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55932	SUMMARY	REJAPANESEEXCHANGERATE	2	ND	Bl
55933	ISSUE PAPER	RE JAPANESE EXCHANGE RATE AND JAPANESE FINANCIAL MARKET RESTRICTIONS	17	ND	Bl

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(CONF~~IDENT~~IAL Attachment) CM #319

October 25, 1982

To: Mr. Roger B. Porter

From: Martin S. Feldstein
Marc E. Leland

Attached is a Treasury-CEA paper on issues raised by the value of the Japanese yen and Japan's financial market restrictions.

(CON~~FIDEN~~TIAL Attachment)

The Japanese Yen Exchange Rate and Japanese Financial Market Restrictions

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55932	SUMMARY RE JAPANESE EXCHANGE RATE	2	ND	B1

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Annex 1: JAPANESE LIBERALIZATION MEASURES

Key liberalization measures taken in recent years have been:

1979 - Replaced administered interest rates with market determined rates for most short-term money market instruments.

- Eliminated reserve requirements on free yen deposits.

- Eliminated maturity prohibitions on non-resident purchases on Japanese securities.

- Lifted restrictions on period for conversion on yen proceeds by non-resident borrowings via bonds or syndicated bank lending.

- Non-residents given access to gensaki market.

1980 - Free yen accounts held by foreign official entities exempted from interest rate ceilings.

- Authorized foreign exchange banks allowed to transfer funds from abroad through their inter-office free yen accounts.

- All commercial banks allowed to make impact loans.

- Implemented "Amended Foreign Exchange and Foreign Trade Control Law." This law embodied principle that all foreign transactions were free unless specifically prohibited. Law codified previous liberalization measures, but also permitted residents to hold unlimited foreign currency deposits and removed screening process for impact loans.

1981 - Relaxed ceilings on foreign yen bond issues and syndicated bank yen lending.

1982 - As noted in the text, this year Japan has dropped administrative guidance concerning eligible borrowers of yen loans;

- U.S. Export-Import Bank reached an agreement with the Japanese authorities providing for access to yen loans under Exim guarantee to finance U.S. exports;

- Several U.S. companies have floated bonds in Japan without being subjected to established Japanese standards for unsecured bond issues;

- Japanese securities firms announced that effective in January of 1983, the maximum wait in the queue for foreign yen bond issues in Japan would be cut from one year to one quarter, a AAA rating would automatically qualify a borrower to issue yen bonds in Japan, and the limit of one foreign corporate yen bond issue per quarter would be eliminated;

- As part of its second economic liberalization program, Japan announced that it would pay due consideration to further facilitating foreign borrowers' access to the Japanese financial system.

- In the period ahead, we know Japan is actively considering establishment of an international banking facility including use of the yen and moving away from traditional reliance on collateralized domestic bond issues towards assuring creditworthiness through the bond rating agencies.

Current Japanese attitude toward internationalization of the yen.

Japanese financial authorities appear to have accepted the inevitability of an increased the international role for the yen. To the extent internationalization occurs, however, Japanese authorities wish to see it happen under their eyes.

The authorities main concern regards the implications of internationalization in lessening their control over the Japanese domestic financial apparatus, and in particular the implications for ceilings on deposit rates and financing of the government's large budget deficits.

In general, the Ministry of Finance, and in particular its International Finance Bureau, has been a more active proponent of internationalization than the Bank of Japan.

Annex 2: JAPANESE CAPITAL CONTROLS

Japanese Controls on Outflows

1. Quantative ceilings on foreign access to syndicated bank yen lending and the Japanese bond market.

In addition to subject text discussion, it should be noted that it is expected that there will be four public offerings per month with offerings varying between ¥ 10-20 billion each depending on the creditworthiness of the borrower plus whatever issues MDBs might conduct and three or four private placements of a maximum amount of 45 billion each.

The three U.S. companies that floated yen bond issues in Japan this year are Proctor and Gamble, National Cash Register, and Dow Chemical. No foreign corporate bond issues are planned in the fourth quarter as no foreign companies expressed interest. We have indications that two companies are willing to float yen bond issues but not at the present time.

2. Japanese Bank Participation in foreign currency loans abroad.

The MOF has determined that banks in Japan will be permitted to lend overseas in foreign currencies around $8.5-9 billion in the October 1982-March 1983 period. This is about the same level as in the prior six-month period. This amount is consistent with the sum of individual bank projections. This figure applies to all foreign currency lending done by banks' head offices in Tokyo and their overseas branches; it does not include subsidiaries or short-term loans of less than one year. The primary source of funding for foreign currency lending is Euromarket deposits.

3. Japanese life insurance companies are restraining investments in foreign securities to 10 percent or less of the increase in their assets.

4. Zero Coupon Bonds. Japanese authorities issued administrative guidance early this year to halt resident investments in dollar denominated discount bonds. There had been outflows of $1.2 billion into this instrument in the first two months of 1982. The Japanese argued this was done to close a tax avoidance/evasion loophole. (At the time, the Japanese Diet was considering a proposal, now apparently shelved, to tighten reporting on interest earnings for tax purposes. Capital gains on discounted instruments are not taxable under Japanese law.) Recent reports indicate that investors have sold off over half of their zero coupon bonds to take advantage of capital gains and dollar appreciation and because the apparent shelving of the proposal to tighten interest reporting requirements has reduced the tax angle incentive to hold zero coupon bonds.

Japanese Controls on Inflows

1. Spot position controls on foreign currency assets and liabilities of banks in Japan.

Spot position controls operate to limit increases in the net foreign currency liabilities of banks in Japan, although they do not limit their net foreign asset position in foreign currencies. The basic concern behind the institution of spot position controls was that banks should not be allowed to over-borrow abroad. The main exception to these position controls is the swap lines, largely for foreign banks, which allow banks to swap foreign currency into yen. It is our understanding that the swap lines have been increased by about $1.3 billion this year, to roughly $6.8 billion.

2. Yen borrowing overseas by residents.

The authorities do not generally favor yen borrowing overseas by residents, and in practice such borrowing is generally limited to private placements of the yen bonds with OPEC investors and certain government guaranteed issues. Similarly, foreign currency bond issues abroad with long-term forward yen cover are generally frowned upon because of their similarity to a yen issue. The reason for this attitude appears to be that as a matter of policy Japan prefers that yen transactions take place in Japan. This probably reflects a desire to abe able to monitor the transactions, maintain control over domestic interest rates, and possibly commercial considerations.

3. Foreign currency convertible bond issues abroad by Japanese corporations.

A rush of such issues in the fall of last year caused prices to fall and left underwriters with losses on unsold issues. Some degree of restraint was subsequently imposed.

4. Foreign trade financing.

Deferrred payments for imports and import usance credit require special approval if the maturity involved is over one year. Similarly, advance payments for exports received over one year in advance require special approval. These provisions are holdovers from earlier provisions concerning the standard method of settlement and presumably reflect a desire to monitor Japanese borrowing abroad and to limit the potential for leading and lagging payments and receipts.

5. Foreign investment in Japanese real estate.

Investment in Japanese real estate for speculative purposes is controlled. Such control probably reflects concern about the already high cost of land in Japan and the relative shortage of land.

6. Foreign transactions in call money and commercial discount bills.

These are inter-bank markets, with participation restricted to financial institutions in Japan, including foreign banks in Japan. These markets are not open to non-financial institutions in Japan, nor to banks or non-banks abroad. These are the markets in which the Bank of Japan implements its monetary policy.

7. Direct investment in Japan.

Despite substantial liberalization of direct investment laws and practices, the actual level of foreign direct investment in Japan in 1981 was very small at $189 million. This amount represents only a fraction of net 1981 Japanese direct investment overseas, which amounted to $4.9 billion. Japan has undertaken substantial liberalization of formal controls on direct investment. The Amended Foreign Exchange Law implemented in 1980 permitted all direct investments in Japan in principle. One hundred percent foreign ownership is restricted in only four industries (agriculture, forestry, and fisheries; mining; petroleum; and leather and leather products) and eleven designated firms. Japan's investment screening process was replaced with an investment pre-notification process. Although individual investment notifications continue to be subject to review by individual ministries under the new law, no case of modification or prohibition of an investment proposal has been reported. Also, in May of 1982, the Government of Japan included in its liberalization program an official statement welcoming foreign direct investment in Japan.

The small level of foreign direct investment in Japan may reflect other factors affecting the investment environment such as high entry and fixed operating costs; local licensing procedures; Japanese practices which limit the scope for acquisitions by both Japanese and foreign firms; and the complexity of the distribution system.

In our discussion with the Government of Japan, the U.S. has encouraged Japan to make its pre-investment notification procedure more transparent, either by publicly indicating what factors would cause the government to modify or reject an investment, or to modify the procedure by substituting simple investment registration for notification to the Government of Japan. In addition, we have generally pressed for national treatment for U.S. companies in Japan and solicited concrete Japanese measures to implement its stated policy of welcoming foreign direct investment.