovery of the Japanese economy than expected to the burst of the IT bubble in the US economy. However, the Japanese Ministry of Finance was critical about the Bank of Japan using such an excuse saying that such a risk was already argued well before the lifting the zero-interest rate policy in August 2000.

In March 2001, the Bank of Japan introduced the quantitative easing policy. This marked the shift of the central bank's policy target from interest rate to current accounts at the Bank of Japan. The press release titled "New Procedures for Money Market Operations and Monetary Easing", issued right after the Monetary Policy Meeting on 19 March 2001 stated as follows;<sup>89</sup>

*1. Japan's economic recovery has recently come to a pause after it*

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<sup>87</sup> Ito, T. (2006), "Japanese monetary policy: 1998-2005 and beyond", Ito, Takatoshi., *BIS Paper No.31*, December 2006, "Two Decades of Japanese Monetary Policy and the Deflation Problem, Ito, T and Mishkin, F.S. (2004), *NBER Working Paper No 10878*, October 2004,

<sup>88</sup> Ito, T (2006), "Japanese monetary policy: 1998-2005 and beyond", *BIS Paper No.31*, December 2006,

<sup>89</sup> "New Procedures for Money Market Procedures and Monetary Easing", Press Release, Bank of Japan, 19 March, 2001, [https://www.boj.or.jp/announcements/release\\_2001/k010319a.htm/](https://www.boj.or.jp/announcements/release_2001/k010319a.htm/)

*slowed in late 2000 under the influence of a sharp downturn of the global economy. Prices have been showing weak developments and there is concern about increase in downward pressures on prices stemming from weak demand.*

- 2. In retrospect, both monetary and fiscal policies have taken considerably strong actions during the past decade in Japan. Whereas fiscal policy has repeatedly implemented expansionary measures, the Bank of Japan has adopted a policy of maintaining interest rates at levels unprecedentedly low during the history of central banking at home and abroad, thereby providing ample liquidity. All this notwithstanding, Japan's economy has failed to return to a sustainable growth path, and is now faced again with a threat of deterioration.*
- 3. In light of this, the Bank has come to a conclusion that the economic conditions warrant monetary easing as drastic as is unlikely to be taken under ordinary circumstances. Accordingly, the Bank decided at its Monetary Policy Meeting of today to take the following policy actions.*
  - a) Change in the operating target for money market operations*  
*The main operating target for money market operations be changed from the current uncollateralized overnight call rate to the outstanding balance of the current accounts at the Bank of Japan. Under the new procedures, the Bank provides ample liquidity, and the uncollateralized overnight call rate will be determined in the market at a certain level below the ceiling set by the Lombard-type lending facility.*
  - b) CPI guideline for the duration of the new procedures*  
*The new procedures for money market operations continue to be in place until the consumer price index (excluding perishables, on a nationwide statistics) registers stably a zero percent or an increase year on year.*
  - c) Increase in the current-account balance at the Bank of Japan and declines in interest rates*

*For the time being, the balance outstanding at the Bank's current accounts be increased to around 5 trillion yen, or 1 trillion yen increase from the average outstanding of 4 trillion yen in February 2001. As a consequence, it is anticipated that the uncollateralized overnight call rate will significantly decline from the current target level of 0.15 percent and stay close to zero percent under normal circumstances.*

- d) *Increase in outright purchase of long-term government bonds*  
*The Bank will increase the amount of its outright purchase of long-term government bonds from the current 400 billion yen per month, in case it considers that increase to be necessary for providing liquidity smoothly. The outright purchase is, on the other hand, subject to the limitation that the outstanding amount of long-term government bonds effectively held by the Bank, i.e., after taking account of the government bond sales under gensaki repurchase agreements, be kept below the outstanding balance of banknotes issued.*
4. *The Bank of Japan has decided to implement these policy measures with firm determination with a view to preventing prices from declining continuously as well as preparing a basis for sustainable economic growth.*
5. *In order to make this monetary easing fully effective in restoring Japan's economy on a sustainable growth path, progress in structural reforms with respect to the financial system, e.g., resolution of the non-performing asset problem, as well as in the area of economy and industry is essential. Structural reform may be accompanied by painful adjustments. Without such adjustments, however, neither improvement in productivity nor sustainable economic growth can be obtained. The Bank of Japan strongly hopes that decisive actions be taken to address fundamental problems both with a clear support of the nation for structural reform and under a strong leadership of the government of Japan (underlined by author).*

The quantitative easing measures was further strengthened by the press release titled “Enhancement of Monetary Policy Transparency” in October 2003, where it was articulated that (1) this commitment requires not only that the most recently published core CPI should register a zero percent or above, but also that such tendency should be confirmed over a few months, and (2) the Bank needs to be convinced that the prospective core CPI will not be expected to register below a zero percent.<sup>90</sup>

The target level for current account balances at the BOJ was frequently revised. After the initial level was set at 5 trillion yen, the target level was raised to 6 trillion yen less than a half a year later, in August 2001, followed by further increase to a range of 10-15 trillion yen and then to 30-35 trillion yen in January 2004. Toshihiko Fukui, who succeeded Masaru Hayami March 2003 as the governor of the BOJ, attempted to demonstrate his willingness to tackle deflationary spiral.

A great number of US economists were also critical about the Bank of Japan monetary policy, claiming that the Bank of Japan had not done enough to address the deflation problem.<sup>91</sup> For example, Ben Bernanke condemned that the Japanese monetary policy’s paralysis was largely self-induced due to the unwillingness of the Bank of Japan to experiment anything that is not absolutely guaranteed to work.<sup>92</sup> In his later speech in Tokyo, Ben Bernanke called for the Bank of Japan to announce a quantitative objective for prices, as well as how such an objective might best be structured and to consider adopting a price-level target, which would imply a period of reflation to offset the effects on prices of the recent period of deflation. Second, he called for the Bank of Japan to consider taking more proactive approach on the relationship between the Bank of Japan's balance sheet and its ability to undertake more aggressive monetary

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<sup>90</sup> “*Enhancement of Monetary Policy Transparency*”, Press release, Bank of Japan, 10 October, 2003. [https://www.boj.or.jp/announcements/release\\_2003/k031010.htm/](https://www.boj.or.jp/announcements/release_2003/k031010.htm/)

<sup>91</sup> Bernanke, Ben S., “*Japanese Monetary Policy: A Case of Self-Induced Paralysis?*”, presentation at the ASSA meeting, 9 January, 2000; Krugman, Paul., “Japan’s Monetary Policy (Wonkish)”, paper available at <http://krugman.blogs.nytimes.com/2010/07/30/japanese-monetary-policy-wonkish/>

<sup>92</sup> Bernanke, Ben. S. , “*Japanese Monetary Policy: A Case of Self-Induced Paralysis?*”, presentation at the ASSA meeting, 9 January, 2000

policies.<sup>93</sup> In the view of Ben Bernanke, the Bank of Japan was too much preoccupied by the idea of being independent from the pressure of the government. He stated that with protracted deflation, however, excessive money creation is unlikely to be the problem, and a more cooperative stance on the part of the central bank may be called for and that under the current circumstances, greater cooperation for a time between the Bank of Japan and the fiscal authorities is in no way inconsistent with the independence of the central bank, any more than cooperation between two independent nations in pursuit of a common objective is inconsistent with the principle of national sovereignty.<sup>94</sup>

Not only many US economists but also international organisations such as the IMF called for the Bank of Japan to take more pro-active monetary policy. The IMF World Economic Outlook in October 2000 pointed out that in Japan, where consumer confidence remains weak and deflationary pressures persist, monetary policy should be highly accommodative until clear signs that the recovery has become self-supporting emerge. However, the Bank of Japan was rather defiant about the domestic pressures from the Japanese Ministry of Finance and the political circle to make monetary policy more accommodative.

In the period of time when Masaru Hayami was the Governor of the Bank of Japan between 1998-2003, the Bank of Japan was far from taking a proactive approach about monetary policy. The Bank of Japan did not admit that the Japanese economy was trapped by deflationary spiral. The then Governor Hayami referred to the progress of technological innovation and the revolution in distribution networks as a key element of price reduction. In his view, the IT and distribution network revolutions continue under the current situation of zero inflation, the Bank of Japan cannot rule out the possibility that the economy could recover while the inflation rate is negative in terms of the existing price indexes, even though they may not sufficiently incorporate these revolutionary changes. And, in the case where cost reductions continue thanks to technological innovation, even if the

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<sup>93</sup> Remark by Bernanke, Ben.S., 31 May 2003, Before the Japan Society of Monetary Economics, Tokyo, Japan, <http://www.federalreserve.gov/BoardDocs/Speeches/2003/20030531/#f4>

<sup>94</sup> Ibid.

inflation rate is statistically negative it would not be appropriate to judge the economy as being deflationary as long as it is recovering steadily.<sup>95</sup>

Masaru Hayami further stated that if the Bank of Japan took more aggressive monetary policies such as the purchase of government bonds, it would undermine the credibility of fiscal stability, and lead to the rise of long-term interest rates because of a higher risk premium occasioned by deterioration in the creditworthiness of the Japanese government. Adoption of such a drastic policy would run the high risk of eroding not only fiscal discipline and the smooth functioning of financial markets but also the credibility of Japan itself.<sup>96</sup> But from the Japanese Ministry of Finance's point of view, this argument was off the mark at all in terms of the role which monetary policy was supposed to play in the self-sustainable recovery of the Japanese economy.

In the assessment by the Bank of Japan, since the early 1980s when the effects of the Second Oil Shock waned in Japan until 2000, the average rate of CPI increase was very low at around 1%, and was only 3% at the peak of the bubble period when the economy was overheated. The Bank of Japan was of the view that in the case of Japan, prices have been extremely stable for nearly twenty years, and therefore Japan was not in a situation where they need to set any inflation target to maintain price stability even if we have not solved such difficult problems as defining and measuring price stability.<sup>97</sup> The Bank of Japan was inherently less sensitive about the risk of deflation, as deflation meant for them a sort of state of price stability. The Bank of Japan did not care about so much misalignment between monetary policy and fiscal policy as the perceived independence of the Bank of Japan as a central bank.

The key issue facing the Japanese economy then was the non-performing loans by Japanese financial institutions, as was explicitly referred to in the BOJ statement. The Bank of Japan repeatedly pointed out the need to resolve the non-performing loan problem as early as possible. The Japanese

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<sup>95</sup> Remark by Masaru Hayami, 21 March 2000, Price Stability and Monetary Policy, BIS, <http://www.bis.org/review/r000324c.pdf>

<sup>96</sup> Ibid.

<sup>97</sup> Ibid.



Ministry of Finance considered that accommodative monetary policy needed to be maintained to alleviate the pains incurred in the process of resolving non-performing loans. The Japanese Ministry of Finance was well aware of the negative impacts of non-performing loans on the overall economy and believed that monetary policy needed to be sufficiently accommodative. On the other hand, Masaru Hayami considered that the deflation problem facing the Japanese economy was the inevitable result of the burst of the bubble economy in the late 1980s and the deflation problem itself was not the issue which the Bank of Japan needed to address. Masaru Hayami encouraged the Japanese financial institutions to increase the buffer of their capital to improve their resilience and to write off non-performing loans from their balance sheet. However, the Bank of Japan considered that the non-performing problem was in principle the problem solved by financial institutions themselves without easing monetary policy.

The non-performing asset problem plagued the Japanese financial system as of March 2001. The US Bush administration, which came to the office January 2001, pressed Japan to address the issues of non-performing loan and financial system as priority agenda. In response to the US demand, Japan reiterated its determination to accelerate the pace of addressing these issues. The joint statement after the meeting with Prime Minister Yoshihiro Mori stated that:

*The two leaders, noting that the United States and Japan together account for roughly 40 percent of the world economy, reaffirmed the importance of working together to promote prosperity in their two countries and around the world. The leaders recognized the need to address the challenges facing their two economies. The Prime Minister reiterated his determination to continue pursuing appropriate economic policies and to promote vigorously structural and regulatory reform to revitalize the Japanese economy and strengthen the financial system, including through effectively addressing the issue of corporate debts and non-performing loans (underlined by author).<sup>98</sup>*

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<sup>98</sup> Joint Statement by US President George W Bush and Japanese Prime Minister Yoshihiro Mori, 19 March 2001

The next Prime Minister Junichiro Koizumi, who came to the office and asserted himself as a reform-minded leader, stepped up the government measures to dispose non-performing loan problem and strengthen financial system. At the first bilateral meeting with US President George Bush, Prime Minister Junichiro Koizumi reaffirmed his determination to implement structural and regulatory reform including effectively addressing corporate debt and non-performing loan problems.

*The President and Prime Minister affirmed their belief that open markets and sound macroeconomic and regulatory policy are vital for sustained prosperity. The Prime Minister expressed his determination to vigorously and comprehensively implement structural and regulatory reform to revitalize the Japanese economy, including through effectively addressing corporate debt and non-performing loans. The President expressed his appreciation for the Prime Minister's plan, "Structural Reform in the Japanese Economy: Basic Policies for Macroeconomic Management." The Prime Minister welcomed the President's strong intention to support sustained economic growth in the United States through tax cuts and other measures. They noted with satisfaction the completion of the Fourth Joint Status Report on Deregulation and Competition Policy, and called for increased collaborative efforts to improve their nations' climates for foreign direct investment (underlined by author).*

*The two leaders announced the launch of a new bilateral economic initiative called the U.S.-Japan Economic Partnership for Growth (detailed in Annex). This initiative establishes a structure for cooperation and engagement on bilateral, regional and global economic and trade issues (underlined by author).<sup>99</sup>*

In October 2002, Prime Minister Koizumi announced that the Japanese government would substantially accelerate the disposal of non-performing loans and conclude the issue of non-performing loans during 2004.<sup>100</sup>

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<sup>99</sup> Joint Statement by US President George W Bush and Japanese Prime Minister Junichiro Koizumi, 30 June 2001

<sup>100</sup> General Policy Speech by Prime Minister Junichiro Koizumi to the 155<sup>th</sup> Session of the Diet, 18 Oct, 2002

Amid the growing concern about the non-performing loan problem and worsening deflation spiral as a result of deleveraging of bank and corporate portfolios, the US Government was of the view that more aggressive monetary policy to increase monetary base was necessary to soften the shocks caused by the disposal of non-performing loan.

The US Treasury saw the Great Intervention as a part of monetary policy by unsterilising the part of the monetary base as a result of intervention. John Taylor, then Treasury Under Secretary for International Affairs, recalls that the US policy towards the Great intervention was a part of a strategy to support Japanese efforts to increase money growth.

In his blog, he stated that *'The U.S policy toward the Great Intervention by Japan was part of a strategy to support Japanese efforts to increase money growth to levels achieved before the start of their deflation. So it did relate to quantitative easing. By not registering objections to the intervention, the U.S. made it easier for Japan to increase money growth. The strategy worked this way: When the Bank of Japan intervenes and buys dollars in the currency markets at the instruction of the Finance Ministry, it pays for the dollars with yen. Unless the Bank of Japan offsets—sterilizes—this increase in yen by selling (rather than buying) other assets, such as Japanese government bonds, the Japanese money supply increases. In the past, U.S. Administrations had leaned heavily against the Japanese intervening in the markets to drive down the yen. By adopting a more tolerant position toward the intervention—especially if it went unsterilized—we could help to increase the money supply in Japan. So when Zembei Mizoguchi, the vice Minister at the Japan's Ministry of Finance, discussed the possibility in late 2002 that currency intervention was going to increase, I did not object, as the U.S. Treasury usually does. (underlined by author)'*

As is shown above, the US Treasury understood that Great Intervention was at least partly unsterilised and helped to increase the money supply in Japan. In his book, Jon Taylor recalled that Japan originally proposed that intervention would occur to support the certain level of band as reference rates, but neither the US nor the EU agreed to such an arrangement. This

shows that the US Treasury was opposed to straightforward intervention to support the certain level of Yen-Dollar exchange rates, but merely acquiesced in the Japan's intervention as a part of monetary policy.

This was also clearly described in the US Treasury Semi-annual Report to the Congress on International Economic and Exchange Rate Policies in April 2004, which stated that:

The Japanese foreign exchange intervention came at the same time as a shift in monetary policy toward more rapid growth in base money in order to overcome persistent Japanese deflation. The provision of yen in the course of foreign exchange intervention has been an important component of monetary base growth, as it has been only partially absorbed ("sterilized") by the sale of government securities. This shift in monetary policy has had some success, with yearly average consumer price deflation moderating to -0.3% in 2003 from -0.9% in 2002. Even though the dollar-yen foreign exchange market is huge, with transactions estimated at \$230 billion per day, the scale of Japanese intervention has been extremely large. Japanese authorities have stated that their "intervention is carried out when excess volatility or over-shooting is observed in the markets," and that they do not target particular values of the exchange rate. The Treasury is actively engaged in discussions with Japanese authorities on these issues, both bilaterally and through the meetings of the G-7 finance ministers and central bank governors. At the G-7 meetings in Dubai and more recently in Boca Raton, the Treasury worked with the G-7 to promote a strong consensus in support of flexible exchange rates. Japan joined the United States and other G-7 nations in these declarations (underlined by the author).

The US government's policy towards the Great Intervention was characterised by two elements:

- (1) The US government supported the Great Intervention on the basis of their understanding that it was a part of monetary policies to increase monetary base;

- (2) The US government supported the Great Intervention on the premise that it did not target particular values of the exchange rate.

The conventional wisdom argues that there are two types of intervention of sterilised intervention and unsterilized intervention in terms of the impacts on monetary base. In that view, sterilised foreign exchange interventions tend to be less effective at moving exchange rates than unsterilized interventions, because sterilized intervention would have no impact on the domestic money supply by requiring the central bank to buy dollar assets with yen-denominated currency, with a countervailing sale of yen assets to mop up the extra yen that that would otherwise be injected into the economy. Conversely, unsterilized intervention would leave at least some part of increased money base intact.

However, there is a strong disagreement against this conventional wisdom. It claims that it would be difficult to identify such a one-to-one correspondence between intervention activity and movements in the Bank of Japan current account balance. According to this argument, the Bank of Japan would incorporate the foreign exchange intervention it conducts on behalf of the Japanese Ministry of Finance into its overall portfolio of daily money market transactions, and achieve its domestic money supply targets by adjusting its other transactions accordingly.<sup>101</sup> In this view, foreign exchange intervention would never be a part of monetary policy.

It is not the purpose of this dissertation to examine whether foreign exchange intervention should or could be considered as a part of monetary policy from the viewpoint of economic theory. But, rather it is interesting to examine why Japan could pursue such a great amount of unilateral foreign exchange intervention for such a long period of time, whereas other G2 (the US and EU) have almost abandoned foreign exchange intervention except a very occasional coordinated foreign exchange intervention. In retrospect, the Japan's so-called Great Intervention stood out in terms of its scale and length of period conducted.

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<sup>101</sup> FRB San Francisco Economic Letter (2003), Number 2003-36, December 12, 2003, "*Japanese Foreign Exchange Intervention*"

Why the exchange rate policy tends to be under so heated discussion in Japan is rather interesting question. For example, the late 1980s after the Plaza Accord, how to prevent Japanese yen from appreciating radically against US dollar was the primary concern for the then finance ministers in Japan. In the Great Intervention between May 2003 and March 2004, the Japanese Ministry of Finance considered that the premature yen's excessive appreciation would hamper the self-sustainable recovery of the Japanese economy from deflation. This assessment was based on the view that the premature yen's excessive appreciate would result in reduced corporate profit of Japanese industries and retard the breakaway from deflation. The preoccupation of the negative side of Japanese yen's appreciation remains deeply in the minds of business leaders of the Japanese industries.

The US Treasury reacted to the request from the Japanese Ministry of Finance to acquiesce in the Japanese Great Intervention in the foreign exchange market rather differently from what they did in the late 1980s. The biggest reason for the different reaction of the US Treasury was that the US Treasury was much more confident about their domestic economy and they did not need to worry much about the political pressure from the Washington's political circle including the US Parliament to oppose to the Japanese intervention.<sup>102</sup> The concerns about the Japanese Yen's appreciation deterioration among Japanese business leaders have persisted because the terms of trade of Japan deteriorated constantly since the late 1990s. This indicated that Japanese industries were gradually losing the ability to sell more value-added goods to the markets and they were working hard to reduce the costs and sell their products at lower price through their rationalisation efforts. Japanese companies have been losing the power to control products' prices. This makes their Japanese business leaders even more sensitive about Japanese yen's appreciation.<sup>103</sup>

Unlike the former governor of the Bank of Japan Masaru Hayami, his successor Toshihiko Fukui took more accommodative policy stance on monetary policy. Since he undertook the position of the Bank of Japan

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<sup>102</sup> Mizoguchi, Z. (2004) Personal View on Foreign Exchange (Kawase-zuikan), <http://www.jcif.or.jp/docs/20040917.pdf>

<sup>103</sup> Trade and Commerce White Paper 2012, Government of Japan, <http://www.meti.go.jp/report/tsuhaku2012/>

Governor in March 2003, the Bank of Japan was considered to change their policy stance on monetary policy and make better efforts to work cooperative way with the Japanese Ministry of Finance. The newly appointed Deputy Governor of the Bank of Japan Toshiro Muto was the former Vice Minister of the Japanese Ministry of Finance. He was considered to play a key role in better communication between the Bank of Japan and the Japanese Ministry of Finance. Under the new Bank of Japan Governor Toshihiko Fukui, the Bank of Japan increased the target for the outstanding balance of current account held at the Bank of Japan steadily up to JPY 35 trillion from the level of JYP 15-20 trillion. This change of course of monetary policy was welcomed by the financial market as a more proactive policy stance by the Bank of Japan. This accommodative monetary policy stance of the Bank of Japan was a necessary condition for the US Treasury to accept the Great Intervention.

The idea of seeing foreign exchange rate policy as part of monetary policy was an elaborated way to place exchange rate policy as a tool of achieving a broader objective of a breakaway from deflation. In the late 1980s after the Plaza Accord, foreign exchange policy was the primary goal for international policy coordination. In the Plaza Accord, exchange rate policy was at the heart of the policy coordination. In the Plaza Accord, the statement read that:

*The Ministers and Governors agreed that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case. They believe that agreed policy actions must be implemented and reinforced or improve the fundamentals further, and that in view of the present and prospective changes in fundamentals, some further orderly appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful.*

In the late 1980s, foreign exchange policy was the primary target of international policy coordination. The then US Treasury secretary James Baker talked down the dollar a number of occasions. For the Japanese

Ministry of Finance, who wanted to avoid fiscal stimulus measures to the extent possible, foreign exchange policy was essentially the only direct measure to address the trade imbalance between the US and Japan. However, the Japanese Ministry of Finance was faced with the situation when they need to correct the excessive force of the foreign exchange markets towards yen's appreciation beyond the target range which they considered in line with the fundamental economic conditions. The Japanese Ministry of Finance worked with the US Treasury in an attempt to send a coordinated message to the market that both Japan and the US did not want yen's appreciation and reverse the trend of yen's appreciation. In that process, the US Treasury pressed the Japanese Ministry of Finance to make fiscal and monetary policy more accommodative.<sup>104</sup>

What was common between the Great Intervention in the early 2000s and yen's appreciation in the late 1980s was that it was the Japanese Ministry of Finance who wanted to prevent the Japanese yen's appreciation from soaring and the Japanese side was eager to obtain the US Treasury cooperation and send a coordinated message to the market in the sense that the US Treasury share the view or at least acquiesce in the Japanese Ministry of Finance's attempt to prevent further appreciation. While it was a part of the G7 Finance Ministers framework within the multilateral system, the Japanese Ministry of Finance saw the relationship with the US as pivotal in their financial diplomacy. From the Japanese Ministry of Finance's point of view, the cooperation with the US Treasury has been a key element of their financial diplomacy based on the strengthening of the G2 relationship in the international financial system. In other words, the Japanese Ministry of Finance used the special relationship with the US as the source of credibility of their presence in the international financial diplomacy. This sense of the special relationship has been further reinforced by the surge of China as the regional powerhouse overtaking Japan in the international economic and financial system.

However, as emerging economies, notably China's economic presence was

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<sup>104</sup> Noguchi, H (1995), "Japan-US Monetary Negotiations 2000 days – the fights by Vice Minister for Foreign Affairs of the Japanese Ministry of Finance" (Nichibei- Tuuka-Koushou-2000-nichi). Funabashi, Y. (1993), Monetary Fights (Tuuka-retsus-retsus); Takita, Y. (2006), "Nichi-Bei Tuuka-Kosho (Negotiation of Financial Affairs Between Japan and the US)"



growing in the 2000s and the US was increasingly concerned about their interventions in their foreign exchange markets to hold down the currency. From the US and Japanese perspectives, the intervention in the foreign exchange markets would keep China locked into an export-led growth model that could result in discontent about unfair competition around the world especially in the markets of developed countries such as the US and Japan. In September 2003, the then US Treasury Secretary John Snow openly commented that the establishment of a flexible exchange rate regime for the Chinese yuan would benefit both the United States and China, as well as their regional and global trading partners. He stated that market-determined floating currencies were really the key to a well-functioning international financial system. While he tried to disseminate a positive tone indicated by the Chinese counterparts, it was apparent that the US Treasury was frustrated about underestimated value of the Chinese currency and called on China to increase their currency flexibility and take concrete steps and make progress towards more currency flexibility.<sup>105</sup>

In the G7 Finance Ministers and central bank governors' statement in February 2004, the statement read that in the paragraph regarding foreign exchange rate:

*We reaffirm that exchange rates should reflect economic fundamentals. Excess volatility and disorderly movements in exchange rates are undesirable for economic growth. We continue to monitor exchange markets closely and cooperate as appropriate. In this context, we emphasize that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms.*

The US Treasury Secretary John Snow suggested to John Taylor that “economic areas that lack such flexibility” after “major countries” with a view to stressing that the G7 kept a close eye on flexibility in exchange

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<http://iipdigital.usembassy.gov/st/english/texttrans/2003/09/20030903104742esromj0.5756494.html#axzz3bx3bUkZV>

rates in China.<sup>106</sup> John Snow urged China to stop persistent intervention in the foreign exchange market. This was based on the increasing concern of the US about the trade imbalance between the US and China. This eventually led to the creation of a formal dialogue of the US-China Strategic Economic Dialogue, which started in December 2006. The press release issued by the US Treasury stated that “During one and a half days of productive and in-depth discussions on overarching and long-term strategic economic issues, we reaffirmed our commitment to pursuing macroeconomic policies, such as China's exchange rate regime reform and increasing the U.S. savings rate, to promote balanced and strong growth and prosperity in our two nations.”

The Japanese Ministry of Finance was increasingly aware of the dilemma between the need to prevent premature Japanese yen's appreciation and the need to distinguish itself from China. Domestically the Japanese Ministry of Finance was faced with the call from the business sector to prevent Japanese yen's appreciation from deviating from economic fundamentals to an unreasonable extent. As the Economic White Paper 2004 pointed out, the Japanese export sectors became increasingly resilient against the pressure from the fluctuation of foreign exchange rates. For example, the Japanese automobile companies reduced the portion of domestic production, and instead increased that of overseas production. The Japanese electronic machinery companies increasingly shifted the production of products to overseas, notably Asian countries, and made efforts to use the factories in Asia as the base for exports to all over the world. In a sense, the Japanese companies increased its resilience against the pressure derived from the fluctuation of the foreign exchange rates. On the other hand, the Japanese export companies were increasingly choosing to avoid raising the price to the as much extent as the foreign exchange moved to Japanese yen's appreciation. While Japanese companies were increasingly resilient against the Japanese yen's appreciation, they were increasingly faced with the difficulty at the same time of gaining as much profit margins as they did in the 1980s.<sup>107</sup>

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<sup>106</sup> Takita, Y (2010). “*Tsuuka-wo-yomu (Reading currency)*”

<sup>107</sup> Economic White Paper (2004), Government of Japan,  
[http://www5.cao.go.jp/j-j/wp/wp-je04/04-00302.html#sb3\\_2\\_1](http://www5.cao.go.jp/j-j/wp/wp-je04/04-00302.html#sb3_2_1)

Since the financial crisis in 1997 in Japan entailing a series of collapses of Japanese financial institutions, the US administration was not increasingly seeing Japan as a threat to the US economy, but rather urging Japan to take effective measures to recover its economic recession and deflation. Especially, under the Bush administration, the US Treasury took the attitude of permissiveness. The Prime Minister Junichiro Koizumi established a close personal relationship with the US President George Bush by giving him a diplomatic support to his attempt to contain the axis of evil and start a war against Iraq. Faced with the severe diplomatic tension against Germany led by Chancellor Gerhard Schröder and France led by President Jacques Chirac, the US needed the diplomatic support from Japan and welcomed the support explicitly given by the Japanese Prime Minister Junichiro Koizumi on the Iraq War. The Japanese Prime Minister Junichiro Koizumi was well aware of the importance of the US-Japan strategic alliance underpinned by the Japan-US Security Treaty as the basis of the post-war economic prosperity in Japan.

Under the Bush administration, the financial and economic diplomacy between Japan and the US was intrinsically linked with diplomatic policy. In general, there was a tendency that the more the US administration needed the diplomatic support from the Japan, the more cooperative the US Treasury became with the Japanese Ministry of Finance. Under the Bush administration, the Japanese government considered that the cooperation with the US would give Japan more influence in the financial and economic diplomacy especially in relation to China. Until the financial crisis in 2008, G7 Finance Ministers and Central Bankers meetings and G7 Summit meetings was essentially the only forum which decided the direction of the discussion on a wide variety of economic and financial issues ranging from macroeconomic policies to financial regulations. While the share of G7 in the international economy decreased as emerging economies grew, the G7 played a pivotal role in the financial and economic diplomacy. While the Japanese Ministry of Finance has continuously made the cooperation with the US the cornerstone of its economic and financial diplomacy, the emergence of China as a global economic giant made the Japanese Ministry of Finance even more aware of the need to maintain this

policy.

## 2-4 Political economy of foreign exchange policy and the increasing tension against China

In the mid-1980s after the Plaza Accord, exchange rate policy was placed as a major macroeconomic policy in the international macroeconomic policy coordination at the G7. In the 1980s, there was an internationally widely shared view that Japan was an international ‘free-rider’ that fails to pay its contribution and undertake leadership responsibility corresponding to economic power, but instead depends on others (notably the US) for the defence of its strategic interests and for the maintenance of the open international economic system that is crucial to its economy. From the US perspective, at least under the cold-war era, Japan was considered as a strategically crucially important ally of the US influence in the Asian Pacific regions against the USSR and China. However, the end of Cold War removed at least a part of the security blanket that required previous leaders in both countries, in the interests of maintaining their anti-communist alliance.

The sharp rise of the US dollar as a result of tight monetary policy in the late 1970s and early 1980s eventually led to the growing call for active government intervention in foreign exchange markets. At this time, the American business leaders, especially in manufacturing sector, was in favour of the dollar weakening because they recognised that the strong dollar was damaging to international competitiveness. While there is a debate concerning to what extent the G5 Plaza agreement and subsequent coordinated exchange rate intervention had an impact on the US dollar decline<sup>108</sup>, the G5 Plaza agreement clearly gave a signal that the dollar was overvalued.

In the late 1980s, there remained a strong momentum for seeking establishing narrow bands within which the industrial countries would

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<sup>108</sup> Feldstein, Martin. 1986, New evidence on the effects of exchange rate intervention. Working Paper No. 2052. Cambridge, Mass. NBER October

agree to reinstitute a fixed rate system to reduce the volatility of exchange rates. The EEC briefly succeeded in fixing bilateral rates within Europe, while fixed rates within the EMS was maintained only through frequently parity adjustments and through the imposition of extensive capital controls.<sup>109</sup> While accepting some degree of the Japanese yen's appreciation, Japan also tried to make the pace of the yen's appreciation orderly and control the yen-dollar exchange rate within narrow bands. But, in retrospect, the agreement was sustained just a brief period of time. At the Louvre accord in February 1987, the finance ministers and the central bank governors of the G5 and Canada reached a major agreement to stabilise exchange rates around current levels, and the substantial exchange rate changes since the Plaza Accord in September 1985 agreement to depress the dollar "brought their currencies within ranges broadly consistent with underlying economic fundamentals".

Since the late 2000s, in particular, China has been increasingly criticised by the US and other trading partners for alleged currency manipulation which they claim that caused China's accumulating trade surplus in relation to trading partners. In policy circle, a key question is whether China should allow its currency to appreciate to encourage global rebalancing by moving towards more flexible exchange rate regime reflecting market demand-supply.

China's trade expansion reflects the increasingly distinctive role of China serving as the final processing and assembly platform for a large quantity of imports going from other Asian countries notably Japan to Western countries through China. These changes have had a great effect on China's bilateral trade balances, with its increasing trade surpluses with Western industrial countries being offset by rising trade deficits with many Asian countries. Reflecting its growing prominence and rising appetite for imports including for meeting domestic demand, China has been an important source of growth for the world economy during the recent global slowdown. China has even contributed to the recent strength in world commodity prices; it is now the world's largest importer of copper and steel,

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<sup>109</sup> Marston, Richard. 1988, "Exchange Rate Coordination", *International Economic Cooperation* edited by Martin Feldstein, NBER Chicago University Press

and among the largest importers of other raw materials, including iron ore and aluminium.<sup>110</sup>

China's export base has become diversified from an initial heavy reliance on textiles and other light manufacturing. In the early 1990s, light manufacturing accounted for more than 40 per cent of China's exports. These products largely consisted of footwear, clothing, toys, and other miscellaneous manufactured articles. A large part of the remaining exports was accounted for by manufactured goods (mostly textiles) and machinery and transport (small electronics). In recent years, China has made substantial gains in other export categories, including more sophisticated electronics (office machines and automated data processing equipment, telecommunications and sound equipment, and electrical machinery), furniture, travel goods, and industrial supplies. For example, the proportion of China's exports represented by machinery and transport (which includes electronics) increased from 17 per cent in 1993 to 41 per cent in 2003, while the share of miscellaneous manufacturing declined from 42 per cent to 28 per cent.<sup>111</sup>

On the other hand, the Chinese authority's cautious approach derives from particularly the concerns that too rapid relaxation of capital control and increased flexibility of exchange rates would lead to exposing domestic financial system to currency risks and getting inflation rate out of control of the domestic macroeconomic authorities, as well as losing comparative competitiveness in international trade.

It has been said that China has regularly intervened in its foreign exchange markets. Prior to 1994, China employed a dual exchange rate system that consisted of an official fixed exchange rate system used by the government and a semi market-based system used by importers and exporters. A semi market-based system was swap market rate established in 1988 as an expansion and centralisation of the fragmented markets that had emerged since the early 1980s.<sup>112</sup> In 1994, the Chinese government combined the

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<sup>110</sup> IMF (2004)., "China's growth and Integration into the World Economy: Prospects and Challenges", *Occasional Papers* 232, edited by Prasad, E. IMF

<sup>111</sup> Ibid.

<sup>112</sup> Ibid.

two exchange rate systems and pegged the renminbi at 8.70 yuan to the dollar, which increased to 8.28 yuan to the dollar by 1997 and remained relatively constant until mid-2005. In 1994, the official rate was devalued and unified with the exchange rate at the swap centres (which accounted for an estimated 80 percent of current account foreign exchange transactions at the time), and the exchange rate system was officially changed into a managed float system. Since then, China officially had a managed floating exchange rate system although the currency was de facto fixed to the US dollar until 2005.<sup>113</sup>

In 2005, the Chinese government reformed its exchange rate system policies. It announced that the RMB would no longer be pegged, and that the renminbi exchange rate would become “adjustable based on market supply and demand with reference to exchange rate movements of currencies in a basket” containing various currencies of major developed countries. While the renminbi would be allowed to fluctuate in relations to the basket on a daily basis, China only allowed the renminbi to appreciate at a very slow and steady pace. From mid-2005 to mid-2008, the USD dollar-renminbi exchange rate appreciated from 8.11 to 6.83, an appreciation of 20.8 per cent (if the initial adjustment from 8.28 to 8.11 yuan is included). In the wake of the global financial crisis, the Chinese government suspended its exchange rate regime in mid-2008 and the exchange rate was held relatively constant at 6.83 until mid-2010. In mid-2010, against the background of increasing call for China to move towards a more flexible exchange rate regime, the People’s Bank of China decided to resume its renminbi reform to enhance the renminbi exchange rate flexibility. The pace at which renminbi appreciated against the US dollar and other major currencies has been rather incremental.

When the Chinese government announced a more flexibility of foreign exchange rate of their own currency in 2005, the US government welcomed its move to a more flexible exchange rate. The then US Treasury John Snow welcomed it saying that “the reform of China’s currency regime is important for China and the international financial system.” The US Treasury considered that a flexible system would help China achieve price

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<sup>113</sup> Ibid.

stability and improve its ability to adjust to shocks, and it will, when combined with more flexible currency exchange systems in other Asian countries, contribute to the orderly unwinding of global current account imbalances.<sup>114</sup> The US Treasury's view about global current account imbalances was well described in the US proposal, which the then US Treasury Secretary Timothy Geithner wrote to his G20 colleagues suggesting that they should adopt a new approach to managing external trade imbalances in October 2010. In that letter, specifically, he wanted the G20 to agree to a limit on their current account surpluses and deficits over a period of years, and also to correct these imbalances if they seem likely to drift away from the agreed targets.<sup>115</sup> The US Treasury has considered that increased flexibility in the exchange rate would be necessary to address the current account imbalances between China and the US since the Bush administration.

The World Trade Organization (WTO) accession was crucial in promoting China's integration with the global trading system and gave a huge opportunity to increase their exports. The China's accession to the WTO increased the market access of Chinese goods and services to overseas markets. Increased market access overseas is the most immediate benefit from WTO accession to China. As an immediate effect on its membership, China was permanently granted most-favoured-nation (MFN) treatment by other WTO members. Upon accession, trading partners eliminated discriminatory restrictive measures against the Chinese goods and services. Over time, easier access to foreign market is expected to boost China's exports in a number of sectors. In the early 1990s, nearly half of the China's exports were dominated by light manufacturing such as footwear, clothing, toys, and other miscellaneous manufactured articles. In recent years, China has made substantial gains in other export categories, including more sophisticated electronics such as telecommunications and electrical machinery).<sup>116</sup>

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<http://iipdigital.usembassy.gov/st/english/article/2005/07/20050721151025saikceinawz0.2017176.html?CP.rss=true#axzz3cOxwS7Y4>

<sup>115</sup> <http://blogs.ft.com/gavyndavies/2010/10/22/a-novel-g20-proposal-from-tim-geithner/>

<sup>116</sup> IMF (2004) edited by Prasad, E., "China's growth and Integration into the World Economy: Prospects and Challenges", Occasional Papers 232, IMF



Under the Clinton administration in the 1990s, the US administration did not consider the emergence of China as much threat as the Bush administration did in early 2000s, but rather did as a land of new opportunity. Robert Rubin, then US Treasury Secretary, described that China contributed to stability of the Asian economy as a whole, which contrasted with Japan's weakness in the late 1980s during the Asian financial crisis. Robert Rubin commended China for the firmness of their commitment not to devalue the Chinese currency during the Asian financial crisis. But, at least the Clinton administration did not urge China to revalue the renminbi, but took a rather soft approach based on the view that it would be more effective and practical to have a strategy of engaging China in the international economy through trade policy. The Clinton administration urged China to lower its trade barriers. Based on the expectation that China would in any case be formidable and staunchly independent force, the Clinton administration considered that it would be greatly to the benefit of both two countries to have an effective relationship.

On the other hand, in the early 2000s, the US business sector was increasingly concerned about the increased Chinese competitiveness, rampant piracy, counterfeiting, and currency manipulation. Even larger US business were concerned that mercantilist Chinese policies would try to direct controlled markets instead of opening competitive markets.<sup>117</sup> The increasing bilateral trade deficit against China led to growing protectionist pressure in the US, and the China's growing global current account surplus led to the growing call for more flexibility of the China's exchange rate policy to adjust to imbalances.<sup>118</sup> This gradual shift of perception of China by the US business sectors was reflected in a tougher approach taken by the Bush administration against China in economic and financial diplomacy.

In addition to its economic footprint, China's rapid military modernisation and increased in capabilities has raised questions about the purposes of this

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<sup>117</sup> Zoellick, R.B. "Whither China: From Membership to Responsibility? Remarks to the National Committee on U.S.-China Relations", NBR (National Bureau of Asian Research) Analysis, Volume 16, Number 3, December 2004

<sup>118</sup> Ibid.

build-up and China's lack of transparency. There was a growing sense that if China seeks to maneuver towards a predominance of power, the US should work together with ASEAN, Japan, Australia, and others for regional security and prosperity through the ASEAN Regional Forum and the APEC forum.<sup>119</sup>

Beginning in 2003, a series of currency exchange rate bills targeted on China's "currency manipulation" have been introduced to Congress. On October 11, 2011, the U.S. Senate passed The Currency Exchange Rate Oversight Reform Act of 2011. The Act would allow the US government to impose countervailing duties on Chinese goods if it deems that China is undervaluing its currency. Its proponents claimed that China's policies interfered with the appreciation of its currency, along with its subsidies in certain industries, and provided its domestic export industries with an unfair competitive advantage. They further claimed that it made US firms forced to choose between outsourcing jobs and going out of business. On the other hand, critics call the Act economic protectionism and is the last thing the United States wants during its financial crisis.<sup>120</sup>

In contrast with the US, Japan did not show a clear approach on the China's de facto fixed exchange rate system to the US dollar taken by the Chinese government since 1995. In 2002, Haruhiko Kuroda (then Vice Minister for International Affairs of the Ministry of Finance of Japan) and Masahiro Kawai (Deputy Vice Minister for International Affairs of the Ministry of Finance of Japan) accused China of exporting deflation because China had pegged the renminbi to the US dollar and was experiencing deflation in the 1998-2002 period.<sup>121</sup> They recommended that the renminbi be appreciated in order to end China's negative impact on its neighbour countries. The Economic White Paper 2003 examined to what extent the increase in Chinese goods in the Japanese consumption markets contributed to the continued deflation in Japan. It found that the penetration of Chinese goods had a certain degree of impact as much as around 0.4% on the deflation in

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<sup>119</sup> Ibid.

<sup>120</sup> Economist (2011), *Trade with China: And Now Protectionism*, Economist, 15 October 2011, <http://www.economist.com/node/21532288>

<sup>121</sup> Kuroda, H. and Kawai, M., (2002). Time for a switch to global reflation. *Financial Times*, 1 December 2002.

the Japanese economy. But, it concluded that the increase in the imported Chinese goods in the Japanese consumption markets was not a major cause of continued deflation of the Japanese economy. The Economic White Paper 2003 did not call on the Chinese government to increase the flexibility of the renminbi in the foreign exchange markets.

Furthermore, the Economic White Paper 2005 pointed out that the de facto fixed exchange rate system of the renminbi to the US dollar made certain contribution to steady economic growth of the Chinese economy, which they considered had still vulnerability in the financial sectors. The Japanese government saw the Chinese banking sector being dominated by state-owned banks and burdened by a large stock of non-performing loans problem.<sup>122</sup> As the IMF analysed, financial intermediation in China was mainly channelled through the banking system. Banks had a crucial role in intermediating the substantial amount of private savings in China, which was estimated to be around one-third of total household income. Bank lending underpinned the high level of investment growth, which made an important contribution to China's growth. Therefore, the stability of the banking system was crucial for promoting sustained growth. The Japanese government and the IMF shared the concern about the stability of the banking sector that the main challenges for the banks would be to improve their commercial orientation and strengthen their financial position. In their views, these challenges were interrelated, as improving the commercial orientation of the bank was a key step towards improving their financial health, both by reducing future accumulation of non-performing loans and boosting profitability, thereby helping to redress the balance sheet weaknesses of the banks.<sup>123</sup>

As the Economic White Paper 2002 demonstrated, the Japanese government did not take the rise of China as much threat as the US administration did in terms of the current account imbalances. The Economic White Paper 2002 stated that while some sectors which were faced with the increased competition directly from the Chinese counterparts,

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<sup>122</sup> Economic White Paper 2005 – Trends of World Economy, Government of Japan, <http://www5.cao.go.jp/j-j/wp/wp-je05/05-00000.html>

<sup>123</sup> IMF (2004), "China's growth and Integration into the World Economy: Prospects and Challenges", *Occasional Papers* 232, edited by Praad, E., IMF

other sectors such as automobiles and other high value-added products did not see China a real threat. It also pointed out that many Japanese industries already consider investing in China to establish a base for exports to the rest of the world there. In the 2002 Economic White Paper, it concluded that most of the exports from China depended heavily on the foreign companies rather than domestic Chinese companies, and that the exports from China were still limited to less high value-added products.<sup>124</sup>

The 2005 Economic White Paper examined the foreign exchange regime in China and concluded that China itself needed the reform of the renminbi regime, which was essentially pegged to the US dollar, to address their domestic economic problems such as the risk of inflation. The Economic White Paper 2005 did not draw a concrete conclusion that the renminbi was undervalued. While the US administration demanded the increased flexibility of the renminbi as a means of redressing the current account imbalance between the US and China, the 2005 Economic White Paper examined the increased flexibility of renminbi as something China itself needed. In the report, the sustainable growth of the Chinese economy was considered as crucially important to Japan, which has been strengthening its economic ties with China. The report especially recognised that most of the Japanese companies had already established or were planning to shift their production bases to China. In fact, the FDI from Japan increased between 2000 and 2005 by 2.5 times.

The 2005 Economic White Paper pointed out that China was increasingly faced with the Mundell's incompatibility triangle or so-called Open Economy Trilemma. According to this theory, a government would not be able to seek three objectives simultaneously, i.e. (1) stable foreign exchange rate, (2) free capital movement, and (3) an independent monetary policy. The paper pointed out that given a sheer size of the Chinese market, the Chinese economy should expand the flexibility of the Chinese currency in the foreign exchange market, also recognising that the Chinese economy was faced with the risk of inflation partly due to the increased prices of natural resources such as oil and that the increased flexibility of the

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<sup>124</sup> Economic White Paper 2002, Government of Japan,  
[http://www5.cao.go.jp/j-j/sekai\\_chouryuu/sa02-02/sa02-01-01-01.html](http://www5.cao.go.jp/j-j/sekai_chouryuu/sa02-02/sa02-01-01-01.html)

Chinese currency in the foreign exchange markets would contribute to absorbing the pressure deriving from the increased prices of imported goods and preventing the pressure from giving rise to the inflation in the Chinese economy.

The 2005 Economic White Paper gave a comprehensive review on the challenges facing the Chinese economy. It identified five key challenges: (1) the underdevelopment of the banking sector in China; (2) the need to reform state-owned companies; (3) the accession of China to the WTO and the need to develop market structures; (4) the need to address the economic disparity between cities and rural areas; and (5) the underdevelopment of infrastructure including electricity and water, in particular.

First, in terms of the underdevelopment of the banking sector in China, the report identified that the main features of the banking system in China were that it was predominantly state-owned, was very large, and was faced with non-performing loans and low capital adequacy ratios and under-provisioning. The report estimated that the ratio of non-performing loans was more than 15%. An IMF report in 2004<sup>125</sup> also pointed out that the bank's balance sheet shortcomings were manifested, to varying degrees, in a combination of high non-performing loans, low capital adequacy ratios, and under-provisioning. The IMF report found out that while there were some reforms including the establishment of the China Banking Regulatory Commission (CBRC) in April 2003, the on-going opening of the market to foreign financial institutions, the measures aimed at strengthening and modernising state commercial banks, and the capital injection to two of state commercial banks.

Second, in terms of the need to reform state-owned enterprises, the Economic White Paper 2005 pointed out most state-owned enterprises were faced with the slow progress of improvement of efficiency of management and remaining low profitability, in spite of the gradual process of giving more incentives and increased autonomy to individual enterprises. As the

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<sup>125</sup> IMF (2004), People's Republic of China, Article IV Consultation Report, <https://www.imf.org/external/pubs/ft/scr/2004/cr04351.pdf>; IMF (2004), "China's growth and Integration into the World Economy: Prospects and Challenges", Occasional Papers 232, edited by Prasad, E. IMF

report stated, the pressure on reform of state-owned enterprises came from the Chinese government policy stance known as “Socialist Market Economy”. In 1992, this new initiative was formally established as the Chinese governing principle for the new Chinese economy. The Chinese government sought to transform state-owned enterprises into economic entities suitable for such a market economy rather than remaining as de facto state production units.<sup>126127</sup>

Third, in terms of the accession of China to the WTO, the Economic White Paper 2005 recognised that the increased market access overseas was the most immediate benefit from the WTO for China, but at the same time pointed out that there were a great number of non-tariff barriers including the lack of administrative capacity to implement rules and regulations and the lack of transparency of implementation by the authorities. As the US Trade Representative (USTR) pointed out, the China’s compliance problems were occasionally generated by a lack of coordination among relevant ministries in the Chinese government. Another source of compliance problems has been a lack of effective or uniform application of China’s WTO commitments at local and provincial levels. In spite of China’s efforts to take steps to address both of these concerns, through more effective inter-ministerial mechanisms at the national level, and through a more concerted effort to reinforce the importance of WTO-consistency with sub-national authorities, compliance problems involved entrenched domestic Chinese interests that may be seeking to minimise their exposure to foreign competition.<sup>128</sup> The Economic White Paper 2005 foresaw that while easier access to foreign markets was likely to boost China’s exports in a number of sectors, it also pointed out the risk of increased bilateral trade conflicts and safe guard measures taken against the imports from China by other countries.

Fourth, in terms of the economic disparity between cities and rural areas,

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<sup>126</sup> [http://www5.cao.go.jp/j-j/sekai\\_chouryuu/sh05-01/sh05-01-01-03.html](http://www5.cao.go.jp/j-j/sekai_chouryuu/sh05-01/sh05-01-01-03.html)

<sup>127</sup> OECD (2009), State Owned Enterprises in China: Reviewing the evidence, Occasional Paper, OECD Working Group on Privatisation and Corporate Governance of State Owned Assets, <http://www.oecd.org/daf/ca/corporategovernanceofstate-ownedenterprises/42095493.pdf>

<sup>128</sup> USTR 2002 Report to Congress on China’s WTO Compliance, [http://www.usvtc.org/trade/wto/China\\_WTO\\_compliance\\_report.pdf](http://www.usvtc.org/trade/wto/China_WTO_compliance_report.pdf)

the Economic White Paper 2005 pointed out that there was a great disparity between cities and rural areas mainly caused by low labour productivity of agricultural sectors in rural areas in China. In the report, the income level in rural areas in China was estimated to be only one-third of that of cities. As the report stated, the China was lowering trade barriers as a result of its accession to the WTO, it was expected that the agricultural sectors in China would be exposed to more intense competition. On the other hand, there was surplus workforce which could not be absorbed in the agricultural sectors. It was exacerbated by the impediments of the free movement of labour from rural areas to cities partly due to the family registration system in China.

Last but not least, in terms of the underdevelopment of infrastructure, the Economic White Paper 2005 raised the two examples of electricity and water as the bottleneck of sustainable economic growth of the Chinese economy. In the report, it was estimated that there was the shortage of electricity as much as 250 billion kW in 2005 due to the slower pace of construction of electronic power plants than the increase in the demand of electricity. The increase in the demand of electricity mainly came from the sharp rise of demand especially in the steel and other basic materials industry such as aluminium requiring a great deal of electricity. Also the report pointed out the worsening problem of water shortage due to the increased demand in water mainly for the industrial use. In addition, there is a geographical discrepancy in terms of water resources between the north and south in China. While there is abundant water sources in the south regions in China, many cities in the north are chronically faced with the water shortages partly due to geographical constraints.

Overall, the Economic White Paper 2005 was rather cautious about the potential of the Chinese economy to continue to develop. This was based on the assessment that the Chinese economy developed mainly based on the export-led growth and that their exports was basically dependent on the imports of most components from other countries and the role of Chinese factories was only to assemble them into final products for exportation. For example, in the case of automobiles, the Economic White Paper 2005 stated that the Chinese automobile industries were still limited to imitating

other foreign products and did not reach yet the stage of developing their own industrial technologies.

In the Economic White Paper 2006, the report stated that while there could be an argument that China's emergence was considered as the threat to the Japanese economy, it could provide more opportunity to neighbouring countries including Japan and ASEAN countries through exporting intermediary goods. According to the Economic White Paper 2006, the exports by Japan to China increased by 2.6 times between 2000 and 2005, with Korea by 3.4 times, Chinese Taipei by 9.7 times, and the ASEAN countries by 3.3 times. It pointed out that the Chinese exports were gradually shifting its focus from textile and other light industries to electric mechanical industries. Between 2000 and 2005, more than half of the increase in exports was attributed to the increase in exported electric mechanical products. In 2005, In terms of the reasons of increased investment, the accession of China to the WTO and the development of domestic infrastructure improved the business sentiments for investment. In terms of financing of investments, the report pointed out that the investments in China were upheld by the high rate of domestic saving in China and the inflow of foreign direct investments. In the report, foreign capitals were estimated to account for as much as 58% in the Chinese exports.

The 2006 Economic White Paper stressed that the reform on the Chinese currency needed to be considered in terms of how to address their own domestic problems in their economy rather than how to respond to that increasing pressure from other countries. In the report, it pointed out undervalued Chinese currency resulted in extraordinary expansion of exports and the resulting increase of trade surpluses entailing the increased foreign reserves, which gave rise to excessive monetary fluidity and investment. The 2006 Economic White Paper took more flexibility of the Chinese currency as a means of preventing inflation from damaging the Chinese domestic economy. The report raised the risk of increased inflow of speculative money fuelling the domestic inflation in the Chinese economy.



The 2006 Economic White Paper pointed out the three risks associated with the rapid development of the Chinese economy. The first risk was concerned with the excessive investment. The report stated that excessive investment could lead to excessive capacity to provide goods if the world economy fell into the recession and the demand declined. The excessive capacity was evident in some sectors such as steels and aluminium partly due to the lack of coordinated programmes of outputs associated with the personnel evaluation based on whether to meet a numerical target. The second risk was concerned with the excessive liquidity. In China, the rapid increase in the current account surpluses and the inbound direct investment with capital account surpluses resulted in the excessive liquidity. The amount of foreign exchange reserves in China surpassed that of Japan in 2006, amounting at USD 987 billion. The 2006 Economic White Paper considered the increased flexibility of the Chinese currency would help to address the misalignment of rapid increase of trade surplus and excessive investment. While the report recognised the recent steps taken by the Chinese authority such as the shift of the foreign exchange system from de facto dollar peg to currency basket system in July 2005, it underscored the further steps to increase the flexibility of the Chinese currency. The third risk was concerned with the excessive saving, which the 2006 Economic White Paper considered that would lead to excessive investment channelled through the deposits of savings in the financial institutions in China. The 2006 Economic White Paper pointed out that the Chinese economy needed to be shifted from investment-driven growth to consumption-driven growth. The report stated that the more efficient use of excessive savings to personal consumption would help to change the Chinese economic growth model to consumption-driven growth, also highlighting that the development of social security system would help the Chinese consumers to spend more savings to buy goods and services without setting aside a great deal of savings.

The 2006 Economic White Paper further stated that the increase in the productivity would be a key to achieving more balanced growth of the Chinese economy. The report stated that as the population between 15-64 ages would peak in 2015 and the Chinese economy would move into ageing society faster than Japan in terms of the cycle of economic

development, the shift from the labour intensive growth model to the growth model based on knowledge and technology would be crucially important to make it possible for the Chinese economy to compensate the decline of the labour resources available in the future. The 2006 Economic White Paper concluded that the rate of economic growth in China would be expected to slow down as the amount of new capital available would decrease gradually and the steady growth of the Chinese economy should be considered as the opportunity for the enterprises of neighbouring countries including Japan and the ASEAN countries, in particular, to sell goods and services in the Chinese market rather than the threat to them.

In terms of the foreign exchange rate system, the 2006 Economic White Paper called on China to increase the flexibility of the Chinese currency to address their own domestic problem associated with excessive liquidity deriving from accumulating trade surpluses and foreign investments towards China and the increased risk of inflation. However, compared with the US approach to call on China to increase the flexibility of the Chinese currency to address their trade imbalance, the Japan's approach was softer and more indirect in the sense that Japan encouraged China to increase flexibility as a means of helping to cope with their domestic economic imbalance.

Dating back to the 1980s, the Plaza Accord marked the watershed in the foreign exchange market policies among the G7. When comparing the Japan's experience after the Plaza Accord, the Chinese responses to the increasing international pressure to accept the currency appreciation were much more incremental. In the late 1990s in the aftermath of the Asian financial crisis, the Japanese Ministry of Finance worked to engage China when they promoted the regional financial cooperation. Then the Japanese Ministry of Finance's attempt to engage China was based on the assumption that Japan would be still in the position to take the initiative in promoting the regional financial cooperation.

Haruhiko Kuroda and Masahiro Kawai described the Plaza Accord and the subsequent international macroeconomic policy coordination as the attempt of the G3 (US, Japan and Germany) to coordinate the foreign exchange

market intervention and macroeconomic policies in order to guide the US dollar downward, thereby containing the protectionist pressure the US and, once the US dollar began to decline rapidly, prevent the free fall of the US dollar so as to avoid a hard landing of the US economy. The European economies coordinated their monetary policies at least since 1979 under the European Monetary System (EMS). But, as they pointed out, these attempts were the approach taken by industrialised countries, and it was still questionable to what extent this approach could be a useful guide to emerging market economies.<sup>129</sup>

Haruhiko Kuroda and Masahiro Kawai saw regional exchange rate arrangements as one of the possible forms of regime setting in the long-term. In their view, regime setting is a joint exercise to agree on a set of rules within their own economic interests. This type of policy cooperation includes arrangements on such issues as regional trade and FDI arrangements, regional exchange rate regimes, regional financing arrangements, other regional frameworks for action at the time of a crisis, and initiatives for regional bond market development. An example is a joint setting of exchange rate policies for intra-regional exchange rate stabilisation, which can prevent competitive depreciation at the regional level. Another example is the creation of a regional financing facility, which can contain regional currency attacks and contagion quickly, supplement IMF roles and resources, and economise on resources through reserve pooling at the regional level. There is also a potential initiative for regional bond market development, which encourages the economies in the region to make concerted efforts to develop national bond markets as well as regional infrastructure, including clearance, settlements, and rating agencies.<sup>130</sup>

However, as they pointed out, not much progress has been made in the area of exchange rate coordination or stabilisation in the region. One of the reasons for the lack of progress is the fact that there was no international rule or best practice with regard to exchange rate regimes. In their view, for

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<sup>129</sup> Kuroda, H. and Kawai, M. 'Strengthening Regional Financial Cooperation in East Asia'. *PRI Discussion Paper Series*, May 2003, Ministry of Finance of Japan

<sup>130</sup> Ibid.

emerging market economies in East Asia, a pure floating system is not desirable because of a potential for excessive volatility and misalignment. Nor is a hard peg desirable except in small open economies like Hong Kong and Brunei. They sought a sort of third way approach of coordinating intra-regional exchange rate policies, underscoring that for the emerging East Asian economies that depend heavily on trade and investment, exchange rate stability is desirable for the promotion of trade and investment and economic development, and that intra-regional exchange rate stability is a public good for the East Asian economies that have increasingly integrated with one another. They concluded that in the pre-crisis period, the de facto US dollar pegged exchange rate regimes ensured extra-regional as well as intra-regional exchange rate stability on an informal basis, but a US dollar based regime was susceptible to fluctuations in effective exchange rates when the US dollar-Japanese yen rate became volatile in 1995-1998.<sup>131</sup>

The Japanese Ministry of Finance's view about the relationship between the US dollar pegged exchange rate systems and the Asian Financial Crisis was well laid out in the discussion paper prepared by the French and Japanese Ministry of Finance staff, for the ASEM meeting in Kobe in January 2001 titled "Exchange Rate Regime for Emerging Market Economies". In this paper, the choice of US dollar as an anchor for a pegged exchange regime are for two reasons, i.e. first, to ensure price stability, and second, to make foreign finance available at a cheaper rate by means of bank loans, portfolio and foreign direct investment with reduced interest rate spreads. The choice of the US dollar as the anchor for a pegged exchange rate regime could be appropriate for a small open economy when at least the following conditions are satisfied: 1) its trade and investment structure is aimed primarily at the dollar area, and 2) its export competitors are also located in the dollar area. In this case, the country's competitiveness would tend to be stable irrespective of any fluctuation in the dollar. The paper considered that dollar-pegged strategies would be more appropriate, for instance, for some smaller Latin American countries than for the emerging East Asian countries. From January 1995 to April 1997, the dollar's nominal exchange rate appreciated by 25% against the

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<sup>131</sup> Ibid.

yen and by 17% against the then euro-equivalent. This appreciation affected in particular the emerging East Asian countries, whose export markets and export competitors are diverse in terms of currency. The increasing overvaluation of the East Asian currencies in effective terms provoked growing current account imbalances.<sup>132</sup>

The discussion paper prepared by the French and Japanese Finance Ministries staffs also stated that fixed exchange rate strategies increased systemic risks by providing an implicit guarantee to domestic companies and international investors, thereby giving them a strong but misleading signal of confidence. Pegging against the dollar lent great credibility to the central bank's commitment to maintain the currency's external stability. On the one hand, in the context of underdeveloped domestic financial sectors, it encouraged domestic companies to take full advantage of the efficiency gap between foreign and domestic financial operators and to borrow directly from foreign banks in US dollars without hedging their liabilities. On the other hand, it prompted foreign banks to lend massively, especially at shorter maturities, without sufficiently checking country risk and debtor creditworthiness.<sup>133</sup>

As a policy recommendation regarding foreign exchange regimes, the discussion paper prepared by the French and Japanese Finance Ministries staffs called on East Asian countries to consider the adoption of managed exchange rate strategies underpinned by basket currency regimes including the US dollar, the Japanese yen and the euro stating that it would better suit the geographical structure of the balance of payments and would foster stability. In the managed exchange rate regimes, the currency moves within a given implicit or explicit band with its centre targeted to a basket of currencies. It argued that when suitably defined, managed exchange rate regimes reconcile lower exchange rate volatility and stable inflation expectations with flexibility in reacting to external shocks. The most important issue in the definition of such strategies is the choice of an appropriate reference currency. This choice depends on several important

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<sup>132</sup> *Exchange rate regimes for emerging market economies* (2001), Discussion Paper, Jointly Prepared by French and Japanese Staff, the 3<sup>rd</sup> ASEM Finance Ministers' Meeting in Kobe (13-14 January, 2001)

<sup>133</sup> Ibid.

factors, including the geographical structure of trade in goods and services and of income and current transfers as well as the geographical structure of foreign capital flows and external debt. The paper argued that the Asian financial crisis showed that it would be unsuitable to choose the US dollar as the sole reference currency. Instead, the paper argued that basket currency regimes including the US dollar, the yen, and the euro would better suit the geographical structure of the balance of payments and would foster stability. It also called on the groups of countries with close trade and financial links to adopt a mechanism that automatically moves the regions' exchange rates in the same direction by similar percentages in order to minimise the risk of non-cooperation.<sup>134</sup>

The discussion paper saw the European Monetary Union as the process which showed a useful example of how further integration can be achieved. It saw the Chiang Mai Initiative in May 2000 as an important step to establish a regional financing arrangement to supplement existing international facilities. In the Chiang Mai Initiative, the finance ministers of the ASEAN plus 3 countries agreed to establish a network of bilateral swap arrangements and repurchase agreements among the ASEAN countries, Japan, China, and the South Korea. In addition, to strengthen financial stability in the East Asian region, they also agreed to close cooperation on monitoring capital flows and the development of a regional supervisory mechanism. The discussion paper stated that regional cooperation frameworks should be fully integrated into the overall monetary and financial system.<sup>135</sup>

In its assessment, the need for regional exchange rate cooperation often arose from more acute awareness of the situation due to increased regional trade integration. This awareness was made more acute during the Asian financial crisis in 1997 and 1998 by the experience of regional contagion. It further stated that there is no compulsory sequencing between the two processes of regional exchange rate cooperation and trade integration. And it also argued that regional cooperation can go hand in hand with increased cooperation in orderly capital movement liberalisation.

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<sup>134</sup> Ibid.

<sup>135</sup> Ibid.

The paper argued that the free-floating regimes without appropriate arrangements may also make regional cooperation more difficult by fostering free riding behaviour. To gain a competitive advantage over its regional competitors each country could be tempted to use the system for its own purposes and implicitly manage its parity, indulging in “dirty floating”. Such behaviour could result in undesirable equilibrium via collective devaluation and/or regional trade tensions, ultimately impacting negatively on other regions in the world. Also, it argued that exchange rate and external financial strategies should be determined consistently to optimise growth and development opportunities while minimising risks. It is clear that countries should choose their level of financial openness together with their exchange rate regime. It further stated that the free-floating regimes may entail the need for temporary regulatory measures for inflows whereas pegs may require more stringent financial supervision.

Based on the experience of the Asian financial crisis, the Japanese Ministry of Finance had a rather cautious approach about the capital liberalisation and free-floating exchange regimes, and even considered that a temporary introduction of capital controls would be sometimes more beneficial. In general, the trends toward liberalisation of capital movements reflected a variety of motivations, including the benefits from increased access to, and a lower cost of, investable funds. The liberalisation of controls on capital outflows was in part been a response to stronger net capital inflows. Liberalisation also reflected a wish to avoid the potential distortionary effects of the controls and concerns about their overall effectiveness.<sup>136</sup>

The IMF emphasised the negative effects of capital control, stating that the effectiveness of capital controls may have some effectiveness in the short run but that it can be eroded quite quickly. It stated that the channelling of capital to avoid the controls can result in less-developed financial markets and can distort financial intermediation and even damage financial sector by encouraging the use of channels and instruments that are less well

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<sup>136</sup> IMF (1999), “*Exchange Rate Arrangements and Currency Convertibility: Developments and Issues*”, Johnston, R.B., IMF, 1999

managed and supervised. In the IMF's view, the circumvention of capital controls also distorts the balance of payments statistics, which, therefore, become a less reliable guide for policy formulation and informed market decision making. The inevitable investment in circumvention techniques by market participants was private profitable, but represented a socially inefficient allocation of resources.

In the IMF's approach, they attempted to integrate advice on capital account liberalisation with financial sector reform. The reform was intended to cover both external transactions in capital account issues and the development of domestic financial markets and institutions. This integrated approach has reflected a number of considerations. In particular:

- the stage of development and the stability of domestic financial systems are critical in the approach to opening the capital account. Countries with developed financial markets and institutions have been better able to attract portfolio capital flows and to withstand the consequences of reversals in capital inflows than countries where such markets were just emerging;
- the opening of the capital account can have important implications for the development and stability of financial markets and institutions. In many cases, the implications are positive in that the liberalisation help develop deeper, more competitive, and more diversified financial markets. However, capital account liberalisation can also increase financial sector risks if it accelerates the deregulation of the financial system without critical supporting reforms;
- the extent to which capital flows contribute to sustained improvements in economic performance depends on the stage of development and the efficiency of the domestic financial system. The central role of banking systems in allocating financial resources points to the importance of focusing attention on the incentives under which those institutions operate, including those associated with connected or politically motivated lending developing a psychology attuned to the need for active management and hedging of currency and related risks; avoiding expectations of government support;



supervising banks effectively, including their liquidity management; and disposing of an efficient legal framework to enforce financial contracts, debt recovery, bankruptcies, and the like; and

- inconsistent monetary and exchange rate policies can create incentives for significant short-term capital flows, hence, increasing the vulnerability of the economy to reversals in capital inflows when policies or circumstance change. Moreover, high capital mobility alters the effectiveness of different monetary instruments in achieving the objectives of monetary policy. Instruments that impose a high cost or administrative constraint on the banks become less effective than indirect monetary instruments, which operate on the overall costs of money or credit in financial markets. The opening of the capital account, therefore, needs to be accompanied by the adoption of indirect methods of monetary control.

In the IMF approach, a key issue was how to maximise the benefits and minimise the risks of capital account liberalisation. While it admitted that issues of the pacing and sequencing are central to this objective, it concluded that the structural benefits of liberalisations would be emphasised, including those that (1) help diversify financial systems and make them more efficient by introducing new technologies and instruments and by promoting competition for financial products; (2) improve financial discipline by facilitating market oversight through transparency and competition while avoiding moral hazard – for example, by providing a catalyst for introducing new accounting and disclosure requirements; (3) help revise out-of-date regulatory structures and weak or ineffective supervisory arrangements; (4) introduce new instruments for hedging and managing risks that provide scope for greater diversification; and (5) favour the channels where regulatory systems are more developed and governance can be stronger. In a nutshell, the IMF's approach was based on the assumption that capital account liberalisation was beneficial to the economy on its own, and any disruptive short-term flows could be avoided by better coordination with domestic financial sector liberalisation and reforms, and a minimum set of rules.

The Japanese Ministry of Finance had a rather different view from the IMF

on the effectiveness of capital controls. Haruhiko Kuroda and Masahiro Kawai, the then Vice Minister for International Affairs and then Deputy Vice Minister for International Affairs respectively, had a rather positive stance on the effectiveness of capital controls. For example, Mr. Kuroda's view is well summarised below:

*On capital controls, in the past currency crises involving emerging economies, there was some contagion between those economies. In contrast, in the recent financial crisis, stress that arose in the United States and the euro area was transmitted at once to many emerging countries, including those in Central and Eastern Europe and Latin America. One of the causes of such international transmission of the crisis is deemed to be financial globalisation and the accompanying global upsurge of gross capital flows, which has led to increasing attention over prudential capital controls. Moreover, in recent years, the International Monetary Fund, which has long emphasized the benefits of capital mobility, has, at least partially, accepted the necessity of capital controls as a macro-prudential policy tool.*<sup>137</sup>

At that time, the Japanese Ministry of Finance and the World Bank took the similar view on the effectiveness of capital controls in that both had broadly shared the view that controls on short-term capital flows may be useful as instrument for managing the transition process of financial market integration. Capital controls may have the additional benefits of (1) providing a degree of monetary policy autonomy under fixed exchange rates, (2) reducing the wedge between the private and social returns of capital inflow when systematic failure of speculators to evaluate the fundamentals causes private capital flow to be destabilising, and (3) curtailing rapid capital outflows in a “second generation” environment – where self-fulfilling expectations lead to multiple equilibria – so as to prevent the economy from slipping out of a “good equilibrium”.<sup>138</sup>

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<sup>137</sup> Opening remarks by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at the 2013 Bank of Japan-Institute for Monetary and Economic Studies (IMES) Conference, hosted by the IMES of the Bank of Japan, Tokyo, 29 May 2013

<sup>138</sup> Kawai, M., and Shinji Takagi, S., “Rethinking Capital Controls: The Malaysian Experience”, PRI Discussion Paper Series, Ministry of Finance, May, .2003; Dooley, M. “Capital Controls and Emerging Markets”, International Journal of Finance and Economics, 1 (July 1996), pp.197-205.

In their view, in order to reduce their risks of crisis, developing countries need to pursue financial safeguards that they can implement in the short-term alongside their longer-term development initiatives. Internationally triggered financial crises became more frequent and more severe in the 1980s and 1990s. Although the susceptibility to crisis varies from country to country, there are studies suggesting about a 10% average likelihood of crisis in any given year.<sup>139</sup>

In the World Bank's view, volatile international capital flows was also associated with a greater number of costly domestic banking crises. Reforms of the international financial architecture, together with continued improvements in countries' macroeconomic policies and their banking systems, were the best protection against crises. Such reforms would also provide developing countries the foundation to benefit from international capital flows. But, in most countries, these international and domestic reforms took time to become effective. Until then, banking and financial systems would likely remain susceptible to externally induced shocks and liquidity crisis. Thus short-term safeguards were needed.

The proposed measures for domestically initiated near-term financial safeguards were of two types: controls on capital flows and measures that would improve countries' access to international liquidity. The former were designed to dampen the volatility of capital flows and hence keep crises from occurring; the latter could help contain crises when they do occur. The proposed safeguards would impose costs on the domestic economy either by restricting the quantity of foreign borrowing or by raising its price. It concluded that the costs, however, were likely to be less than the cost of a full-fledged financial crisis. Safeguards measures are valuable also because they would help insulate the poor by reducing the likelihood of a deep recession and instead shift the burden of crisis on to those who benefit

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<sup>139</sup> World Bank (2000), *Global Development Finance*, 2000; Kaminsky, G., and Carmen Reinhart., 1999, "The Twin Crises: The Causes of Banking and Balance of Payments Problems", *American Economic Review* 89: 473-500; Bordo, R. and Barry Eichengreen, 1999, "Is Our Current International Economic Environment Unusually Crisis Prone?", University of California, Berkeley, Processed.

more directly from foreign borrowing.<sup>140</sup>

Capital controls were motivated in the 1990s by concerns that rapid inflow lead to loss of autonomy in macroeconomic policy and that their reversals have significant follow-on effects throughout the economy. In the early and mid-1990s, the major concern with rapid capital inflows was inflationary pressure, generated by the creation of high-powered money through the direct or indirect transfer of foreign currency reserves into the banking systems. However, since the Mexican crisis of December 1994, a more overriding concern has been the rapid outflow of capital and the inability to access new capital inflows. The reversibility of capital flows – and the “sudden stop” in new flows – has led to the consideration of policies that slow down inflows during boom times and restrict outflows during a crisis.<sup>141</sup>

The World Bank drew a positive set of conclusions on the effectiveness of the capital controls including:

- Capital inflow controls do not seem to affect the level of flows: aggregate capital inflow fell immediately following the imposition of controls, but rose soon thereafter.
- Inflow controls do seem to affect the composition of flows by extending their maturity structure. Short-term inflows declined sharply in the year controls were imposed – the negative sign implies that the stock of short-term debt fell in the majority of the cases after the imposition of controls – and tended to rise much more slowly thereafter compared with other flows.
- Protection against liquidity crises is likely to be stronger where capital controls are combined with measures to increase reserves relative to short-term debt.
- In Malaysia, which introduced capital outflow controls, it is evident that the fall in Malaysian output was less than in the other crisis countries, and moreover, Malaysia’s recovery has occurred at a more rapid pace than in similar inflicted countries.

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<sup>140</sup> World Bank (2000), Global Development Finance 2000, Chapter 5,

<sup>141</sup> Ibid.

With regard to the Japanese Ministry of Finance's stance on capital controls as an instrument for managing financial market integration and financial crisis, it was generally based on the following views:

- Sound macroeconomic and exchange policies: In order to enjoy the benefits of global financial integration, emerging market economies must minimise the risk of crisis first and foremost by pursuing sound policies designed to maintain macroeconomic stability, prevent an overvaluation of the currency, and avoid an unsustainable accumulation of short-term external debt.
- Information disclosure: Much of the over-lending typically found prior to currency crisis might be avoided if international investors correctly appraise the macroeconomic and structural conditions of the host economy. Harmful herd behaviours can be mitigated to some extent by better information disclosure.
- Sequencing of capital account liberalisation: While capital account liberalisation provides emerging market economies with substantial benefits, it can be costly if the macroeconomic supervisory policy framework is weak or if the domestic financial corporate sectors are not able to manage risks prudently. For the right "sequencing" of capital account liberalisation, the country in question must first establish a resilient and robust domestic financial system, by ensuring adequate capitalisation, loan-loss provisions, risk management practices, and disclosure and accounting standards.
- International support with private sector involvement: If a currency crisis results from illiquidity, and not insolvency, internationally coordinated liquidity support to the crisis country can be justified in order both to prevent the crisis from becoming unnecessarily severe and to limit the contagion to other countries. When support is provided by international financial institutions, it is essential to "bail in" private foreign creditors through debt restructuring, including standstills, rollover agreements, maturity extensions, and possibly interest or debt reductions.
- Regional financial corporation: Because a capital account crisis is often regional in character, simultaneously affecting several

economies in the same regions, a cooperative framework for regional financial management can become useful. First, regional surveillance places peer pressure on each country to pursue macroeconomic and structural policies that reduce the risk of crisis and contagion. Second, a regional financial facility can supplement global sources of international liquidity. Third, choosing mutually consistent exchange rate arrangements is desirable, when the economies are interdependent. This process may entail coordinated efforts to ensure intra-regional exchange rate stability. Forth, while mobilising fiscal resources is essential to quickly resolving the crisis, the resources may be limited by the lack of fiscal headroom or constraints on external financing on market terms. Regionally concerted action to mobilise such resources, particularly from the core countries in the region, would contribute greatly to crisis resolution.<sup>142</sup>

In the late 1990s, the Japanese Ministry of Finance's view on the effectiveness of the capital control was influenced by the experience of Malaysia. The Malaysian capital controls were introduced in September 1998 at the height of the crisis aimed at restricting portfolio capital outflows and eliminating offshore ringgit activities. Portfolio investors were restricted from repatriating funds invested in Malaysia for at least one year, and the offshore trading of ringgit was prohibited. As the economy began to stabilise, however, controls on portfolio outflows were eased and eventually removed. The 12 month holding period restriction on portfolio capital was replaced by a two-tier. Price-based exist system in February 1999, which was further eased and simplified in September 1999 and February 2001, and finally eliminated in May 2001. In short, the Malaysian authorities introduced a set of complex but selective capital controls and a pegged exchange rate regime in September 1998. The purpose was to eliminate any room for private investors to take speculative positions against the ringgit through restrictions on all international financial transactions unrelated to trade and foreign direct investments. They effectively closed the offshore market, cut off ringgit credit to foreigners

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<sup>142</sup> Kawai, M. and Takagi, S. "Rethinking Capital Controls: The Malaysian Experience", PRI Discussion Paper Series No.03A-05, Ministry of Finance of Japan, May 2003

and put a 12 month moratorium on the repatriation of portfolio capital.<sup>143</sup>

The elements of the controls can be summarised as follows:<sup>144</sup>

- Imposition of a 12 month holding period restriction on repatriation of the proceeds from sale of Malaysian securities held in external accounts;
- Mandatory repatriation of all ringgit held abroad;
- Restriction on transfers of funds between external accounts;
- Limits on transport of ringgit by travellers;
- Prohibition of resident-to-nonresident credit arrangements;
- Prohibition of trade settlement in ringgit;
- Prohibition of resident-to-nonresident offer side swaps and similar hedge transactions; and
- Freezing of transactions in Malaysian shares traded at Singapore's Central Limit Order Book over-the-counter market.

The primary objectives of the controls, especially the suspension of repatriation non-resident investments in ringgit-denominated financial assets for a 12 month period and prohibition of ringgit trading in offshore markets, together with the pegging of exchange rate, were, to enhance monetary autonomy, thereby facilitating economic recovery and providing breathing space for the implementation of structural reforms. By de-linking monetary policy from exchange rate movements, the authorities allowed interest rates to decline without inducing further capital flight and a sharp depreciation of the ringgit. They maintained that the controls would be removed once stability returned to financial markets and an appropriate global regulatory framework governing international capital flows was in place.

The imposition of outflow controls put an immediate and virtually complete stop to offshore ringgit trading, curtailed speculative capital outflows, and allowed interest rates to be reduced substantially. At the same time, under the umbrella of the capital controls, the authorities pursued

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<sup>143</sup> Ibid.

<sup>144</sup> Ibid.

bank and corporate restricting and achieved strong economic recovery in 1999 and 2000. With the restoration of economic and financial stability, administrative controls on portfolio outflows were replaced by a two-tier, price-based exit system in February 1999, which was finally eliminated in May 2001.

In terms of the benefits of capital controls, two benefits of controls on capital outflows in Malaysia were identified. First, they represented a national safeguard against further turbulence in international financial markets and ensured greater policy autonomy – in lowering interest rates. At the time the controls were introduced, the Malaysian currency and equity markets were highly volatile, and it was uncertain whether financial instability in the region was likely to intensify or abate. In this sense, the controls together with the pegging of the ringgit contained currency speculation and provided a degree of certainty to market participants. Second, the capital controls provided breathing space to pursue economic adjustment and to accelerate the structural reforms necessary for sustained economic recovery. Arguably the controls provided a margin of safety by insulating the economy from further potential shocks and allowed these critical programmes to be launched with greater confidence.<sup>145</sup>

On the negative side, the imposition of controls did have costs created uncertainty for foreign investors and eroded their confidence. First, international rating agencies downgraded Malaysia's sovereign risk and credit ratings, immediately and substantially widening the spreads on sovereign debt in September 1998. While the spreads rose for almost all emerging economies following the Russian default in August 1998, the widening of the Malaysian spreads – about 300 basis points – was much larger than those for Thailand, Korea and the Philippines. Following the February 1999 shift to a system of exit levies, the spreads declined significantly, though lagging behind those of the other countries by about two months. Hence, the controls had only a transitory adverse effect on Malaysia's access to international capital markets. Second, despite the explicit exemption of FDI from controls and the institution of a more liberal regime in July 1998, FDI declined during 1999-2000 to less than

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<sup>145</sup> Ibid.



half the pre-crisis level.<sup>146</sup>

In the overall assessment by the Japanese Ministry of Finance, the Malaysian capital controls had a generally positive effect. First, they provided a safeguard against possible further disturbance for a country that opted not to seek IMF assistance and created breathing space for pursuing necessary structural reforms. The authorities made significant progress in financial and corporate sector restructuring through pushing ahead with the regulatory and supervisory reforms needed for a stronger financial sector and a resilient capital market. Essentially, the authorities did not use the capital controls as a substitute for the needed restructuring and reform measures. Second, it was clear that the authorities exerted the strongest possible effort to make the capital controls a temporary measure, to disseminate information about the controls and their subsequent revisions, and to clarify misunderstandings. A clear signal of what was to be expected was provided to market participants by the announcement, made well ahead of time, to make a shift in the control regime to a system of exit levies and to terminate much of the controls. The perception that the controls were temporary helped to maintain market confidence, thus preventing large capital outflows from taking place. To be sure, not all the subsequent recovery of the Malaysian economy can be attributed to the capital control regimes. However, the Malaysian experience does suggest that the use of capital controls has its place in the policy instruments, to be used within the context of a policy framework and circumstances specific to the country in question. It appears that the costs of the controls were kept modest by careful and comprehensive design and execution, although the benefits may also have been equally modest.<sup>147</sup>

In the IMF's analysis in 2000, they concluded that the while capital controls appeared to have provided a breathing space in which to implement more fundamental policy reforms such as prudent macroeconomic policies, rapid progress in financial sector reform, the results of capital controls achieved so far do not seem to have come without

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<sup>146</sup> Ibid.

<sup>147</sup> Ibid. and Hood, Ron (2000). "Malaysian Capital Controls", Mimeographed (October 2000), East Asia and the Pacific Region, Washington DC, World Bank

costs. In their findings:

- Although domestic business viewed positively the relatively greater stability of the ringgit and faster cuts in interest rates that were facilitated in part by the controls, the reaction of international financial markets has been more negative.
- The confidence of international investors in Malaysia has weakened relative to other countries in the region.
- The cost of funding from foreign sources has increased, foreign direct investment continues to be relatively weak, and the strict implementation of the controls imposed significant administrative costs on investors, commercial banks, and the authorities.<sup>148</sup>

The IMF analysis on China and India provided interesting examples in the context of how capital controls could be effective in preventing financial crises from damaging domestic economies. In the IMF analysis in 2000, they concluded that China and India were less affected by the Asian crisis of 1997-1998 than other countries in the region and the relatively closed capital account regimes of these two countries have been credited with helping to limit vulnerability to financial contagion. It admitted that both India and China experienced only a minor slowdown in their strong growth and the impact of the crisis on their financial system was limited. China was able to maintain the de facto peg of its currency to the US dollar. India continued to follow a flexible exchange rate policy.<sup>149</sup>

In the IMF's assessment, long-standing and extensive controls on capital transactions may have had some role in reducing the vulnerability in terms of helping shift the composition of capital inflows toward long-term flows, but not a crucial role. In their view, other factors such as a strong external position with ample foreign exchange reserves, larger sizes of the domestic markets, relatively weak trade and financial linkages with the rest of the world compared with the other countries in the region, relatively earlier

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<sup>148</sup> IMF (2000), Capital Controls: country experiences with their use and liberalization, *Occasional Paper* No.190, Akira Ariyoshi et al. IMF, 2000

<sup>149</sup> Ibid.

stages of financial market development, a lower level of financial intermediation by the banking systems, have played a role as well in reducing their financial vulnerability. In both India and China, enforcement of the controls was facilitated by strong administrative capacity.<sup>150</sup>

In conclusion, the IMF review in 2000 illustrated the difficulty of precisely assessing the effects of capital controls, which may have benefits as well as costs. While they partially admitted that capital controls was effective in realising their intended objectives of reducing the ringgit's internationalisation and helping contain capital outflows by eliminating the offshore ringgit market and by restricting the outflows of capital by residents and non-residents. It stressed that capital controls cannot substitute for sound macroeconomic policies and countries with serious macroeconomic imbalances and no credible prospect for improvement in the short run were regularly unable to address large-scale capital flows, or their adverse economic effective, with capital controls. In their analysis, it was difficult to disentangle the contribution of capital controls in achieving a certain objective, and more flexible exchange rate policies, prudential policies and liberalisation of outflows (in case of excessive inflows) were some of the policies that have been employed in conjunction with capital controls.

During the 1980s and early 1990s, a large number of advanced nations moved slowly toward reducing the degree of exchange rate flexibility. The exchange rate mechanism (ERM) of the European Monetary System, with its narrow plus and minus 2.25 per cent bands, represented the institutionalisation of a system of limited flexibility. It was thought that by reducing the extent to which nominal exchange rate could fluctuate it was possible to combine the best features of purely floating and purely fixed exchange rate regime. The crisis of the ERM in 1993 introduced, however, very serious doubts of the desirability of fixed exchange rates in a world with a very high degree of capital mobility.<sup>151</sup>

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<sup>150</sup> Ibid.

<sup>151</sup> Edwards, S.(1995), "Introduction", *Capital controls, exchange rates, and monetary policy in the world economy*", Cambridge University Press, 1995; Giavazzi F., and A, Giovannini (1989), *"Limited Exchange Rate Flexibility"*, Cambridge, Mass.: MIT Press

As the presence of the Chinese economy increased in the international trade and financial system, the Chinese authorities took an incremental approach towards increased flexibility of their currency. On 21 July 2005, China allowed the Chinese renminbi to appreciate 2.1 per cent discretely and announced that it was moving to a more flexible exchange rate regime. This incremental process of appreciation against the US dollar has been a core of the China's financial diplomacy as the China's current account surplus has kept remaining substantial. In July 2008 just before the global financial crisis deepened, the Chinese authority announced that they would go back to the de facto US dollar-peg exchange system, which last almost two years until June 2010.

The shift of the Chinese currency regime towards a basket currency regime was broadly in line with what Japan called on other Asian countries to introduce in the paper which they worked on with the French government as a part of preparation of the ASEM meeting in 2000. The nature of the currency issue in the international financial system along with the increased presence of the Chinese economy made the increased flexibility of the Chinese currency more an issue of the international financial system, rather than that of only the Asian regional financial cooperation. In the late 1990s when there was an increased momentum and call on the need for closer regional cooperation, the Japanese Ministry of Finance's financial diplomacy was not primarily oriented towards the Asian regional cooperation.

In retrospect, however, the financial diplomacy of the Japanese Ministry of Finance has continued to be oriented towards the policy coordination in the international financial system. The regional cooperation has not been seen as a goal to be achieved independently from international policy coordination, but rather a goal which needs to be compatible with the broader goal of the policy coordination in the international financial framework including the G7 until the financial crisis in 2008, in particular.

## Chapter 3: Globalisation of financial and fiscal policies and new form of international policy coordination

### 3-1 New form of international policy coordination from macroeconomic policy to financial regulation and fiscal codes

The Asian Financial Crisis provided the impetus for the new form of international coordination to contain and resolve the financial crisis by reforming the institutions, structures and policies underpinning the international financial crisis. The general trends of international financial liberalisation and growing international capital flows are largely inevitable and irreversible. The rapid development of information and communication technologies has made it far more difficult to restrict the financial transactions in which market participants engage. Controls on international transactions have run the risk of ending up with being distortionary. On the other hand, policy makers were increasingly aware that the general trends of financial liberalisation and growing international capital flows do not mean that capital account liberalisation must be embraced before financial institutions developed their risk-management practices and supervisors have strengthened their oversight of financial institutions.

Capital markets are characterised by information asymmetries that can give rise to overshooting sharp corrections, and in the extreme financial crisis. In a world of integrating financial markets partly due to technological development and growing capital flows, stabilising the financial system ultimately requires institutional reforms extending well beyond policies towards external trade and payments. It also requires domestic financial stability by imposing a certain level of disclosure requirements and effective supervision of financial institutions and corporations borrowing on financial markets through the use of internationally recognised auditing and accounting practices so that lenders can accurately assess the financial conditions of financial institutions and corporations to which they lend. It extends to investor protection laws to prevent insider trading market manipulation, fair and prompt corporate bankruptcy procedures.

In the 1998 G7 summit, the Finance Minister of G7 countries presented the report on strengthening the architecture of the global financial system. In this report, the G7 finance ministers identified the need for action in five key areas:

- Enhanced transparency;
- Helping countries prepare for integration into the global economy and for free global capital flows;
- Strengthening national financial systems;
- Ensuring that the private sector takes responsibility for its lending decisions; and
- Enhancing further the role of the International Financial Institutions and co-operation between them.

The report was followed in the introduction part as follows:

*4. Broad based prosperity and growth require financial institutions, commercial enterprises and entrepreneurial individuals that are prepared to take risks. Risk inevitably involves the possibility of failure. We could not and should not seek to eliminate failure entirely, rather large financial systems need to be robust enough to accommodate the occasional failure and to contain risks which might threaten the whole financial system. And borrowers and lenders, be they governments, companies or individuals should be responsible for their decisions and actions. The principles and measures set out below are designed to help meet these objectives.*

*5. This report focuses on a range of areas where specific changes could help prevent and handle future crises. This focus should not undermine the important message that, as far as individual countries are concerned, the pursuit of sound economic policies that promote sustainable broad based non-inflationary growth is the most important single contribution to avoiding a crisis. And when countries implement an IMF supported reform programme, their commitment to and ownership of the programme is crucial to its success. Sound policies need to tackle structural economic issues so that sufficient provision is made for the poorest sections of society and other vulnerable groups, development is sustainable and living and working standards for all are improved. This is also key to securing the*

*support needed for successful economic reform. In this respect we also encourage the IMF and MDBs to work with the ILO to promote core labour standards and with the competent international institutions to promote sound environmental standards. (underlined by the author)*

#### *Strengthening National Financial Systems and Corporate Governance*

*14. Weaknesses in the financial sectors in some Asian countries increased their vulnerability to external shocks. These weaknesses included over-extended lending to the property sector; the build up of large off-balance sheet positions, excessive exposure to highly leveraged borrowers, policy directed loans and excessive reliance on short-term borrowing in foreign currency. Had information about these developments been more widely available earlier, the international markets and International Financial Institutions might have been better placed to assess the risks in Asia and elsewhere. The crisis also highlighted weaknesses in risk assessment in our own financial sectors. Some institutions paid inadequate attention to risks. There is therefore a need for strengthened mechanisms to ensure appropriate risk analysis. This points to the need for enhanced international surveillance and improved prudential standards, and to the need to encourage internationally active financial institutions to act prudently on available information.*

- Supervisors, co-operating at Basle and elsewhere, should work to encourage private sector financial institutions to adopt better systems in private sector financial institutions for country risk assessment.*
- We need to continue to improve the supervision of large internationally active financial groups. A separate G7 report on financial stability addresses the need to improve co-operation and information sharing between national supervisors on the activities of such groups.*
- Supervisors and regulators should consider how best to encourage individual banks and their supervisors to monitor the adequacy of foreign currency liquidity (maturity of liabilities in relation to assets) separately from domestic currency liquidity.*

*15. A primary need is to encourage countries to strengthen their own financial systems, to ensure that banks and other financial intermediaries have the information, skills and corporate incentives to take well founded credit and risk decisions, and are properly supervised and regulated; that corporate and financial sectors follow good accounting, disclosure and auditing practices; and to promote deeper, more transparent and more open local bond and equity markets that will provide alternative sources of finance to short-term foreign currency bank borrowing.*

- In addition to the core principles for banking supervision, we also need to develop internationally accepted principles for auditing, accounting and disclosure in the corporate sector, together with arrangements for ensuring that these principles are put into practice.*
- We also welcome the OECD's initiative to develop standards and guidelines on corporate governance, and to report by Spring 1999.*

*16. Strong efforts are needed to ensure that sound and transparent standards are implemented. While this is primarily a matter for the national authorities concerned, incentives need to be put in place that will help deliver this. The primary incentive is the need for emerging markets to maintain confidence in order to access capital market. In addition:*

- The Fund has taken steps to sharpen the focus of its surveillance of the financial sector, for example during Article IV consultations. We encourage the Fund to build on this in collaboration with the supervisors, and to promote the Basle Committee Core Principles on Effective Banking Supervision. Similarly we encourage the World Bank to strengthen its reviews of countries' financial sector policies and corporate governance, and highlight these issues in its Country Assistance Strategies.*
- Further consideration should be given to how incentives to adopt, within a reasonable period of time, the core principles of financial supervision could be strengthened for example by making access by foreign financial institutions to major financial centres conditional in part on the implementation of adequate prudential and regulatory*



*standards in their home countries.*

- *We encourage the World Bank and regional development banks to help foster transparent markets, open to all well founded financial institutions, skilled management, independent banks able to make professional credit and risk decisions, and market structures that support these objectives.*

*17. There is a gap in the current international system with respect to surveillance of countries' financial supervisory and regulatory systems. Enhanced surveillance in this area would help encourage national authorities to meet international standards and help reduce financial risk. Such assessments of supervision and regulation can lay the groundwork for policy discussions and appropriate assistance, where needed, from the IMF and MDBs for programmes to strengthen financial systems. We need to address how best to organise international work in this and related areas. A number of international institutions are involved in various aspects of policy advice in the regulation of national financial systems. Their functions include assistance at times of financial crisis, long-term systems building and regular surveillance. There is a case for considering how to co-ordinate this work more effectively.*

- *The International Financial Institutions and international regulatory bodies have an important role to play in providing technical assistance and advice to emerging markets on strengthening and restructuring financial systems. The World Bank has enhanced its capacity to provide advice on financial sector development, through the establishment of the Special Financial Operations Unit (SFOU) to provide assistance to crisis countries. Also the Basle Committee and the Bank for International Settlements have established an institute for financial stability at Basle.*
- *We see an urgent need for a system of multilateral surveillance of national financial, supervisory and regulatory systems. This could encompass surveillance of such areas as banking and securities supervision, corporate governance, accounting and disclosure, and bankruptcy. We are considering ways, and ask the relevant institutions to develop proposals on ways, in which greater*

*co-operation can be achieved including options for institutional reform. In any event, this will include greater co-operation and an improved relationship among all these institutions, and drawing on national regulatory expertise. We will review progress on this important area by the autumn.*

The G7 Finance Ministers made clear that the focus would be to help not only handle but also prevent future crisis. In the context of the Asian Financial Crisis, they drew the conclusion that Asian Financial Crisis pointed to the need to strengthen the capabilities of financial regulators to assess risks in financial sectors and also the need for enhanced international surveillance and improved prudential standards. In terms of the need for safety net, the report struck a delicate balance not to undermine the role of IMF, without clearly mentioning the regional framework except the potential usefulness of bilateral financing to the extent that it is compatible with. The FSF was created in February 1999 to promote international financial stability through enhanced information exchange and international cooperation in financial market supervision and surveillance. One example of a series of renewed efforts to take coordinated efforts was the establishment of Financial Stability Forum (FSF). The FSF was established to bring together, on a regular basis, national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The Forum was serviced by a secretariat housed at the BIS.

#### *IFI Resources and Financing*

*21. The response of the IMF and World Bank to the Asian crisis has confirmed their role at the centre of the international financial system. The Asian Development Bank has also played a crucial part in responding to the crisis. However, this has involved an unprecedented level of new commitments for the IMF and other International Financial Institutions. We need to address the increased demand on resources:*

- *To enable the IMF to play its central role in the international*

*monetary system, it is essential to implement from January 1999 the increase in quotas as agreed under the IMF's recent Quota Review in order to ensure the IMF has sufficient usable resources. It is also essential to bring the New Arrangements to Borrow (NAB) into effect as soon as possible. We welcome the creation of the Supplemental Reserve Facility (SRF).*

*22. The Asian crisis also demonstrated that in special circumstances bilateral financing can provide a source of additional financing for balance of payments:*

- It will be important to ensure that bilateral financing is developed in conjunction with the IMF, is consistent with the IMF response and does not undermine IMF conditionality.*

*23. We have suggested a number of ways to enhance the role of the IMF and World Bank.*

- It will be important to consider whether the distribution of staff and resources needs to be adjusted to address the new priorities.*
- Closer co-operation between the Bank and Fund will be particularly important to avoid overlap and maximise use of expertise.*

Against the background of increased awareness of the need to take a coordinated approach about crisis prevention, Japan continued to take a supportive approach as a part of the G7. In spite of some argument that Japan intended to build a regional block against the US-led Washington based international financial organisations, Japan did not opt out from the G7-led discussion and but rather took more supportive and assertive approach towards the global efforts to reform the international financial architecture. A set of Japan's arguments was well summarised at then Japanese finance minister (Kiichi Miyazawa)'s speech at the IMFC (International Monetary and Financial Committee) in April 2000.

*Finance Minister Kiichi Miyazawa's remark at the IMFC in April 2000*

#### *4. Responses to vulnerability to crisis*

*Japan has made various proposals about policies that emerging markets need to pursue in order to reduce their vulnerability to crisis: (1) capital account liberalization needs to be carried out in a well-sequenced manner; (2) more detailed data of capital inflows and outflows need to be collected in order to strengthen the monitoring of capital movements; (3) domestic financial systems, including appropriate supervisory and regulatory systems need to be strengthened; (4) appropriate exchange rate regimes must be adopted in accordance with countries' particular situations; and (5) capital controls, though they should not be a substitute for sound macroeconomic and structural policy, may be helpful in certain cases. Many of these proposals are becoming part of an international consensus.*

*As to issues concerning creditors, Japan has proposed for several years that: (1) disclosure and risk management of market participants, including highly leveraged institutions (HLIs) such as hedge funds, should be strengthened; (2) risk management by the counterparties to hedge funds and supervision by the authorities on those counterparties should be strengthened; and (3) emerging economies should adopt appropriate defensive policies and maintain the integrity of their markets. For example, monitoring by the authorities of emerging economies should be intensified when markets are being influenced by the activities of investors such as hedge funds.*

*These Japanese proposals are reflected in the final report of the Financial Stability Forum's Working Group on HLIs, and we believe that, first of all, it is important that the recommendations of that report are fully implemented. We also wish to emphasize that the international community should keep a close watch on the conduct of international investors such as HLIs, and that we should continue to explore what measures are needed, including some type of direct controls.*

As was clearly mentioned in their finance minister's remark, Japan pushed the agenda of highly leveraged institutions like hedge funds with priority. The issue was timely especially given the collapse of the Long Term

Capital Management (LTCM) in the financial turmoil. It raised the concerns about the potential systemic risks posed by highly leveraged institutions and the spill-over effects from financial crises like the Asian Financial Crisis and the Russian Crisis, where highly leveraged institutions raised the concerns of destabilising impacts on the financial markets. In more detail, there were two key issues identified in the LTCM episode. The first issue is concerned with how best to address the systemic risks arising from the accumulation of high levels of leverage in financial markets. The second is concerned with how to reduce the potential market and economic impact of the sudden and disorderly collapse of an unregulated highly leveraged institution. In the market conditions of late 1998, the disorderly liquidation of a hedge fund as large and as leveraged as LTCM could also have imposed substantial direct losses on its counterparties. Significant secondary losses could have been imposed on other firms, through the rapid liquidation and closing out of LTCM's positions and the collateral supporting its funding. The potential widespread disruption in financial markets and possible collapse of some major firms would have posed grave dangers to the stability of the financial system and the health of the global economy.

In terms of the wording of communique of G7 Finance Ministers, there was still much emphasis on macroeconomic policy coordination, notably exchange rate policy coordination, but was increasing awareness of the need to call for financial safeguards measures including financial regulation in international financial markets. For example, in the G7 Finance Ministers report to the Heads of State and Governments in Lyon on 28 June 1996, the overall aim of the policy coordination was defined as to promote non-inflationary growth with the remaining shadow of the Mexican crisis in 1995.

*In our discussions in Halifax last year we concluded, more specifically, that:*

- *the most important foundation for exchange rate stability is the maintenance of sound macroeconomic policies aimed at achieving sustained non-inflationary growth and avoiding the emergence of large external or internal imbalances;*

- *flexibility in exchange rates of the major currencies is a basic feature of the system because unanticipated events occur; economic fundamentals change, and national financial and economic developments are sufficiently different that they require that policies be able to respond to them;*
- *exchange market intervention can be effective and even decisive in specific circumstances, but those circumstances are difficult to determine in advance;*
- *there is no effective regulatory structure or tax mechanism that will produce greater exchange rate stability without major costs in terms of other economic objectives.*

*These conclusions remain valid today. Our overriding objective is to promote sustained non-inflationary growth. In this context, the G7 can best promote greater stability in exchange markets through the pursuit of appropriate macroeconomic policies along with close cooperation in the exchange markets where appropriate. (underlined by the author)*

*For the past two decades, the international monetary system has been based on a flexible exchange rate system among major currencies. There are circumstances when it is appropriate to allow exchange rates among major currencies to fluctuate rather than to adjust monetary and fiscal policies in a manner inconsistent with the needs of the economy.*

*Experience since 1973 suggests that major exchange rate adjustments have been caused by clearly identifiable changes or distortions in the underlying economic fundamentals or in macroeconomic policies. Efforts to preserve an exchange rate that is inconsistent with underlying fundamentals are likely to introduce distortions to and constraints on central instruments of economic management. At the same time, financial authorities cannot be indifferent to exchange rate fluctuations that do not appear justified on the basis of macro-economic policies or fundamentals and as a consequence could adversely affect output or prices. There are circumstances where*

*close cooperation in exchange markets can reinforce sound economic policies and enhance stability in exchange markets.*

*The G7 has an important responsibility in promoting an effective and stable monetary system by advancing policies that will strengthen our capacity to manage risk and prevent crises and improve our ability to respond to such events when they occur. Towards this objective, we have adopted a number of initiatives over the past several years and improvements were initiated at Halifax. This paper reviews the main initiatives, and proposes, where appropriate, further improvements.*

#### *Continuing G7 close cooperation in exchange markets*

*Exchange rate misalignments can heighten uncertainty in the global economy and can be detrimental to growth and trade. When exchange rates appear to move out of line with underlying fundamentals, close monitoring is necessary and coordinated responses may be required.*

*The "orderly reversal" in key exchange rates since April 1995 is a positive and promising development. Several factors lie behind it. Most important were changes in economic policies and fundamentals, but the signals given to the markets by the G7 in 1995, through communiqués and - under appropriate circumstances - concerted intervention, were helpful in providing impetus to bringing exchange rates better in line with fundamental trends.*

*We should continue our close cooperation in exchange markets on this foundation, taking into account the fact that:*

- clear and consistent articulation of a common G7 view can have a stabilizing influence and help reinforce the credibility of our commitment to cooperate in the exchange market when circumstances warrant;*
- interventions can be effective in certain circumstances, especially when they reinforce changes in policies and/or underlying fundamentals that lead to changes in market expectations about*

*future exchange rates;*

- *the instrument of intervention must be used judiciously given its implications for monetary policy and the amount that the authorities can mobilize relative to the size of international capital markets. Nevertheless, these factors do not impede our joint ability to send a clear message to the markets, if and when appropriate;*
- *interventions are more likely to be effective when they are concerted and reflect a common assessment;*
- *an important condition for success is the appropriate timing of intervention.*

The communique at the G7 Halifax Summit in 1995 well illustrated the argument which the then G7 discussion was based on. Against the background of the 1995 Mexico crisis, there was a broad consensus that economic policy should be geared towards promoting non-inflationary growth by avoiding large external and internal imbalance. More emphasis was put on how to avoid inflationary and depreciating pressure leading to exchange rate instability caused by fiscal and current account imbalance.

But, it should be also noted that the G7 Finance Ministers report to the Heads of State and Governments in Lyon on 28 June 1996 called for more cooperation between the bank and securities regulatory bodies on derivatives to promote improved risk management, a common reporting framework and improved disclosure practices through strengthening the relationship between the Basle Committee and IOSCO. The risks associated with derivative transactions were increasingly made aware by national regulatory authorities following the collapse of Bearing Bank in 1995.

*(Excerpt from Harifax G7 Summit Communique in June 1995)*

### *Strengthening the Global Economy*

*12. The world economy has changed beyond all recognition over the last fifty years. The process of globalization, driven by technological change, has led to increased economic interdependence: this applies to some policy*



areas seen previously as purely domestic, and to interactions between policy areas. The major challenge confronting us is to manage this increased interdependence while working with the grain of markets, and recognizing the growing number of important players. This is especially important in the pursuit of global macroeconomic and financial stability.

13. Close consultation and effective cooperation on macroeconomic policies among the G7 are important elements in promoting sustained non-inflationary growth avoiding the emergence of large external and internal imbalances, and promoting greater exchange market stability. Our Ministers have adopted a number of changes to the structure of their consultations over time, in order to strengthen policy cooperation, including enhanced consultation with the IMF. (underlined by the author)

14. The growth and integration of global capital markets have created both enormous opportunities and new risks. We have a shared interest in ensuring the international community remains able to manage the risks inherent in the growth of private capital flows, the increased integration of domestic capital markets, and the accelerating pace of financial innovation.

15. The developments in Mexico earlier this year and their repercussions have sharpened our focus on these issues. We welcome the recent more positive turn of events in Mexico, as well as the positive developments in a number of emerging economies.

16. The prevention of crisis is the preferred course of action. This is best achieved through each country pursuing sound fiscal and monetary policies. But it also requires an improved early warning system, so that we can act more quickly to prevent or handle financial shocks. Such a system must include improved and effective surveillance of national economic policies and financial market developments, and fuller disclosure of this information to market participants. To this end, we urge the IMF to (underlined by the author):

- establish benchmarks for the timely publication of key economic and

*financial data;*

- *establish a procedure for the regular public identification of countries which comply within these benchmarks;*
- *insist on full and timely reporting by member countries of standard sets of data, provide sharper policy advice to all governments, and deliver franker messages to countries that appear to be avoiding necessary actions.*

*17. If prevention fails, financial market distress requires that multilateral institutions and major economies be able to respond where appropriate in a quick and coordinated fashion. Financing mechanisms must operate on a scale and with the timeliness required to manage shocks effectively. In this context, we urge the IMF to:*

- *establish a new standing procedure--"Emergency Financing Mechanism"-- which would provide faster access to Fund arrangements with strong conditionality and larger upfront disbursements in crisis situations.*

*18. To support this procedure, we ask:*

- *the G10 and other countries with the capacity to support the system to develop financing arrangements with the objective of doubling as soon as possible the amount currently available under the GAB to respond to financial emergencies.*

*19. To ensure that IMF has sufficient resources to meet its ongoing responsibilities, we urge continued discussions on a new IMF quota review.*

*20. Solid progress on the elements discussed above should significantly improve our ability to cope with future financial crises. Nevertheless, these improvements may not be sufficient in all cases. In line with this, and recognizing the complex legal and other issues posed in debt crisis situations by the wide variety of sources of international finance involved, we would encourage further review by G-10 Ministers and Governors of other procedures that might also usefully be considered for their orderly*

*resolution.*

*21. We continue to support the inclusion of all IMF members in the SDR system. Moreover, we urge the IMF to initiate a broad review of the role and functions of the SDR in light of changes in the world financial system.*

*22. Closer international cooperation in the regulation and supervision of financial institutions and markets is essential to safeguard the financial system and prevent an erosion of prudential standards. We urge:*

- a deepening of cooperation among regulators and supervisory agencies to ensure an effective and integrated approach, on a global basis, to developing and enhancing the safeguards, standards, transparency and systems necessary to monitor and contain risks;*
- continued encouragement to countries to remove capital market restrictions, coupled with strengthened policy advice from international financial institutions on the appropriate supervisory structures;*
- Finance ministers to commission studies and analysis from the international organizations responsible for banking and securities regulations and to report on the adequacy of current arrangements, together with proposals for improvement where necessary, at the next Summit.*

*23. We also recognize that international financial fraud is a growing problem. We are committed to improving communication between regulators and law enforcement agencies.*

*Excerpt from G7 Finance Ministers' report to the G7 Summit in Lyon in 1996*

*Better prudential safeguards in international financial markets (underlined by the author)*

*The globalisation of financial markets and the substantial increase in cross-border capital flows have created a more complex financial*

*environment. Comprehensive and effective financial regulation, market-reinforced prudential supervision and enhanced international cooperation among regulators are among the keystones for maintaining stability of the international financial and monetary system.*

*Industrial countries have been cooperating in the development of prudential frameworks for many years. The BIS/Basle Committees have taken important steps to develop international standards for prudential supervision of banks and to strengthen payments and settlements systems which link international markets. IOSCO has undertaken similar work for prudential regulation of securities firms and markets. In recent years, banking and securities regulators have increased their contacts at the international level to address supervisory concerns that cut across markets.*

*We recognise the substantial recent and ongoing cooperative work between the Basle and IOSCO Committees on derivatives to promote improved risk management, a common reporting framework and improved disclosure practices.*

*We welcome the publication in December 1995 of the Basle Committee capital adequacy standards for bank's exposure to market risk, which will be a very useful complement to existing prudential ratios.*

*Nevertheless, the changes in the structure of global finance and the emergence of new participants and markets require the supervisory response, including international cooperation, to evolve continually. We welcome the Basle and IOSCO Committees' reports on prudential regulation and supervisory cooperation. These reports should pave the way for continuing progress on current initiatives and expanding efforts in the following directions:*

- Enhance cooperation across markets to strengthen supervision of financial institutions. In this context, we welcome the joint efforts of the Basle and IOSCO Committees to enhance their collaborative arrangements and the work of the Joint Forum of banks, securities and insurance supervisors. Suitable arrangements should be*

*established within which that cooperation can be better organised. It would be useful to clarify the role and responsibilities of the relevant supervisors to foster an appropriate degree of cooperation in the supervision of internationally-active financial institutions, and to establish a more comprehensive network of bilateral arrangements between authorities.*

- *Strengthen prudential standards in, and supervisory cooperation with, emerging markets. Effective prudential regulation and supervision must cover all important financial marketplaces, particularly those which are experiencing high growth rates and/or substantial capital flows. The Basle and IOSCO Committees are performing work in this area which reinforces bilateral and regional efforts underway. Because emerging markets are growing in significance, these Committees, and other appropriate fora should be encouraged to strengthen their outreach to and cooperation with emerging market supervisors in order to promote high prudential standards. The International Financial Institutions should give more attention to promoting effective regulatory and supervisory structures in emerging markets.*
- *Encourage private sector efforts to enhance market transparency. Notwithstanding past or future regulatory activities, primary responsibility for risk management rests with market participants. Regulators should encourage - and where necessary exert pressure to induce - private sector efforts to enhance market transparency in order to strengthen market forces' capacity for sound and responsible risk taking and control.*
- *Improve reporting and disclosure of derivatives activities. Effective monitoring of derivatives activities is crucial, and requires closer cooperation among supervisors. In this regard, we welcome the global market survey conducted in the spring of 1995 by the BIS, and the follow-up action which is being planned. We also look forward to the conclusion this year of a joint Basle/IOSCO approach to reporting standards for derivatives exposure and to further progress*

*in improving derivatives disclosure practices.*

- *Enhance cooperation among exchanges. We look forward to implementation of the recommendations in the Windsor Declaration for increasing cooperation among futures exchanges and regulators. We also note with approval the development of information sharing arrangements among securities exchanges and welcome conclusion of an information sharing arrangement among major futures exchanges and relevant regulatory authorities. We also look forward to the IOSCO study of methods to identify large firm exposures that may have an effect on the market and to protect market participants from potential defaults by firms.*

#### *Strengthening of our collective ability to respond to financial crises*

*The increased integration of global capital markets, the change in magnitude and composition of capital flows, and the increase in the diversity and number of creditors and borrowers present new opportunities and challenges to the financial system. At Halifax, Heads proposed a range of initiatives to strengthen the global financial system, with particular attention to the IMF's role. We strongly welcome their implementation:*

- *Improvement of the early warning system is being implemented: the IMF's surveillance capabilities have been enhanced; the IMF has established standards for timely publication of economic and financial data, and subscription on a voluntary basis is underway.*
- *In order to better respond to crises, an emergency financing mechanism, aiming at faster procedures, has been set up in the IMF.*
- *We welcome the agreement in principle reached on a doubling of the resources currently available to the IMF under the General Arrangements to Borrow. These arrangements will include a broader group of countries with the capacity to support the international monetary system. We welcome this sharing of monetary responsibilities, thereby adapting our cooperation to new economic*

*circumstances.*

- *We welcome the report of the G10 Working Party on the Resolution of Sovereign Liquidity Crises.*
- *We fully support the ongoing 11th review of IMF quotas to ensure that the IMF continues to have sufficient resources to meet its ongoing responsibilities. We believe it is important for the IMF to remain a quota based institution with the resources necessary to fulfil its important role in the global financial system*

*Lyon Summit Economic Communique on 28 June 1996*

## *I. STRENGTHENING ECONOMIC AND MONETARY COOPERATION*

6. *Growing international economic interdependence unquestionably holds out new opportunities for the entire global community. At the same time, it adds to our collective responsibilities and the need for more effective cooperation among our countries to face new challenges.*

7. *Since we met in Halifax, economic developments have been on the whole positive and disparities of economic performance among us have been narrowing. Canada and United States continue to enjoy sustained non-inflationary growth. In Japan, the recovery is gathering strength. Some European countries, admittedly, experienced a slowdown, but economic fundamentals are improving and we are confident that growth will pick up in the second half of the year.*

*Looking ahead, the economic fundamentals remain sound and well oriented: inflation has settled at a low level, the interest rates have come down substantially, reaching historically low levels in some of our countries and external and internal imbalances have been substantially reduced. However, we recognize that some difficulties still lie ahead: public deficits and debt remain too large and national savings too low, unemployment is still unacceptably high in many countries and despite all the progress already achieved in the area of structural reforms, our*

*economies are not yet as resilient and adaptable to changes as they should be.*

*Outside the G7 sphere, economic prospects also look very encouraging. Emerging economies are experiencing robust growth. Sound macroeconomic policies and progress toward market-based institutions have contributed to improving economic performance in many developing countries and countries in transition (underlined by the author).*

- *In this context, our economic policies will continue to be directed at sustaining non-inflationary growth. This is a vital prerequisite to the creation of jobs and bringing down unemployment. While recognizing that our individual circumstances may vary, we share a common commitment to a medium-term economic strategy: credible fiscal consolidation programs, successful anti-inflationary policies and as a consequence low interest rates, and strengthened structural reform. These should contribute to investment, growth and job creation. Such policies will contribute to reducing external imbalances, thereby promoting international monetary stability and maintaining the conditions for harmonious growth in global trade and business.*

9. *Sound economic policies are the most important foundation for preventing exchange rate misalignment that may heighten uncertainty in the global economy and be detrimental to trade and growth. We welcome the broad movements in the major currencies since April 1995. These are positive and promising developments, and have helped to improve the conditions for sustained growth across the G7. We endorse the views of our Ministers of Finance on international monetary stability. We request our Ministers of Finance to continue to cooperate closely on economic policy and in the exchange markets. In this connection, we attach importance to the implementation of improved practical measures to deal with risks relating to the operation of the global financial markets and we request our Ministers to report to the next Summit on this issue.*

10. *The globalization of the financial markets has contributed to the*



*creation of a more complex financial environment. Better prudential regulation and supervision in the financial markets are essential elements in preserving the stability of the international monetary and financial system. In this respect, we welcome the progress on the strengthening of capital standards, including the recent agreement on capital adequacy standards for banks' exposure to market risk, improved disclosure and enhanced surveillance.*

*11. Cooperation among regulatory and supervisory authorities should continue to adapt to financial innovations, and to the growth in cross-border capital movements and internationally-active financial institutions. We welcome the work accomplished by the international bodies concerned with banking and securities regulation. Over the year ahead, we should seek to make maximum progress on the following objectives:*

- enhancing cooperation among the authorities responsible for the supervision of internationally-active financial institutions, importantly by clarifying their roles and responsibilities;*
- encouraging stronger risk management and improved transparency in the markets and connected activities, especially in the innovative markets ;*
- encouraging the adoption of strong prudential standards in emerging economies and increasing cooperation with their supervisory authorities ; international financial institutions and bodies should increase their efforts to promote effective supervisory structures in these economies. We ask our Finance Ministers in consultation with the relevant institutions to report back on this issue at our next meeting ;*
- studying the implications of the recent technological advances which make possible the creation of sophisticated methods for retail electronic payments and how to ensure their benefits are fully realized.*

12. The increased integration of global capital markets, the changes in magnitude and composition of financial flows, and the increased diversity and number of creditors and borrowers present new opportunities and new challenges. That is why, in order to promote monetary stability, we proposed last year in Halifax a number of measures for the international financial system, notably the International Monetary Fund, to strengthen the ability to deal effectively with these challenges (underlined by the author).

*We welcome the work accomplished since the Halifax Summit toward the implementation of these proposals. The surveillance capacities of the IMF have been enhanced, standards for the provision of economic and financial information to the markets have been established and an emergency financing mechanism has been created. We welcome the G10 report on resolving the liquidity crises of sovereign borrowers. This report emphasizes the importance of market discipline, and calls for the enhancement of current procedures for handling international financial emergencies, in order to minimize the need for official support in the future.*

13. Together with the international community as a whole, we undertake to ensure that the IMF has the resources needed to perform its tasks in the service of international monetary stability:

We welcome the agreement reached on a framework for doubling the resources currently available to the IMF under the General Arrangements to Borrow in order to respond to financial emergencies. These arrangements will include a broader group of countries with the capacity to support the international monetary system. We welcome this sharing of monetary responsibilities, thereby adapting our cooperation to new economic circumstances;

The IMF should remain an institution based on quotas providing the resources necessary to accomplish its traditional tasks. Any quotas increase should take into account the changes in the economic and financial weight of its members. Given the prospective evolution of the Fund's liquidity, we request that the 11th quota review be completed as soon as possible

(underlined by the author).

14. *Lastly, the IMF should continue to reflect on the role of Special Drawing Rights within the international monetary system. We continue to hope for progress on proposals that would permit all Member countries to participate on an equitable basis in the SDR system. We invite the IMF Member States to pursue their dialogue in order to settle this issue.*

15. *As we recognized last year, international financial fraud is a growing problem for our financial systems. In order to strengthen the fight against this phenomenon, we will continue to look for ways of facilitating, as much as possible, the exchange of information on cases involving serious financial crime and regulatory abuse between law enforcement agencies and regulatory bodies, in accordance with our own domestic legal systems and other basic principles. We intend to maintain our dialogue to review progress and developments in this field (underlined by the author).*

16. *Finally, globalization is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment and could lead to the erosion of national tax bases. We strongly urge the OECD to vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices. We will follow closely the progress on work by the OECD, which is due to produce a report by 1998. We will also follow closely the OECD's continuation of its important work on transfer pricing, where we warmly endorse the significant progress that the OECD has already achieved (underlined by the author).*

In the late-1980s where US economy was in the deep trouble characterised by the dual deficits of fiscal and trade imbalances, the G7 functioned as the forum where the US called for reluctant Japan and Germany to take more expansionary measures by keeping interest rates low and taking a series of fiscal stimulus programmes in return for the US commitment to reduce its budgetary deficits and cooperate with stabilising dollar values.

However, as the US economy recovered in the early and mid-1990s, the focus of the G7 Finance Ministers meeting was gradually shifting to addressing the problems facing globalisation of international financial markets, rather than calling for each G7 country to take specific macroeconomic measures. In the macroeconomic terms, the G7 communique was increasingly playing the role of endorsing the support of the US domestic economic policy approach characterised by fiscal discipline and the low-interest policy. In the Clinton administration era, the macroeconomic policy approach adhering to fiscal responsibility allowed the FED to lower the interest rates. Also the monetary policy was left to the FED. Partly thanks to his communicative skills of the Fed Chairman Alan Greenspan, the FED achieved low and steady inflation and enjoyed the freedom of manoeuvre to adjust monetary policy.<sup>152</sup>

Since the early and mid-1990s, the focus of the G7 agenda shifted from macroeconomic policy to the coordination of regulatory frameworks in financial and tax matters. There was already some degree of efforts of international policy coordination such as the bank capital regulation formulated at Basel Committee's bank capital rule. The discussion was initiated by the joint proposal by the US and the UK. The rule was intended to work as a common standard for evaluating capital adequacy. The US-UK proposal provided for (1) a common definition of capita, which comprised shareholders' equity, retained earnings, minority interests in subsidiaries, and perpetual debt; (2) adoption of a risk-weighted system for evaluating capital adequacy; and (3) the inclusion of all off-balance-sheet commitments in capital adequacy determinations.

At the Halifax Summit in 1995, the communique called on the strengthening the international monetary system, including its capacity to prevent and where necessary respond to crisis. As a result of the outbreak Mexican crisis, the Halifax Summit communique explicitly raised the issues of the risks inherent in the growth of private capital flows, the increased integration of domestic capital markets, and the accelerating pace

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<sup>152</sup> Frankel, J. and Orszag, P. "Retrospective on American Economic Policy in the 1990s", Brookings Paper, 2001, <http://www.brookings.edu/views/papers/orszag/20011102.pdf>

of financial innovation, and also called on the need for international coordinated efforts. It urged finance ministers to commission studies and analysis from the international organisations responsible for banking and securities regulations and to report on the adequacy of current arrangements, together with proposals for improvement where necessary, at the next Summit.

*Halifax Summit communique in 1995*

*14. The growth and integration of global capital markets have created both enormous opportunities and new risks. We have a shared interest in ensuring the international community remains able to manage the risks inherent in the growth of private capital flows, the increased integration of domestic capital markets, and the accelerating pace of financial innovation.*

*15. The developments in Mexico earlier this year and their repercussions have sharpened our focus on these issues. We welcome the recent more positive turn of events in Mexico, as well as the positive developments in a number of emerging economies.*

*16. The prevention of crisis is the preferred course of action. This is best achieved through each country pursuing sound fiscal and monetary policies. But it also requires an improved early warning system, so that we can act more quickly to prevent or handle financial shocks. Such a system must include improved and effective surveillance of national economic policies and financial market developments, and fuller disclosure of this information to market participants. To this end, we urge the IMF to:*

- establish benchmarks for the timely publication of key economic and financial data;*
- establish a procedure for the regular public identification of countries which comply within these benchmarks;*
- insist on full and timely reporting by member countries of standard*

*sets of data, provide sharper policy advice to all governments, and deliver franker messages to countries that appear to be avoiding necessary actions.*

*17. If prevention fails, financial market distress requires that multilateral institutions and major economies be able to respond where appropriate in a quick and coordinated fashion. Financing mechanisms must operate on a scale and with the timeliness required to manage shocks effectively. In this context, we urge the IMF to:*

- establish a new standing procedure--"Emergency Financing Mechanism"-- which would provide faster access to Fund arrangements with strong conditionality and larger upfront disbursements in crisis situations.*

*18. To support this procedure, we ask:*

- the G10 and other countries with the capacity to support the system to develop financing arrangements with the objective of doubling as soon as possible the amount currently available under the GAB to respond to financial emergencies.*

*19. To ensure that IMF has sufficient resources to meet its ongoing responsibilities, we urge continued discussions on a new IMF quota review.*

*20. Solid progress on the elements discussed above should significantly improve our ability to cope with future financial crises. Nevertheless, these improvements may not be sufficient in all cases. In line with this, and recognizing the complex legal and other issues posed in debt crisis situations by the wide variety of sources of international finance involved, we would encourage further review by G-10 Ministers and Governors of other procedures that might also usefully be considered for their orderly resolution.*

*21. We continue to support the inclusion of all IMF members in the SDR system. Moreover, we urge the IMF to initiate a broad review of the role*

*and functions of the SDR in light of changes in the world financial system.*

*22. Closer international cooperation in the regulation and supervision of financial institutions and markets is essential to safeguard the financial system and prevent an erosion of prudential standards. We urge:*

- a deepening of cooperation among regulators and supervisory agencies to ensure an effective and integrated approach, on a global basis, to developing and enhancing the safeguards, standards, transparency and systems necessary to monitor and contain risks;*
- continued encouragement to countries to remove capital market restrictions, coupled with strengthened policy advice from international financial institutions on the appropriate supervisory structures;*
- Finance ministers to commission studies and analysis from the international organizations responsible for banking and securities regulations and to report on the adequacy of current arrangements, together with proposals for improvement where necessary, at the next Summit. (underlined by the author)*

*23. We also recognize that international financial fraud is a growing problem. We are committed to improving communication between regulators and law enforcement agencies.*

There was increasing recognition that the effects of unilateral or bilateral responses to economic problems that is inherently multilateral are increasingly limited and more efforts were needed to identify ways in which governments can best establish a common framework within which countries could operate individually and collectively. The internationally coordinated efforts were seen not only in financial regulation, but also fiscal rules.

The OECD Ministerial Communiqué of May 1996 called upon the OECD to:

*“develop measures to counter the distorting effects of harmful tax*

*competition on competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998.”*

This request was subsequently endorsed by the G7 countries, which included the following paragraph in the Communiqué issued by the Heads of State at their 1996 Lyon Summit:

*“Finally, globalisation is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment and could lead to the erosion of national tax bases. We strongly urge the OECD to vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices. We will follow closely the progress on work by the OECD, which is due to produce a report by 1998.” (underlined by the author)*

The OECD launched its work to establish an international framework to counter the spread of harmful tax competition and finalised in 1998 the report “Harmful Tax Competition: An Emerging Global Issue”. The goal was to secure the integrity of tax systems by addressing the issues raised by practices with respect to financial and other geographically mobile activities that unfairly erode the tax bases of other countries and distort the location of capital and services, which could cause undesired shifts of part of the tax burden to less mobile tax bases such as labour, property, and consumption and increase administrative costs and compliance burdens on tax authorities and taxpayers.

The OECD made it clear that their work was not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, striking the delicate balance between preserving fiscal sovereignty and needing to build internationally agreed code of tax practices. The OECD report in 2000 “Report to the OECD Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and Eliminating Harmful Tax Practices” stated that:



*“It is important to note at the outset that the project is not primarily about collecting taxes and is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates. Rather, the project is about ensuring that the burden of taxation is fairly shared and that tax should not be the dominant factor in making capital allocation decisions. The project is focused on the concerns of OECD and non-OECD countries, which are exposed to significant revenue losses as a result of harmful tax competition. Tax base erosion as a result of harmful tax practices can be a particularly serious threat to the economies of developing countries. The project will, by promoting a co-operative framework, support the effective fiscal sovereignty of countries over the design of their tax systems. (underlined by the author)”*

The work on harmful tax competition was also carried out in the European Union (EU). The European Council agreed on 1 December 1997 to a package of measures to tackle harmful tax competition in order to help to reduce distortions in the Single Market, to prevent excessive losses of tax revenue and to develop tax structures in a more employment-friendly way. The package includes a Code of Conduct on business taxation, taxation of savings income and issue of withholding taxes on cross-border interest and royalty payments between companies. The Code of Conduct identifies potentially harmful regimes in the field of business taxation and gives factors for the assessment of harmful regimes. It includes a commitment not to introduce new harmful tax regimes and to rollback existing regimes.<sup>153</sup>

The parallel works between the EU and the OECD made the OECD work easier in the sense that the EU countries accounting for more than half of the OECD memberships find it less difficult to accept the OECD work to the extent that they would accept in the EU work. In the EU context, the "Code of Conduct for business taxation" defined harmful tax measures as measures (including administrative practices) which affect or may affect in a significant way the location of business activity in the Community, and

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<sup>153</sup> OECD (1998), “Harmful Tax Competition: A Emerging Global Issue”

which provide for a significantly lower level of taxation than those that generally apply in the Member State concerned. Under the Code, which applies both to Member States and to their dependent and associated territories, over 400 business taxation measures have been assessed and over 100 of these, being considered harmful, have been removed or amended.<sup>154</sup>

### 3-2 Transcending the regional integration: Transformation of the role of G7 and its role in the new framework of G20 – the meaning of G7 for Japan

Since the Financial Crisis in 2008, the G20 has also significantly contributed to the ongoing process to strengthen the international financial structure and governance, pushing forward key changes to ensuring global financial stability. The very reason of the emergence of the G20 is the coordinated efforts by G20 to enhance the voice and representation of emerging economies and developing countries. This is based on the broad consensus that level-playing-field in the regulatory and fiscal frameworks cannot be achievable without the commitment by emerging and developing countries, especially those key economies participating in the G20, notably such as China, Brazil, India, Russia, and Indonesia.

The G20 Leaders' Declaration on 15 November 2008 in Washington DC, the first G20 after the collapse of the Lehman Brothers, pointed out that, as the root causes of the current crisis that weak, inadequately weak regulatory frameworks led financial market participants to undertake excessive risks and create vulnerabilities in the system.

#### *G20 Leaders' Declaration on 15 November 2008 in Washington DC*

*3. During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise*

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<sup>154</sup> European Commission,  
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0201:FIN:EN:PDF>

*proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.*

*4. Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption.*

In the letter released from Dominique Strauss-Kahn, then Managing Director of the International Monetary Fund (IMF) dated November 6, 2008 to the Group of 20 Heads of Governments and Institutions, he identified two tasks ahead: (1) dealing with the immediate fallout of the financial crisis i.e., coordinating policy responses and providing financing to restore confidence and growth, and (2) dealing with the longer-term global architecture i.e., fixing an inadequate regulatory system and developing a reliable early warning and response system.

In his assessment, global demand was falling rapidly around the world and additional monetary and fiscal policy response needed to be on the agenda. He stated that there was a scope for fiscal expansion in many advanced and some emerging market economies; and with inflation declining, some central banks have scope for further monetary easing. In terms of emerging market, he pointed out that emerging markets are under great stress as the capital flows that have sustained growth dry up across the board. Against this background, he announced the Fund's proactive initiative to move rapidly to assist several countries with substantial financing and policy advice, and also put in place a new Short-Term Liquidity Facility to provide rapid financing for countries with strong fundamentals.

The G20 Summit highlighted the need to rethink the design of financial regulation. Based on the assessment that the financial crisis underlined the importance of having its ultimate implementation by national authorities subject to surveillance by a body or network of institutions alert to systemic implications across financial instruments, markets, and countries at the global level, the communique stressed the need to agree on a consistent approach that might frame follow up at the national and multilateral levels.

The G20 Summit communique specifically referred to the need of strengthening transparency and accountability of financial market, enhancing sound regulation, promoting integrity in financial markets including international standards with respect to bank secrecy and transparency, and reinforcing international cooperation in terms of formulating regulations and other measures in a consistent manner.

What is also noteworthy is that the G20 Summit communique emphasised the closer engagement of emerging and developing economies. It was apparent that the specific emphasis was put on G20 emerging countries such as China, Russia and India, in particular. It acknowledged the commitment of advancing the reform of the Bretton Woods Institutions so that they can more adequately reflect changing economic weights in the world economy in order to increase their legitimacy and effectiveness. It further stated that emerging and developing economies, including the poorest countries, should have greater voice and representation. It also stated that the Financial Stability Forum (FSF) must expand urgently to a broader membership of emerging economies, and other major standard setting bodies should promptly review their membership.

The G20 has fundamentally changed the gravity of the rule-making power of the international financial system, shifting the G7 to the G20 as a forum playing a prominent role in formulating the international policy coordination in the international monetary and fiscal policy. Under this new paradigm of G20, the G7 has been increasingly faced with the dilemma. On the one hand, the G7 could be placed as a forum among like-minded developed countries and formulate the coordinated position among the G7

countries. On the other hand, the G7 has been increasingly less influential as a forum to formulate the international policy coordination.

While it could be argued that the G20 has already been a dominant forum and the role of G7 has diminished, the G7 has remained a prominent forum to discuss at least the international currency issue for the Japanese Ministry of Finance. For example, when the Japanese Ministry of Finance made a coordinated foreign exchange market intervention in March 2011 in the aftermath of the big earthquake and the Fukushima, the G7 issued a statement that the G7 countries were ready to provide any needed cooperation and our confidence in the resilience of the Japanese economy and financial sector, in order to prevent the Japanese yen from appreciating in an excessive way.

China participated in the G7 Finance Ministers meeting on 1 October 2004 for the first time. The statement of the G7 Finance Ministers and Central Bank Governors met informally with China's Finance Minister and Central Bank Governor, and stated that they discussed the global economic outlook, macroeconomic policies in G7 economies and the Chinese economic situation in a candid way. The statement also stated that, among other things, they exchanged views on economic impact of oil prices, fiscal and monetary policies in G7 economies, Asian economic outlook, and exchange rate flexibility. The statement further stated that G7 and China agreed that this meeting was a constructive channel to share views on issues of mutual concern and to promote mutual understandings.

This statement in October 2004 made it clear that they had a collective interest in monitoring the Chinese currency regime. The G7 statement in April 2006 further stated that greater exchange rate flexibility was desirable in emerging economies with large current account surpluses, especially China, for necessary adjustments to occur. From the Japanese government's perspective, the increased collectiveness of the G7 finance ministers calling on China to increase the exchange rate flexibility gave more legitimacy and impacts on the Chinese financial diplomacy than if Japan unilaterally pressed China to do. This G7's collective call on China to increase the flexibility of their currency in the foreign exchange markets continued in

the statement of G7 Finance Ministers and Central Bank Governors in October 2008. It stated that given China's important role in the global economy we encourage the authorities to allow accelerated appreciation of the Chinese renminbi's effective exchange rate as a means of further rebalancing of the domestic economy and promoting external stability. In the G7 statement, the tone was as modest as stressing that the increased flexibility of the Chinese renminbi would be a means of rebalancing of the domestic economy and promoting external stability, rather than rebalancing a great deal of current account surplus.

In the late 1990s after the Asian financial crisis, there was a growing momentum for establishing a framework for regional cooperation to enhance the prospects for financial stability. As a statement of the first Manila Framework in November 1997 stated, a series of then initiatives underscored the importance of maintaining sound macroeconomic and structural policies, appropriate exchange rate policies, strong domestic financial institutions and supervisory regimes in fostering and sustaining growth.<sup>155</sup> The increased flexibility of the Chinese currency was a potential issue for a regional financial framework to discuss as a part of the process of engaging China in establishing a regional mechanism. However, there was not substantive development in the regional framework in terms of engaging China to persuade them to increase the flexibility of their currency. For the Japanese Ministry of Finance, the G7 process was increasingly a major channel for Japan to call on China to increase the flexibility of their currency, along with their bilateral talk with the Chinese financial counterparts.

Compared with the Japan's experiences in the 1980s, the G7's approach towards China was rather modest and soft. In the late 1980s after the Plaza Accord, Japan was under pressure from the US to accept the foreign exchange market adjustment. There are a few reasons which can be identified to explain this difference. Japan was already in the part of the G7 countries in the late 1980s. For the Japanese Ministry of Finance, the G7

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[http://www.mof.go.jp/english/international\\_policy/financial\\_cooperation\\_in\\_asia/manila\\_framework/if000a.htm](http://www.mof.go.jp/english/international_policy/financial_cooperation_in_asia/manila_framework/if000a.htm)

was the most prominent and important forum to participate in the discussion on the policy coordination in the international financial system. Especially in the late 1980s since the Plaza Accord, the Japanese Ministry of Finance was under the increased pressure from the US to accept the Japanese yen's appreciation as a means of addressing current account surpluses. The US administration repeatedly called on Japan to accept the Japanese yen's appreciation and take substantial fiscal stimulus measures.

In the late 1980s, Japan was also increasingly aware of the great role of the Japanese economy in the international economy as China is now. As the Diplomatic Bluebook 1986, the Japanese government stressed that the economic prosperity of Japan in the post-war period was achievable only as a result of the political and economic cooperation with the liberal and democratic world, notably the US, and that Japan would need to undertake the special responsibility of contributing to the peace and prosperity of the international community. Based on this awareness of increased responsibility and self-achievement, the Japanese government stressed that the continued cooperative Japan-US relationship was the fundamental pillar of the Japanese diplomacy. This sense of responsibility of Japan making contribution to the peace and prosperity in the international society was linked with the sense that Japan pursued economic prosperity relying on the US on the Japan's security and defence policy. This sense of guilt or at least paying too little costs in enjoying the economic prosperity and peace in the post-war period was the key element in affecting the policy-making of the Japanese government.

The primary reason why the Japanese government accepted the sharp appreciation of the Japanese yen was that they considered that reducing rapidly increasing current account surplus of Japan was essential to the stability of the international economy. The Japanese government was particularly aware of the responsibility which Japan needed to play in providing international public goods such as sustainable international monetary system and free trade systems which underpinned the prosperity of the Japanese economy in the post-war period.<sup>156</sup> The Japanese

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<sup>156</sup> Economic White Paper 1986,  
<http://www5.cao.go.jp/keizai3/keizaiwp/wp-je86/wp-je86-00401.html>

government was increasingly concerned that if the Japanese economy continued to increase the current account surplus, the world economy would become unstable and give negative impacts on the Japanese economy. The Japanese government was also aware of the need to change the structure of the Japanese economy from export-led growth to domestic demand-led growth.

In Japan, domestic demand-led growth was considered by the Japanese government as essential to enable Japan to achieve sustainable growth. While a series of Economic White Paper stressed the self-efforts by the US to reduce their budgetary deficits and current account deficits, the Japanese government pointed out that economic growth had not yet improved the quality of living of the general Japanese public in proportion to its sharp increase in the GDP. The Economic White Paper recognised that the impact of monetary and fiscal policies were giving greater impacts on the economies of the other countries and Japan would need to play a greater role with the US in stabilising the international economy. While the Economic White Paper 1987 pointed out that the shift of the Japanese economy to domestic demand-led growth by itself would not contribute to addressing the US current account deficits, it stressed the need of the Japanese government to coordinate their fiscal and monetary policies with other G7 countries, notably the US. In the process leading up to the Plaza Accord, the US Treasury in principle approached the Japanese Ministry of Finance and worked to reach the agreement between the two countries first. In the Japan-US Yen-Dollar Committee, the Japanese Ministry of Finance

At the same time, China was increasingly aware of the increased presence of the Chinese economy and the global nature of its currency issue. Since 2002, the Chinese authorities have used massive, largely sterilized, official intervention to prevent their currency from appreciating excessively. The Chinese authority kept the nominal exchange rate pegged at 8.28 to the dollar until July 2005. The Chinese authority intervened to resist strong upward pressures on the exchange rate of the Chinese renminbi. While the Chinese authority felt its need to respond to the increasing call by others for increased flexibility of the Chinese currencies, they were not inclined to give the impression that they simply succumbed to external pressures to



call for the increased flexibility of the Chinese currency.

From the Chinese perspective, China has been sensitive about at least giving the impression that China was forced to increase the flexibility of their currency. The Chinese foreign exchange policy has been based on the view that free floating exchange rate system could result in exchange rate distortions and are vulnerable to currency crisis and speculative capital flows. In terms of the increased flexibility of the Chinese currency, the Chinese authority considered that an incremental approach rather than a big-bang approach with a radical reform was more appropriate to achieve the balanced balance of payments as well as avoid the risk of further disputes with trade partners to the extent possible.<sup>157</sup> The Chinese authority has had the view that foreign exchange market intervention can be justified when the exchange rate exceeds the predetermined band, or when the capital account experiences large imbalances and there are excessive trades in the foreign exchange market, or the financial market falls into crisis-scale turmoil. In their view, market intervention is still necessary to prevent and correct a large, short-term fluctuation of the exchange rate.

Evidently the Chinese authorities have been considering the increased flexibility of the Chinese currency could result in excessive capital inflows and outflows and give undesirable effects on the domestic economy and fail to achieve the goal of balanced balance of payments.<sup>158</sup> There have been some literatures on what lessons the China should learn from what the Japanese economy experienced between its rapid expansion in the bubble economy and the so-called lost decades after the burst of the bubble economy in the early 1990s. One possible argument could be that the Chinese authorities are particularly cautious about the increased flexibility of the Chinese currency because they consider that the Plaza Accord was the cause of the bubble economy and the subsequent lost decades of the Japanese economy in the sense that the Plaza Accord forced Japan to accept the Japanese yen's appreciation and constrain their monetary policy,

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<sup>157</sup> Yi, Gang. "Exchange Rate Arrangement: Flexible and Floating Exchange Rate Debate Revisited", 16-17 April 2013, IMF, <http://www.imf.org/external/np/seminars/eng/2013/macro2/pdf/gy.pdf>

<sup>158</sup> Ibid.

thereby resulting in excessively long period of low interest rates.

If the Chinese authorities seek to achieve more balanced balance of payment and avoid increased conflict with trade partners like the Japanese authorities in the late 1980s, the increased flexibility of the Chinese currency and the acceptance of currency appreciation are sure to be a part of major means of achieving these goals. But, it is not clear to what extent the Japan's experiences could have to do with the Chinese foreign exchange policy.

The Economic White Paper 1987 called for the shift from export-led growth to domestic-demand led growth. As the Economic White Paper 1987 stated, the call for the domestic demand growth was based on the view that the living standards of the ordinary Japanese public did not improve at the same pace and extent as the Japanese yen appreciated and the Japanese trade surplus increased. The Economic White Paper 1987 admitted that while the competitiveness of tradable goods was significantly enhanced, the competitiveness non-tradable goods and services was still lagging behind and the disparity between domestic prices and foreign prices became more clearer. The US administration called on Japan to stimulate the domestic demand, but they were not interested in the structural reform at the Japanese domestic industry including the shift of labour force to less competitive economic sectors to more competitive industrial sectors. The domestic-led growth was wrongly oriented towards taking additional fiscal stimulus measures to stimulate domestic demand at the macroeconomic level rather than encouraging the Japanese domestic industries to make structural reform by themselves, and ended in discouraging individual companies and economic sectors to make structural efforts after the Japanese yen's sharp appreciation.

The biggest difference between Japan and China is that essentially China does not belong to any international economic framework which would constrain their freedom of economic policy to a significant extent as Japan did to the G7 in the late 1980s. While Japan has belonged to many economic initiatives such as G7 and APEC, China has not substantively committed to economic multilateral frameworks such as the G7 beyond a

soft framework of exchange of views on particular topics. Though the G20 has become a paramount economic regime in the international economic and financial system, the G20 itself has not been a framework which forces each of member states to commit to particular macroeconomic policies.

In terms of the macroeconomic policy framework, the G7 has been a framework of a group of more likeminded countries. Because of its more likemindedness, the G7 functioned as a framework which gave more peer pressure on member countries. Since the defeat in the Second World War, it was the first experience of Japan which felt the sense of achievement both economically and politically. In the Bretton Woods system of fixed exchange rates, the national authorities were committed to intervening in the foreign exchange markets whenever the exchange rate reached a 1 percent band on either side of its part vale vis-à-vis the US dollar. In the World Economic White Paper 1971, the Japanese government considered the collapse of the Bretton Woods system as a result of the US's inability to deal with the current account deficits and force the other countries to adjust their macroeconomic policies to help the US to address the external balance domestically<sup>159</sup>. It was based upon the view that the collapse of the Bretton Woods system represented the end of the US's dominance as an economic superpower to uphold the international monetary system. But, it also stated that while the current account imbalance of the US was largely attributed to the failure of economic policies of the US, the current account surplus countries needed to undertake a due responsibility. What is most noteworthy was that the Japanese government did not consider the yen's appreciation as the mere constraint of reducing the volume of exported goods and the competitiveness of Japanese companies, but rather an opportunity to modernise the structure of the Japanese industry by shifting labour forces to more efficient sectors.<sup>160</sup>

In 1972, while the Japanese government was concerned about the impacts of the Japanese yen's appreciation on the domestic industries through the decline in competitiveness, they were also concerned about the inflationary

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<sup>159</sup> World Economic White Paper 1971, Government of Japan,  
<http://www5.cao.go.jp/keizai3/sekaikeizaiwp/wp-we71/wp-we71-000i1.html>

<sup>160</sup> Economic White Paper 1972, Government of Japan  
<http://www5.cao.go.jp/keizai3/keizaiwp/wp-je72/wp-je72-00205.html>

risks exacerbated by the rise of oil prices. In terms of the impact on prices, the Japanese yen's appreciation after the collapse the Bretton Woods regime was not necessarily a negative element in the sense that it worked to mitigate the upward pressures of the rise of the imported goods. The Economic White Paper 1972 stated that the Japanese yen's appreciation would give positive impacts on prices and would mitigate the risks of inflationary pressures becoming out of control.

### 3-3 Emergence of the new alliance between the US and Japan?

As the economic growth of China has been accelerating and their position in the international political economy has become larger, the relationship between Japan and the US has been gradually shifting from the competing rivals to a sort of alliance against China. One of the key issues on which Japan and the US made a coordinated position against China was exchange rate policy. Since 2005, China began to attend the G7 Finance Ministers and Central Governors meeting informally. The Statement on the Meeting of G7 Finance Ministers and Central Bank Governors with Chinese counterparts, London, 5 February 2005, stated that "The Finance Ministers and Central Bank Governors of the G7 countries met informally with China's Finance Minister and Central Bank Governor to continue the productive dialogue begun in Washington in October 2004. They enjoyed an open and helpful exchange of views on a wide range of economic issues of mutual interest in a candid way. Among other things, they exchanged views on fiscal and monetary policies in G7 economies, the Asian economic outlook, and exchange rate flexibility. It was agreed that this meeting was an effective means of increasing shared understanding of the challenges and opportunities of an increasingly integrated global economy".

Having an opportunity to meet the China's Finance Minister and Central Bank Governor and release the statement as the G7 was politically important especially in the US. The undervalued Chinese currency allegedly gave an incentive to other Asian countries to intervene in the currency markets to remain competitiveness with Chinese goods. The US

administration has been faced with the political pressure to give the impression that the US government has been calling on the Chinese authority to accept increased flexibility of their currency. In this respect, the US and Japan were increasingly aware of the shared interests and concerns about the lack of exchange rate flexibility of the persistently undervalued Chinese currency and their impacts on trade patterns.

From the US perspective, there are some key differences between the current China and the Japan in the late 1980s and early 1990s. First, China does not depend on the US military forces and but rather has been increasing their military presence in the Pacific. In the case of Japan, the Japan-US Security Treaty was been the key cornerstone of the Japanese defense and diplomatic policy. Second, unlike Japan, China has not expressed enthusiastically their wish to be recognised as one of the developed countries. China has been cautious about being recognised as one of the developed countries and treated on an equal footing, because the Chinese authorities has been always weighing carefully the risks of promoting liberalisation of capital controls and the flexibility of their currency in the foreign exchange markets leading to less control by the Chinese authorities. It has been generally said that both the potential and the incentive for economic policy coordination have increased as the world economy has become increasingly integrated.<sup>161</sup>

However, economic policy coordination depends on to what extent any single government authority in the framework considers the economic benefits and is ready to accept the results of the negotiations among the countries concerned. In the case of Japan in the 1980s, Japan was ready to accept the policy coordination as a part of their responsibility to play its expected role in accordance with the growing economic presence. In the case of China, there is a political constraint facing the Chinese authority. Unlike Japan, the risk of any economic disorder leading to political instability was a key consideration which the Chinese authority has taken into in terms of maintaining a political system upheld solely by the Chinese Communist Party. In China, capital and exchange controls for current

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<sup>161</sup> Fisher, S. "Macroeconomic Policy", *International Economic Cooperation*, National Bureau of Economic Research, 1988

international transaction is heavily intertwined with its political desire to maintain their political system and avoid any risk of creating economic disorder which could have the spillover effects.

The increased trade surplus and inbound foreign direct investment in China has inevitably given increased upward pressure on the Chinese currency for further appreciation. Faced with this upward pressure, the Chinese monetary authorities have worked to intervene in the foreign exchange market to buy the US dollar and sell Chinese currency. It is well-known that in this process the Chinese authorities have adopted the so-called sterilised intervention to mitigate the inflationary risk of domestic economy through increased monetary base in the domestic market. This sterilisation led to the increase in China's foreign exchange reserve in recent periods. The accumulating trade and capital account surpluses under the regime of capital control have made the Chinese authority aware of the need to contain inflationary pressure in the domestic economy.

Today it seems that the financial diplomacy of the Chinese authorities is broadly oriented towards the two major directions. The first is that they are increasingly looking at the more liberalisation of capital account, outbound flow of the Chinese currency overseas, in particular. This is evidently witnessed in the China's approach to the London city market. The UK Treasury and the London City have been welcoming the China's approach to use London as a hub for the Chinese currency's business. From the UK perspective, they believe that London is best equipped with the technical infrastructure for the renminbi business and could play a leading role in development of the renminbi product market in Europe and beyond Europe. At the same time, the China has started to call on the IMF to include the renminbi as a part of the SDR. The second is that against the background of the accumulating foreign reserves, China has been aggressively using it to exert a diplomatic influence in the infrastructure investment. It is clear that the idea of Asian Infrastructure Investment Bank was based on the accumulating foreign reserves in China in terms of financing. The SDR and the AIIB are the clear examples of the attempt of the Chinese authorities to use the accumulating trade and capital surpluses to exert more diplomatic influence.

Although the G7 has been collectively calling on China to increase the flexibility of their currency, the division between the two camps, i.e. the US and Japan, on the one hand, and the others, the UK, in particular, could become larger. G7 is now increasingly functioning as a forum of like-minded countries within the framework of G20. G7 has been the driving force for setting the international standards and promoting international coordination of macroeconomic policies. Although the coordination of macroeconomic policies has been increasingly difficult, there still remain some policy areas for promoting cooperation or coordination of international standards in financial regulation and combatting international tax evasions and avoidances. Nowadays, the global landscape of positions of each country on specific policy issues is rather difficult to give a holistic view to. It depends on an issue by issue. In general, as the economic presence of China and the impact of the Chinese economy on other countries and regions are growing, there are almost shared interests among the other countries to keep China engaged in the international framework.

An important fact to bear in mind is that as far as the financial diplomacy is concerned, China is increasing aware of the need to take a global strategy and use the renminbi as a tool to exert diplomatic pressure in relation to not only Asian countries but also other global regions including Europe. While Japan saw the special relationship with the US as the cornerstone of financial diplomacy, China has been seeking to leverage their global relationship including Europe to counter the balance against the pressure from the US. China is not likely to follow the same path as Japan in the sense that Japan attached the greater importance on seeking to strengthen the tie with the US and accepting the responsibility to undertake the responsibility in proportion to its increased economic power. For Japan, which has not had as much military and political power in the international regime as China with a seat as a permanent member of the Security Council in the United Nations, strengthening the tie with the US and accepting the responsibility in the G7 framework has been the best and most effective way to increase their presence in its financial diplomacy. As China has been increasing its economic presence, the strengthening tie with the US will be

even more important for Japan, which would maintain its economic presence in financial diplomacy in the international financial regime.

## **Chapter**



## Chapter 4: Conclusion

The Asian Financial Crisis marked the watershed in terms of strengthening a regional financial cooperation. The Crisis raised the awareness among the majority of East Asian countries of the need to create and strengthen regional financial cooperation as a means of securing regional financial stability. This was based on the assumption that Japan would continue to play a leading role in strengthening the regional financial cooperation in Asia. When the proposal of “Asian Monetary Fund” was partly formulated as the “Chiang-Mai Initiative”, Japan took the initiative of establishing a regional mechanism of bilateral swap arrangement. It could be argued that the strengthening of the regional financial cooperation in Asia showed that the Japanese financial diplomacy was increasingly oriented towards Asia.

In fact, the Japanese Ministry of Finance did not seek to take a regional initiative at least from an early stage of the Asian Financial Crisis. As the turmoil of the Asian Financial Crisis was deepening, the Japanese Ministry of Finance attached the greatest importance on how to play the role of moderating the two sides, i.e. the IMF and the Asian countries facing financial difficulty. In fact, the proposal of Asian Monetary Fund was made by the Japanese Ministry of Finance realised that the IMF approach with the so-called “Washington consensus” underpinned by a neo-liberal ideological position, was not appropriate, while the US kept supporting the IMF. For Japan, a series of their attempts to strengthen a regional financial cooperation were a part of their efforts to deal with domestic financial crisis in 1997-1998.

The cooperation with the US has been a cornerstone of the Japanese financial diplomacy. In the Plaza and Louvre Accord era, the time when Japan increased its economic presence in the international economic regime, the financial diplomacy of Japan was driven by how to respond to the political pressure from the US. Then establishing the strong G2 (US and Japan) cooperation was a key element in the Japan’s financial diplomacy. Japan attempted to use the G2 special relationship as the base of its increased influence in the international financial regime within the framework of the G7. This G2 relationship strengthened in the late 1980s

weakened badly in the awkward partnership between the US and Japan under the Clinton administration in the 1990s, where the US regained the confidence with its economic recovery and Japan suffered from a prolonged recession characterised by bad loan problem. The alliance between Japan and the US was strengthened again under the Bush administration partly in response to the need to fight against the terrorism after the 9.11 and the emergence of China as an economic power.

In financial diplomacy, the foreign exchange policy has been at the heart of the US-China relationship. US called on China to increase flexibility of the Chinese currency. China has been increasingly criticized by the US for alleged currency manipulation which they claim that caused China's accumulating trade surplus. In response to these calls, China has taken an incremental approach in its foreign exchange policy. As the economic growth of China has been accelerating and their position in the international political economy has become larger, the relationship between Japan and the US has been gradually shifting from the competing rivals to a sort of alliance against China. Exchange rate policy is one of the key issues on which Japan and the US has taken a coordinated position against China.

From the Chinese perspective, China has been sensitive about at least giving the impression that China was forced to increase the flexibility of their currency. In terms of foreign exchange policy, China's position has been based on the view that free floating exchange rate system could result in exchange rate distortions and are vulnerable to currency crisis and speculative capital flows. The Chinese authorities have considered that an incremental approach rather than a big-bang approach with a radical reform would be more appropriate to achieve the balanced balance of payments as well as avoid the risk of further disputes with trade partners to the extent possible.

The greatest difference between Japan and China is that essentially China does not belong to any international economic framework which would constrain their freedom of economic policy to a significant extent as Japan made great efforts to contribute to the policy coordination in the G7 in the late 1980s. There was no similar incentive in the Chinese authorities to the

one which Japan had in the late 1980s. Rather, China has tacitly chosen the strategy of how China should be seen depending on the policy context. For example, China has been making efforts to make them seen as a developing country rather than the second biggest economy in the world in some policy areas such as climate change and trade negotiation where developing countries are supposed to pay as much price as developed countries.

However, as China's sheer number of GDP is expected to continue to increase at a higher rate than most developed countries, China will be faced with more pressure by other countries to call on them to play a more positive role in at least adjusting their economic policies to the internationally coordinated framework. It seems that China has been seeking to adopt the more selective approach based on the globalization of financial markets. The China's approach to the UK with an indication of their wish to use London as a hub for the Chinese currency's businesses as an international currency seems to have a certain influence on the UK's application of its membership to the AIIB (Asian Infrastructure Investment Bank). The currency policy cannot be decoupled from the globalisation of financial markets. While the regional framework of financial cooperation could be supplementary to the global framework, the forces of globalisation of financial markets are becoming greater and expected to continue to do. Japanese financial diplomacy is expected to be determined more by how they see the Japanese Yen and Chinese Renminbi in the international financial markets than by merely in the Asian financial markets.



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