JAPAN-US ECONOMIC RELATIONS - THE INTERNATIONALISATION OF JAPANESE FINANCIAL MARKETS - "DOLLAR-YEN AGREEMENT"

The size of Japan's balance of trade surplus with the US and the EEC, and the relatively low value of the yen in terms of the US dollar have been a point of contention between the US and Japan for some months. According to The Economist 26 May 1984, page 84, the US "...started to put the heat on Japan last autumn after American manufacturers, led by Caterpillar Tractor, complained that the cheap yen was costing them business. They blamed the yen's cheapness in part on Japanese controls on international use of the yen. Foreign banks' grumbles about restrictions on access to Japanese financial markets, and general ideas about the benefits of deregulation also got caught up in the dispute".

The Economist reported that the dispute ended in a draw when in talks in Rome in May "... a list of Japanese concessions" were adopted by US and Japanese representatives. In return, the US agreed to lift its veto on increasing Japan's voting power at the World Bank.

The "final" report referred to by The Economist is published below, the Report by the Working Group of Joint Japan - US Ad Hoc Group on Yen Dollar Exchange Rate, Financial and Capital Market Issues to Japanese Minister of Finance Noboru Takeshita and US Secretary of the Treasury Donald T. Regan, May 1984. The Report was released simultaneously in Washington and Tokyo on 30 May, 1984, and was generally referred to in the financial press as the "Dollar-Yen Agreement". The US Treasury Secretary said it would have far reaching implications for the world economy: The Australian, 31 May 1984, page 13. Describing the agreement as "an historic development", Mr. Regan said it would elevate the yen to its rightful place as a major world currency and provide important new access to Japanese capital markets for European and American financial institutions. The Australian observed:

"From the US perspective, the most important element of the agreement, which was announced simultaneously in Tokyo, was the development of the Euroyen market by creating Euroyen bond and banking markets, which will broaden the range of yen-dominated financial instruments and allow non-Japanese to borrow in yen outside Japan.

"The development of this market is the area most important to the internationalisation of the yen", Mr. Regan said, while acknowledging the effects of the agreement would not be felt immediately, perhaps not until 1986. The main features of the Report, which is in effect an agreement, in relation to the Euroyen bond market are:-

- Foreign corporations, government and government agencies will be able from 1 December, 1984 to issue Euroyen bonds on an unsecured basis: para V.CI
- While the qualifications of foreign issues of Euroyen bonds will be initially limited, these will be broadened from 1 April 1985: para V.CI
- There will be no restriction on the number and size of these issues: para V.C2
- By the end of 1984, foreign and Japanese banks will be authorised to issue outside of Japan short term (6 months or less) negotiable Euroyen Certificates of Deposit: para V.C4.

. Japanese and foreign banks will be free to make Euroyen loans with maturities of one year or less: para V.C5

. However, while Japanese witholding tax will not apply to Euroyen bond issues by non-residents, the tax will apply to issues by residents. The US, and foreign observers (see Euromoney, June 1984) see this as an impediment to the growth of the Euroyen market and a factor which will lead to its segmentation. This is to be the subject of a further study: paras. V.C3; V.AI

. A number of other concessions were made in relation to interest rates, funding and lending, forward exchange and Japanese access to foreign bank accounts: paras: V.A.

. It was anticipated that in 1985 foreign banks would be able to participate to a limited extent in trust banking business: para V.B.2.

. Access by foreign firms to the Tokyo Stock Exchange is to be examined: para V.BI (While the rules now permit foreign membership, "a number of factors, including lack of availability of seats" preclude entry.)

. Both sides affirmed the desirability of providing basically "national treatment" for foreign investors to both existing investment, and most importantly "new entry": para V.D.2

On the U.S. side, the following concessions were made:-

. An indication that unitary taxation should be limited to the US operations of foreign transnationals, the so-called "water's edge" rule. The Report comments that the relevant U.S. report recommending this policy "... will be submitted to the individual states under the United States' federal system, implementation of this agreement will remain the responsibility of the states": para IV.A The reference to the limitations of the US federal system is probably a reference to political rather than legal limitations; otherwise the report would be stating categorically that neither treaty nor federal legislation could constitutionally contain state unitary taxation.

. The US agreed in principle that all banks, US and foreign, should be able to compete in the US market on equal terms. The US government then explains some of the particular regulations applying, and its views thereon: para IV.B (These comments will be of particular interest to Australian and other foreign bankers)

. However the US continued to refuse further contributions above those already agreed to the International Development Association, the IDA, and Japan affirmed that any additional Japanese funding was conditional upon increased US funding.

In addition to the Report, we are also publishing the text of the document "External Economic Measures" 27 April 1984. These measures by the Japanese government involve market opening, import promotion, liberalisation of financial and capital markets, encouragement of investment to and from Japan etc. The comments in para VI, entitled "Foreign Lawyers Activities in Japan" are still inconclusive.

The text of both documents were supplied by the Japanese Embassy, Canberra.

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REPORT
by
the Working Group of
Joint Japan-U.S. Ad Hoc Group on
Yen/Dollar Exchange Rate,
Financial and Capital Market Issues
to
Japanese Minister of Finance Noboru Takeshita
U.S. Secretary of the Treasury Donald T. Regan

THE JAPANESE MINISTRY OF FINANCE
AND
THE UNITED STATES DEPARTMENT OF THE TREASURY
WORKING GROUP ON YEN/DOLLOR EXCHANGE RATE ISSUES

Japanese Ministry of Finance

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Yasutaka Miyamoto, Director General, Banking Bureau
Akira Nishigaki, Director General, Financial Bureau
Kenzo Sakai, Director General, International Finance Bureau
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Table of Contents of the Report
to
Japanese Minister of Finance Takeshita
and
U.S. Secretary of the Treasury Regan
by the
Ministry of Finance-Department of the Treasury Working Group
on Yen/Dollar Exchange Rate Issues

Co-Chaired by Vice Minister Oba and Under Secretary Sprinkel

I. Introduction

On November 10, 1983, Finance Minister Takeshita and Treasury Secretary Regan jointly released an announcement in which they agreed, inter alia, that "open, liberal capital markets and the free movement of capital are important to the operation of an effectively functioning international monetary system."

Minister Takeshita stated in the announcement that the Ministry of Finance would "assure the prompt and thorough implementation, following due procedures, of the measures listed in the "Comprehensive Economic Measures" of October 21, 1983, which would further liberalize Japan's capital markets, internationalize the yen, and allow the yen to more fully reflect its underlying strength." Secretary Regan also announced that the United States would take a number of measures.

The Ministers agreed that further progress was required. Toward that end, they agreed upon the establishment of a joint U.S.-Japan Ad Hoc Group of financial authorities to investigate yen/dollar issues, co-chaired by the Ministers and chaired at the working group level by the respective Under Secretaries. The purposes of the Group were to:

-- monitor U.S. and Japanese progress in implementing the agreed measures, and develop and implement additional

steps; and

-- strengthen mutual understanding and establish a common recognition of the current state of the yen/dollar rate and its determinants.

The Working Group met under the co-chairmanship of Vice Minister of Finance Oba and Under Secretary of the Treasury Sprinkel on six occasions between February and May. The results of these meetings are contained in the following sections of this report.

II. Follow-up to the November Joint Press Announcement

As noted in Section I, the Working Group was mandated, _inter alia_, to "monitor U.S. and Japanese progress in implementing the agreed measures" in the November Joint Press Announcement.

Implementation of these steps by Japan and the United States is outlined below. Those items not specifically covered in other sections of the report are followed by a brief description.

Japan's Measures

1. Real demand rule in forward exchange transactions.
   (See Section V.A. (Other) 1.)

2. Designated company system.
   (See Section V.D.1.)

3. Foreign currency denominated national bonds.

   The Japanese government submitted a bill on March 27, 1984 to provide the legal framework for issuing foreign currency denominated national bonds abroad. The bill was passed by the Diet on May 18, 1984 and entered into force on May 25, 1984.

4. Yen-denominated banker's acceptance market.
   (See Section V.A. (Funding and Lending) 2.)

5. Minimum denomination of domestic yen certificates of deposit.
   (See Section V.A. (Funding and Lending) 1.)

6. Enlargement of the ceiling on domestic yen certificates of deposit.
   (See Section V.A. (Funding and Lending) 1.)

7. Guidelines on the issue of Euroyen bonds by residents.
   (See Section V.C. 1.)

8. Withholding tax on non-residents' interest earnings on investment in Euroyen bonds issued by Japanese residents.
   (See Section V.C. 3.)

U.S. Measures

1. Unitary taxation.
   (See Section IV.A.)

2. Japanese government guaranteed bond issues in the U.S. capital market.

   The Japan Development Bank successfully issued government guaranteed bonds with a currency swap transaction in the U.S. capital market on February

29, 1984, and the Treasury Department welcomes further issues of Japanese government guaranteed bonds in the U.S. capital market.

3. Reduction of the U.S. budget deficit.

The Treasury Department reaffirmed the U.S. commitment to reducing its budget deficit, primarily by cutting government spending. At President Reagan's initiative, efforts to develop a deficit reduction plan that would represent a "downpayment" on the deficit have produced encouraging results. Recent Congressional action has significantly enhanced the prospects that legislation will be passed this year that will have the effect of substantially reducing the U.S. budget deficit.

The U.S. Administration will continue to explore other alternatives that would reduce the deficit. In this connection, it has proposed some longer-term measures to address the problem, including a balanced budget amendment and line-item veto authority for the President.

4. Eighth quota increase of the IMF.

(See Section IV.C.)

5. Seventh replenishment of the International Development Association (IDA VII).

(See Section IV.C.)

III. Yen/Dollar Exchange Rate

A. Developments in the Yen/Dollar Exchange Rate

The Japanese yen reached a low value of 278 yen per dollar in November 1982. By early March 1984 the exchange rate had appreciated to the level of 223 yen per dollar, an appreciation of approximately 25 percent. The bulk of the yen appreciation took place early in the 1982-84 period, with the yen rising sharply between early November 1982 and early January 1983 to the level of approximately 230 yen per dollar. Since then, the yen/dollar rate has been relatively steady, usually within 223 to 246 yen to the dollar, a range of approximately 10 percent. Throughout the period, the yen has been strong against European currencies, reflecting Japan's relatively favorable economic fundamentals.

B. Factors Underlying Yen/Dollar Developments

The Working Group considered a number of factors that have played a role in determining the yen/dollar exchange rate. The factors which have contributed to the strength of the yen include: continued strength in Japan's external performance; excellent inflation performance compared to other countries; solid noninflationary growth prospects; and, in the Treasury Department's view, market perceptions of Japan's commitment to internationalize the yen and liberalize its capital markets. The yen might have appreciated even further during the period against the dollar, had it not been for the general strength of the dollar against all currencies. This strength was also due to a range of factors, including: the U.S. recovery; the sharp improvement in U.S. inflation performance and inflation expectations relative to Japan's more stable inflation performance; improved after-tax rates of return in the United States on capital; and, at times, "safe-haven" considerations, the LDC debt situation and relative interest rate developments.

Attention was focused in the Working Group on the relative importance of interest rates in determining the yen/dollar exchange rate. The Ministry of Finance believed that the major factor explaining a strong dollar was high U.S. interest rates which, in turn, were related to its budget deficit.

The Treasury Department pointed out that close examination demonstrated that, during many periods, exchange rates moved in a direction opposite from that suggested by movements in interest rate differentials.

The Treasury Department also stated that there is no demonstrable connection between budget deficits and interest rates, pointing out that interest rates are significantly influenced by a number of factors, including monetary policy and inflation expectations.

The Working Group expected that comprehensive measures to internationalize the yen and liberalize Japan's capital markets, which are primarily aimed at achieving world economic efficiency and fulfilling Japan's responsibilities as the second largest economy, will lead to a stronger yen.

IV. Japanese Points of Interest

A. Unitary Taxation

The Ministry of Finance expressed concern that the system of worldwide unitary taxation applied in a number of states could impose a heavy financial and administrative burden on foreign subsidiaries in the United States and thus discourage foreign investment in the United States. Consequently, the Ministry of Finance requested the U.S. government to take concrete measures which would lead to the replacement of the worldwide unitary taxation system by another method.

In response to the Ministry of Finance's concern, Secretary Regan stated in the November Joint Press Announcement that the Treasury Department would fully take into account the views of the Japanese authorities in its review of the issues related to unitary taxation. In accordance with that commitment, the Task Force of the Worldwide Unitary Taxation Working Group, which had been established by President Reagan, received and carefully considered the views of many interested parties, including the Government of Japan.

On May 1, 1984, the Worldwide Unitary Taxation Working Group reached a general agreement to recommend a "water's edge" limitation on the worldwide unitary method. The recommendation of the Worldwide Unitary Taxation Working

Group is being submitted shortly for President Reagan's approval; it then will be forwarded to the individual states for their consideration. It was noted that under the United States' federal system, implementation of this agreement will remain the responsibility of the states. However, the Treasury Department is confident that competition among the states for investment will spur them to act quickly on this issue. While the Working Group believed that this approach was generally responsive to Japan's concerns, certain questions remain unanswered.

The Ministry of Finance asked for continued efforts by the United States to resolve the problem.

B. Activities of Japanese Financial Institutions in the United States

Entry Restrictions in Certain States

The Working Group discussed the ability of Japanese and other foreign banks to operate in the United States. It was agreed that all banks, American and foreign, should be able to compete on equal terms. The Treasury Department stated its strong commitment to such a policy of national treatment, which enhances competition, stimulates the development of U.S. capital markets, and can improve U.S. access to foreign sources of capital. Non-American banks are able to enter the U.S. banking market on essentially the same conditions as domestic institutions and are subject to regulations that are similar to or in some cases more favorable than those applied to U.S. banks.

In particular, the Working Group examined the restrictions certain states place on entry of foreign banks. The Treasury Department explained that such restrictions affect the form in which foreign banks operate, but not their ability to do so. Although some states do not permit foreign banks to establish branches, these restrictions do not prevent a foreign bank from operating a subsidiary, which can conduct the full range of banking business.

Approval of Interstate Banking

In discussing the ability of Japanese banks to compete in the United States, the Working Group considered U.S. restrictions on interstate banking, which generally limit banks to establishing full service deposit-taking offices in only one state. The Treasury Department explained that these restrictions are applied equally to U.S. and foreign banks. It was agreed that while these restrictions do not prevent banks, including foreign banks, from doing business with customers throughout the country, they make it more difficult for banks to operate in additional states across the United States.

The Treasury Department noted that many non-American banks, including Japanese banks, have full service deposit-taking offices in more than one state because they were permitted to retain their existing interstate networks under the grandfathering provisions of the International Banking Act of 1978.

The Treasury Department stated that it favors steps to ease or remove restrictions on interstate banking that are outdated in today's financial marketplace; specifically, it supports the regional experimentation provided in Senator Garn's omnibus banking bill as a first step in the process.

Asset Maintenance Requirements

In the Working Group's discussion of national treatment, the Ministry of Finance noted that in some states asset maintenance requirements were imposed on foreign but not American banks and, therefore, were putting a financial burden on foreign banks. The Treasury Department explained that the Federal Deposit Insurance Corporation and certain states required foreign banks' branches and agencies that are subject to their jurisdiction to maintain domestic loans or other assets at a level sufficient to cover their liabilities to U.S. depositors. The Treasury Department noted that subsidiaries of foreign banks which, like U.S. banks, must meet minimum capital standards, are not subject to this requirement and that in some states such requirements are being removed or reduced.

Depository Money Requirements

The Working Group also discussed the depository money requirements imposed by the office of Comptroller of the Currency and by some states on foreign bank branches chartered by them, whereby a deposit equal to a certain

percentage of a branch's external liabilities must be maintained at an independent bank. The Ministry of Finance noted that since such requirements were imposed in states like New York and California, where many foreign banks were active, they imposed a financial burden on foreign banks; consequentry, the Ministry of Finance asked for their early removal. The Treasury Department explained that such requirements are imposed in lieu of separate capitalization of foreign bank branches and agencies and parallel the capital requirements for U.S. banks. The Treasury Department also noted that many countries require branches of foreign banks to maintain reserves or capital locally; for example, Japan requires that a portion of foreign bank branches' profits be retained in Japan as a reserve.

Special Treatment of Foreign Banks' Banker's Acceptances (BAs) and Certificates of Deposit (CDs)

The Ministry of Finance noted that New York State generally prohibits mutual savings banks from purchasing CDs issued by foreign banks and that this and any similar restrictions in other states placed BAs and CDs issued by foreign banks in a disadvantageous position.

The Treasury Department explained that the United States does not restrict or regulate the ability of any bank in the United States, including offices of foreign banks, to issue, sell, trade, or buy banker's acceptances and certificates of deposit, other than by applying the statutory limit on BAs as a percentage of each bank's capital.

However, in a few cases, states restrict or limit the investment that agencies of the state government or banks subject to its regulation can make in BAs or CDs issued by foreign bank branches. The Working Group agreed that such regulations may hamper the sales of foreign banks' CDs.

The Treasury Department noted that an easing of the New York State restriction is proposed in omnibus legislation now before the State legislature, and reaffirmed its support of such deregulation.

C. Cooperation in International Financial Institutions

The Working Group discussed the importance of continued cooperation between Japan and the United States in the international financial institutions. The Working Group agreed that such cooperation is vital to the smooth functioning of those institutions and welcomed the progress outlined below in strengthening key international financial institutions.

International Monetary Fund (IMF)

The Working Group reaffirmed its support for a strong, effective IMF and welcomed recent steps taken to ensure that the Fund has resources adequate to fulfill its responsibilities. The Ministry of Finance welcomed, in particular, the successful efforts of the Treasury Department to secure passage of legislation enabling the United States to participate in the eighth quota increase of the IMF and increase its commitment to the General Arrangements to Borrow (GAB). The Working Group also stressed the importance of preserving and strengthening the monetary character of the IMF, and of assuring that its policies and practices were both supportive of this objective and consistent with the resources available to the IMF. In this connection, the Working Group welcomed the decisions taken in late 1983 by the IMF limiting access to IMF resources to levels compatible with the monetary character and resource base of the Fund.

International Development Association (IDA) Contribution

The Working Group also agreed on the importance of implementing IDA VII as well as the Selective Capital Increase (SCI) of the World Bank. It welcomed the decision to seek a $9 billion increase in IDA funding through IDA VII, and agreed that this could be highly effective if IDA funds are directed to the poorest and least creditworthy countries which lack alternative financing (e.g., Sub-Saharan Africa), and linked to the implementation of appropriate policies by borrowing countries. In this connection, the Ministry of Finance welcomed the progress achieved by the Treasury Department toward securing passage of the legislation necessary to enable the United States to provide its share of IDA VII.

With regard to the proposed additional contribution to IDA, the Ministry of Finance expressed its position that additional funding for IDA should be subject to further consideration, but that Japan would not, in any case, agree to additional funding without U.S. participation. The Treasury Department expressed its view that this additional funding of IDA was inappropriate and infeasible, pointing out that the level of IDA VII was already agreed, that

additional funding would increase the U.S. budget deficit at a time when many other countries, including Japan, are seeking a reduction in the U.S. budget deficit, and that an effort to seek additional funding for IDA at this time could derail current efforts to secure funding for IDA VII as well as the SCI.

D. Foreign Direct Investment and National Security Considerations

The Treasury Department recognized the concerns of the Japanese Government over the transparency of criteria for U.S. Government intervention in foreign direct investments in the United States on national security grounds.

The United States is now reviewing the criteria for government intervention based on national security considerations from the viewpoint of improving transparency and promoting direct investment in the United States. The Treasury Department strongly supports the need for increased transparency in these matters and urges that the U.S. review be completed as soon as possible.

E. Purchase of Japanese Government Bonds by U.S. Monetary Authorities

In the course of the Working Group discussions, the Ministry of Finance suggested that U.S. monetary authorities consider purchasing Japanese Government bonds directly from the Government of Japan for the purpose of strengthening the yen, as well as internationalizing the yen. While the Treasury Department supported, of course, these basic objectives, it explained that U.S. monetary authorities did not have authority to purchase, and could not consider the purchase of, foreign government bonds for such purposes.

V. U.S. Points of Interest

A. Capital Market Liberalization

Introductory Section

The Working Group agreed that the free play of market forces enhances economic efficiency. Allowing supply and demand to determine prices provides the market signal for optimal resource allocation.

It was recognized that Japan's domestic capital market is in the process of steady liberalization, although there still remain some restraints. The tendency toward financial liberalization is inevitable due to the internationalization of the economy as well as continued massive issues of government bonds. In fact, if restrictions on interest rates continue persistently, a shift of funds from regulated interest rate instruments to free interest rate instruments will occur to the detriment of smooth financing, and the international flow of capital, as well as exchange rates, will be affected.

In recognition of the above, the Ministry of Finance has affirmed its intention to liberalize Japanese capital markets spontaneously and positively. This will be accomplished in a step-by-step manner, while building on market forces, to avoid undesirable effects on the stable functioning of the monetary system and eventually on the national economy as a whole. The Treasury Department welcomed the commitment of the Ministry of Finance toward steady liberalization of its capital markets.

Interest Rates

1. Withholding Tax on Earnings by Non-Residents on Japanese Deposits and Securities

The Working Group considered the question of withholding taxes on non-residents' earnings on deposits and securities. As far as the U.S. withholding tax is concerned, the Treasury Department stated that it was making every effort to remove existing U.S. withholding taxes on non-residents' earnings.

The Treasury Department expressed its hope that Japan will reconsider the removal of its withholding tax on earnings by non-residents on Japanese deposits and securities, a major barrier to investment by non-Japanese in the principal Japanese financial instruments for foreign investors, since it has an adverse effect on the yen/dollar rate and the objective of internationalizing the yen. The Ministry of Finance stated, however, that the removal of the withholding tax on these assets within the Japanese domestic market would impair the basic principles of Japan's tax system and that there is no willingness to consider such removal.

2. The Removal of Interest Rate Ceilings on Time Deposits

As part of the Working Group's discussion of the need for liberalization of Japan's domestic financial markets, it considered the effects of interest rates on the allocation of resources, both within Japan and in the rest of the world, including through exchange rates. It was agreed that removal of restrictions on interest rates was central to the overall process of financial liberalization.

The Ministry of Finance affirmed its intention to proceed on the deregulation of interest rates on deposits as expeditiously as circumstances warrant without causing market instability.

The Ministry of Finance outlined an approach initially centered on liberalization of interest rate ceilings on large denomination deposits, then moving to interest rates on smaller deposits.

According to this approach, the Ministry of Finance will seek to:

--lower the minimum denomination of certificates of deposit from ¥300 million to ¥100 million by April 1985;

--enlarge further the ceiling on each bank's CD issues;

--permit banks to sell new types of large denomination deposit instruments with market determined interest rates by April 1985; and

--relax and remove interest rate ceilings on large denomination deposits in 2 to 3 years.

The Ministry of Finance stated it expects that the above steps will put market forces in motion enabling further progress on interest rate deregulation.

3. Change in Short-Term Government Debt Practices

As part of the Working Group's discussions under the heading of the liberalization of Japan's capital markets, the Group discussed the possibility of changing short-term government debt practices. The discussion was from various points of view, such as developing Japanese financial markets and providing both Japanese residents and non-residents with better financial instruments.

The Treasury Department noted that short-term government debt could provide investors with highly safe and liquid investments and potentially be an important element in Japan's money markets.

The Ministry of Finance explained that in Japan, the budget is compiled so that total revenues and total expenditures are equal in each fiscal year. Budget revenues are composed of tax and stamp receipts, proceeds from national bond issue and miscellaneous receipts. Japanese Government short-term securities are issued for the purpose of raising funds which do not comprise budget revenues; in other words, their function is limited to cash management. They are not equivalent to U.S. Treasury bills. The Ministry of Finance noted that the Japanese system of government short-term securities and practices thereof are appropriate and efficient in light of its current

fiscal, financial and treasury systems.

As for the securities to raise funds that comprise the budget revenues, the recent notable pnenomenon in the market is an increasing amount of newly-issued medium-term government bonds and already-issued government bonds of near maturity. There are no restrictions or limitations on the purchase of those bonds by either Japanese-residents or non-residents in the marketplace.

The Ministry of Finance further explained that the large scale maturing of Japanese long-term government bonds and its refunding operation are expected to begin in Japan's fiscal year 1985, which reflect the large-scale issue since fiscal year 1975. To achieve the refunding operation, it will be necessary to diversify the range of government debt instruments in terms of maturity and other characteristics in the years to come.

Under these circumstances, a market in short-term government debt is one of the subjects to be studied. The study shall be done from various points of view including, as well as other considerations discussed above, its effects on Japan's fiscal system and its financial markets, taking into account that the subject is closely related to the fiscal and national treasury systems.

4. Dealing in Japanese Government Securities by Non-Japanese Banks

As part of the Working Group's discussion of Japan's domestic capital market, attention was focused on how to enhance the functioning of the secondary market in Japanese government securities. It was agreed by the Working Group that efficient functioning of the market is a desirable objective.

Toward that end, the Ministry of Finance has already announced that as of June 1, 1984 qualified Japanese banks will be able to buy and sell government securities in the secondary market. The Ministry of Finance intends to allow qualified Japanese branches of non-Japanese banks to trade government securities, and interested non-Japanese banks have begun informal discussions with the Ministry of Finance with a view toward completing their preparatory work which is expected within the next few months. It is therefore anticipated that non-Japanese banks qualified in the business of government securities dealing will be notified within the next few months that the Ministry of Finance will accept formal applications for licences to deal in government securities, and that those banks will be able to start dealing in Japanese government securities shortly thereafter. It was understood that in considering whether a non-Japanese bank is qualified to deal in Japanese

government securities, experience in trading government securities in the bank's home market would be taken into account, and that membership in the Japanese government bond underwriting syndicate would be a factor but not a prerequisite.

Funding and Lending

1. Domestic Certificates of Deposit (CDs)

In discussing the liberalization of Japan's capital and money markets and the deregulation of interest rates, the Working Group agreed on the importance of yen certificates of deposit (CDs) in providing a short-term, market-rate instrument for investors and a flexible source of funds for banks.

Following the Joint Press Announcement in November 1983, the Ministry of Finance, taking necessary procedures, has liberalized the restrictions on CDs as follows:

-- lowering the minimum denomination of CDs to 300 million yen from 500 million yen, effective January 1, 1984; and

-- enlarging the ceiling on each bank's CD issues, effective April 1, 1984. For a domestic bank, the ceiling is enlarged from 75% to 100% of its net worth with quarterly increases of 5%. For a foreign bank, the ceiling has been enlarged from 30% to 50% of its yen-denominated assets, with the enlargement of the minimum guarantee from 5 billion yen to 8 billion yen.

The Ministry of Finance affirmed its intention to ease further the restrictions on domestic CDs in a step-by-step manner, both now and in the future, since it is considered

to be an effective and practical approach toward the liberalization of interest rates on deposits.

With this in mind, the Ministry of Finance will seek not only to lower the minimum denomination and to enlarge the ceiling further, as elaborated in the points and text of the item "The removal of interest rate ceilings on time deposits", but also to shorten the minimum maturity from 3 months to 1 month by April 1985.

It was noted that the outstanding amount of domestic CDs at the end of March 1984 was 6.5 trillion yen which was 4 times as large as that at the end of March 1980. Moreover, the secondary market of CDs, where nearly 10 trillion yen of CDs are traded per month recently, has expanded rapidly.

2. <u>The Establishment of a Yen-Denominated Banker's Acceptance (BA) Market</u>

The November Joint Press Announcement of Minister Takeshita and Secretary Regan announced the decision to expedite the study concerning the establishment of a yen-denominated banker's acceptance market. As part of the Working Group's discussion of the need for liberalization of Japan's domestic financial market, it was agreed that the creation of a yen-denominated BA market was instrumental to the further development of Japanese short-term money markets and to the internationalization of the yen.

The study of this issue, which has been undertaken by the Financial System Research Council, is expected to be completed by early June 1984. Upon receiving the report by the Council and referring to the discussion at the Study Group of International Finance, the Ministry of Finance will establish a concrete scheme by the end of 1984 for the creation of a yen-denominated BA market. It is expected that the market will become operative shortly thereafter.

3. <u>Swap Limitations and Brokerage Requirements in the Bill Discount Market</u>

(a) <u>Swap Limitations</u>

As part of the Working Group discussion of the liberalization of Japan's capital market, the Working Group considered the importance of effective foreign exchange swap markets, operating free from administrative controls, in providing banks with a readily available source of short-term funds. With a view to facilitating international capital flows, the Ministry of Finance announced that effective June 1, 1984, the limits on oversold spot foreign exchange positions, so-called swap limits on the conversion of foreign currency into yen, will be removed for branches of foreign banks, as well as for Japanese banks.

(b) <u>Brokerage Requirements in the Bill Discount Market</u>

The Working Group also discussed the operation of the bill discount market and the role of brokers in that market. It was agreed that the choice between transactions through brokers and direct transactions should be made by the participants themselves.

The Bank of Japan, which conducts market operations, informed the Ministry of Finance that it did not restrict or guide direct transactions and that interest rates in the market were determined among market participants. The Bank wished to express the view that brokers perform a useful service in the market because they can enable the Bank to grasp more accurately market conditions, such as the volume of transactions and prevailing interest rates, and to conduct appropriate market operations.

The Ministry of Finance confirmed that there exist no brokerage requirements in the bill discount market.

4. Nonprudential Limits, including Restrictions on Syndication Management, on Japanese and Non-Japanese Bank Participation in Overseas Yen Lending from Japan

In order to further the development of Japan's financial market and the internationalization of the yen, the Ministry of Finance decided to liberalize, by abolishing nonprudential limits, overseas yen lending from Japan by Japanese and non-Japanese banks, effective April, 1984.

Specifically, no prior consultation will be required, and syndication management and participation will be left to the judgement of market participants. Characteristics of overseas yen lending from Japan are set forth in Appendix 1. In the case of a syndicated loan, only the agent bank will be required to submit a notification to the authorities.

Other

1. Real Demand Rule in Forward Exchange Transactions

In order to develop further Japan's foreign exchange market and to support internationalization of the yen, the Ministry of Finance stated in the November Joint Press Announcement its intent to eliminate the real demand rule of residents' forward exchange transactions effective April 1,1984.

On that date, the Ministry of Finance completely abolished the real demand rule in forward exchange transactions. It confirmed that there are now no regulations, requirements, or restrictions on the usage of this market and specifically that any resident can engage in forward exchange transactions for any purpose, including investment, without limitation on amount, provided that residents must conduct transactions through authorized banks.

2. Accounts in Financial Institutions Abroad by Japanese Residents

The Working Group discussed the question of permitting Japanese residents to have accounts at financial institutions located outside of Japan as a means of improving the access of Japanese residents to foreign capital markets.

The Ministry of Finance explained that Japanese financial institutions were allowed to have bank accounts abroad and that it would authorize other residents, on a case-by-case basis, to have bank accounts in connection with overseas business activities. In addition, foreign subsidiaries of corporations are free to have accounts with banks abroad. However, Japanese residents are not authorized to have bank accounts abroad for investment purposes.

The Ministry of Finance also explained that since a license system has been adopted for securities trading, Japanese law prohibited non-licensed foreign securities firms from trading investment securities with Japanese residents except with financial institutions, and that the rationale for the license system is to protect the interests of Japanese resident investors.

The Treasury Department and Ministry of Finance agreed that protection of individual investors was an important consideration.

The Treasury Department expressed the view that preventing Japanese residents from doing business with banks and securities firms abroad restricted their choice in terms of types of accounts and securities as well as different kinds of services and fee structures.

The Ministry of Finance stated that it was not necessary for residents to have accounts at securities firms abroad because they are free to have access to foreign securities via securities firms in Japan including licensed branches of foreign securities firms.

The Ministry of Finance pointed out that qualified foreign securities firms can get approval to open branches in Japan; if they wish to deal with Japanese residents they should proceed in this way.

B. Access of Foreign Institutions to Japanese Money and Capital Markets

Introductory Section

The Working Group considered the question of the entry and operation of foreign financial institutions in Japan. It was agreed that from the perspective of enhancing the efficiency of Japan's capital markets and assuring national treatment of foreign financial institutions, it is important to ensure that these institutions be accorded the opportunity to participate fully in Japan's domestic financial system.

With respect to the question of national treatment, it was agreed that this means that foreign financial institutions be afforded equal competitive opportunity with domestic firms. Both sides reiterated their respective commitments to the principle of national treatment. In this connection, both sides expressed their intent to assure national treatment in existing and newly emerging financial business areas.

The Working Group also discussed the problem of transparency and the need for greater transparency in Japan's policies toward entry and operation in the Japanese capital market in order to provide these firms with equal effective opportunity. The Working Group agreed that progress had been made in this area, and the Ministry of Finance affirmed its commitment to further progress. To this end, the Ministry of Finance indicated that clear, straightforward guidelines, statements, or rule interpretations will be made available in writing as appropriate so that both domestic and non-Japanese firms would be operating in a competitive environment.

It should be clearly recognized that each country's financial system and practices are the product of historical developments and that institutional and other differences exist in these frameworks. Active efforts should be continued, therefore, to deepen understanding of each other's situation and to try to facilitate free and active intercourse of financial institutions.

1. Membership of Foreign Securities Firms in the Tokyo Stock Exchange

The Working Group considered the issue of non-Japanese membership of the Tokyo Stock Exchange. It was noted that such membership was desirable in the light of national treatment and to enhance competition in the securities industry. The Ministry of Finance noted that the rules of the Tokyo Stock Exchange had been amended two years ago to permit non-Japanese securities firms to become members. The Treasury Department agreed that this change was an important step toward providing national treatment but added that a variety of factors, including the lack of availability of seats, actually prevent non-Japanese securities firms from becoming members, thus precluding equal competitive opportunity in this area.

The Ministry of Finance pointed out that the Tokyo Stock Exchange was an autonomous membership organization, and that the government was not in a position to determine the terms and price of membership. Concerning the point that a seat is not actually available to the foreign firms at present, the Minister of Finance has requested the Tokyo Stock Exchange, the autonomous membership organization, to

study ways of providing opportunities of membership to foreign a d domestic non-member firms, including the revision of the existing system. In the meantime, the Ministry of Finance is prepared to assist non-Japanese securities firms in efforts to join the Tokyo Stock Exchange under the existing system.

2. The Management of Investment Funds in Japan by Foreign Firms

With a view to assuring national treatment to foreign banks in the trust banking business, the Ministry of Finance announced its new policy to license qualified foreign banks to participate in the same range of trust banking activities as is performed by Japanese trust banks. Such participation could include partnership with Japanese trust banks, but would exclude partnership with non-licensed firms. This would not exclude the establishment of service and advisory relationships for the conduct of trust banking business. The precise form of such participation and the criteria for selecting qualified banks will be part of a concrete scheme to be announced by the end of 1984.

The Working Group agreed that this represents a major development in the policy administering the trust banking in Japan. In establishing the scheme the Ministry of Finance will give due regard to the sound development of trust business in Japan.

It is anticipated that foreign banks will be able to enter the trust banking business in 1985.

3. Transparency

It was agreed by the Working Group that a central element in facilitating both the access of non-Japanese financial institutions to and their operations in the Japanese capital market is the transparency with which the regulations and policies governing the activities of these institutions are carried out. It was recognized that such transparency is important to non-Japanese participation in Japan's capital markets and to place foreign institutions on a more equal footing with Japanese institutions. It was also recognized that it is important for non-Japanese financial institutions to make their best effort to deepen their understanding of the Japanese market and to abide by Japanese laws and regulations. The Ministry of Finance expressed its commitment to continuing to promote transparency in the execution of its policies on entry and operation of foreign branches in Japan's capital markets and to continuing to assure that the application process is as expeditious as possible.

This commitment has been reflected in a number of recent actions taken by the Ministry of Finance. It was noted, for example, that the Ministry of Finance has issued written guidelines, effective April 1, 1984, on domestic trading of foreign currency denominated certificates of deposit and commercial paper. Important policy changes announced elsewhere in the Report will also result in a

transparent operating environment for non-Japanese institutions in Japan. These include the decision by the Ministry of Finance to eliminate completely swap limits on the conversion of foreign currency into yen as of June 1, 1984, to liberalize policies governing overseas yen lending, and to clarify the policy on brokerage requirements in the bill discount market.

C. Development of a Euroyen Investment and Banking Market

Introductory Section

As noted above in Section I, the Working Group was mandated to "develop and implement additional steps" toward internationalization of the yen and liberalization of Japan's financial and capital markets. The Working Group agreed that it is fitting for the yen to play a role in international financial transactions that reflects Japan's importance as a great trading and financial world power. It was recognized that steps should be taken for the yen to assume its proper role in international financial markets, so as to reflect more fully its underlying strength.

The yen's internationalizaton will basically proceed as a natural evolution through the choices of market participants. Thus, what is needed are policy initiatives to remove a barrier and to provide an environment enabling market participants to select the yen whenever they wish.

More concretely, the yen's internationalization calls for the liberalization of Japan's domestic financial and capital markets as well as permitting the use of the yen in the Euro market. An important consideration for Japan is to maintain its sound economic fundamentals and confidence in its currency.

Allowing markets in yen-denominated financial instruments to develop will result in a more efficient use of scarce capital resources, not only in Japan but internationally as well. Given the increasing international integration of capital markets, restrictions or limitations in one market can quickly lead to distortions in others. Development of the Euroyen market presents an effective means of pursuing liberalization since the Euro market already has established financial, legal and tax pratices followed by Japanese borrowers in other sectors of the Euro markets.

The Treasury Department believes that the establishment of a completely free Euroyen market is the cornerstone of progress toward the internationalization of the yen, and therefore that Japan should approach the yen's internationalization from the Euroyen market.

The Ministry of Finance believes that a too rapid establishment of a free Euroyen market may have adverse effects on Japanese fiscal and monetary policies, exchange rates, and Japan's domestic financial systems;
and also that there is no consensus on whether the Euro market should play the major role in internationalizing one's currency.

the role of the Euro market in internationalizing the yen. Both governments, however, showed an interest in the development of a Euroyen market in the context of internationalizing the yen. The Working Group agreed that the development of a Euroyen market would represent a significant contribution to the Japanese and world economies.

The Ministry of Finance has taken and will take various policy measures to help develop the Euroyen market. In addition, the Ministry of Finance announced that Minister Takeshita would ask the Committee on Foreign Exchange and Other Transactions (hereafter referred to as the Advisory Committee) on May 28, 1984 to review the overall policy measures on the yen's internationalization and to recommend within one year appropriate liberalization in specific areas in the Euroyen market.

1. Euroyen Bond Market

The Working Group agreed that the development of a Euroyen bond market was one of the important factors for the internationalization of the yen.

Euroyen Issues by Non-Japanese Residents

The Ministry of Finance decided that effective December 1, 1984 non-Japanese private corporations, state and local governments and government agencies, as well as national governments and international organizations, will be authorized to issue bonds in the Euroyen market. Issues will be on an unsecured basis.

Qualification standards initially will be those applied in the Samurai market, under which public entities with a rating of A or better, or private corporations with the same rating and meeting the financial criteria for the Samurai market, can use the Euroyen market.

It is noted that there will be relaxation on the scope of non-resident issuers to be operative from April 1, 1985, which will have the effect of qualifying corporations with a credit rating of AA or better as well as a reasonable portion of the universe of world corporations whose outstanding debt would be rated A.

The Ministry of Finance noted that if in the future such qualification standards could be replaced by credit ratings by leading credit rating agencies of the two countries, it will consider moving toward using such a credit rating system.

There will be no restrictions on the number or size of issues in the Euroyen bond market by non-residents. Prior use of the Samurai market is not a pre-requisite.

Euroyen Issues by Japanese Residents

A number of steps have been taken to liberalize Euroyen bond issues by Japanese residents. In the Joint Press Announcement issued by Minister Takeshita and Secretary Regan on November 10, 1983, it was announced that guidelines on the issue of Euroyen bonds by Japanese residents would be eased effective April 1, 1984. These guidelines have in fact been eased.

As a result of this liberalization, approximately 30 Japanese firms became eligible to issue straight Euroyen bonds, and approximately 100 Japanese firms became eligible to issue convertible Euroyen bonds. (These firms account for 70 to 80 percent of the amount of issuance of straight bonds and 40 to 60 percent of convertible bonds in the domestic market.) There are no limits on the size of individual issues, or on the total number of issues.

In order to help protect the integrity of the domestic bond market, which generally operates on a secured basis, and because of disclosure requirements, the reflow into Japan of Euroyen bond issues by Japanese residents will not be allowed for a period of 180 days after issuance. Japanese withholding tax will apply to interest payments on these issues.

Other Matters

Naturally, it is expected that the issues of Euroyen bonds, whether by Japanese residents or non-residents, will follow the general characteristics in the Euro bond market. (See Appendix 2 for the characteristics of the market.)

In addition, the Ministry of Finance announced that both Japanese residents and non-Japanese residents would be able without limitation to swap non-yen bond issues into yen using either the forward exchange markets or currency swap techniques.

The Ministry of Finance will ask the Advisory Committee to make a recommendation concerning the further liberalization of Euroyen bond issues by residents or non-residents within one year.

2. Lead and Co-Lead Management

In accordance with the agreed objective of developing the Euroyen bond market, and in order for non-Japanese firms engaged in the business of underwriting securities to participate fully in that market, the Ministry of Finance announced that:

1) Effective December 1, 1984 there will be no guidance, restrictions or requirements on lead managers of Euroyen bond issues by Japanese residents or non-residents. After that, all firms (as defined above), Japanese and non-Japanese, will be able to engage in these activities and compete on an equal basis, and it will not be necessary to have a branch or representative office in Japan.

2) There is no guidance, restrictions, or requirements on the choice of co-lead managers or on the composition of the underwriting or selling groups for Euroyen issues by Japanese residents or non-residents. And there are no regulations on the distribution or allocation of such issues; however, such securities may not be sold to Japanese residents for 180 days after issuance.

In addition, the Ministry of Finance confirmed that there are no restrictions, requirements, or guidance on the choice of lead or co-lead managers or on the composition of underwriting or selling groups for non-yen Eurobonds issued by Japanese residents, and that there are no restrictions, regulations, or requirements on the choice of lead or co-lead managers, on the composition of underwriting or selling groups and on the distribution or allocation of bond issues in the Samurai market, except that managers must be licensed to do securities business in Japan.

Foreign securities firms not licensed to do business in Japan, would, of course, be permitted to sell such issues only to their customers outside of Japan.

3. Withholding Tax on Earnings by Non-Residents on Investment in Euroyen Bonds Issued by Japanese Residents

With regard to the withholding tax on interest earnings by non-residents on Euroyen bonds, the Working Group agreed that the widespread availability of attractive yen-denominated bonds free of withholding tax would be significant for the continued development of the Euroyen market. The Treasury Department noted that the application of withholding tax on Euroyen issues by Japanese residents, while issues by non-residents have no withholding tax, will lead to segmentation in the Euroyen market.

The Ministry of Finance expressed the view that the evaluation of the impact of removal of withholding tax upon the total tax system and capital markets should take into account the characteristics of the basic structure of the withholding tax system applied to the Japanese domestic market and expressed concern that the removal of withholding tax on Euroyen issues by Japanese residents could undermine the integrity of Japan's tax system.

Accordingly, the Working Group agreed to expedite a study between Japanese and U.S. tax and financial officials with the aim of finding an appropriate solution. In so doing, due regard shall be paid to:

(1) the internationalization of the yen;

(2) the sound development of domestic and international capital markets;

(3) securing tax equality; and

(4) the maintenance of the well developed withholding tax system.

It is anticipated that a report based upon this study is to be made to the Minister of Finance and the Secretary of the Treasury by the end of this year. If any recommendation requiring legislation is made, best efforts will be exercised to take the necessary legislative procedures in the earliest Diet session, on the condition that the necessary requirements, including the examination by the Tax Council and other concerned institutions, are fulfilled.

4. Euroyen Negotiable Certificate of Deposit (CD) Market

In its discussion of the development of the Euroyen market, the Working Group agreed that the creation of a market in negotiable certificates of deposit was instrumental to the development of the Euroyen market.

Toward that end, the Ministry of Finance decided that foreign and Japanese banks will be authorized by the end of 1984 to issue from their offices outside of Japan short-term (6 months or less) negotiable Euroyen CDs sold outside of Japan.

It will not be necessary for a bank to have a branch or representative office in Japan in order to participate in this market, either as issuer or purchaser of such CDs.

Except for the restrictions on sale to Japanese residents and on maturity, the issuance, trading, and purchase of negotiable Euroyen CDs will not be restricted or regulated by the Japanese authorities. (See Appendix 3 for the characteristics of the Euroyen CD market.)

5. Syndicated Euroyen Lending

The Working Group agreed that another important element in the development of the Euroyen market and internationalization of the yen is to permit syndicated Euroyen lending.

Since June 1983, Japanese and non-Japanese banks have been free to extend Euroyen loans with maturities of one year or less to non-residents. The Ministry of Finance announced that effective June 1, 1984 Japanese and non-Japanese banks, for the time being, would be free to make Euroyen loans with maturities of one year or less to Japanese residents.

The Ministry of Finance also will ask the Advisory Committee for a recommendation concerning liberalization of Euroyen lending with a maturity in excess of one year. (See Appendix 4 for the characteristics of the market.)

D. Direct Investment

Introductory Section

The Working Group discussed the role of foreign direct investment in promoting the efficient allocation of resources internationally. It agreed that the international flow of inward and outward direct investment would help vitalize the economic activities of both the United States and Japan. In this context, the Working Group recognized that it was desirable to eliminate barriers, impediments and policies that interfered with the free international flow of direct investment.

1. Designated Company Rule

In the November Joint Press Announcement, the Ministry of Finance announced its decision to submit a bill to the Diet to reform the designated company system. Following this decision, and after completing the necessary procedures, including the consultation with the Advisory Committee, the Government of Japan submitted, on March 27, 1984, a bill to eliminate that system.

The Ministry of Finance indicated that the bill was passed by the Diet on May 18, 1984 and will enter into force within a few months. The Treasury Department acknowledged the efforts made by the Ministry of Finance and agreed that this legislation is a significant additional step in Japan's progress towards liberalizing investment policy.

In addition, the Ministry of Finance explained that the Government of Japan decided to take further measures to promote foreign direct investment in Japan as part of the "External Economic Measures" announced on April 27, 1984. These measures include, among others, improving the information dissemination system, strengthening the Office of Trade Ombudsman system, and improving the notification procedure for foreign direct investment.

2. National Treatment

Both sides reaffirmed the desirability of providing basically national treatment for foreign investors with respect to both existing investment and new entry. In particular, the policy of the Ministry of Finance on the treatment of foreign financial institutions is clearly described in Section V-B above.

The Ministry of Finance supports further efforts to promote direct investment, and noted the importance of translating this, through discussion including the Investment Committee of the U.S.-Japan Economic Sub-Cabinet Consultations, into specific measures producing further progress in this field.

VI. Conclusion

The Ministry of Finance and the Treasury Department agreed that the Working Group has provided the framework for a useful exchange of views between both countries' financial authorities. In addition, the Ministry of Finance and the Treasury Department believe that the commitments by both governments outlined in this report will have important positive effects on the functioning of the international financial system and on the world economy.

Both sides expressed the expectation that the measures agreed and follow-up steps to liberalize the Japanese capital market, to internationalize the yen, and to improve access by foreign financial firms to the Japanese capital market will help enable the yen to reflect more fully its underlying strength and Japan's importance as a great trading and financial world power, and will significantly improve the efficiency of the Japanese and world capital markets.

The Working Group was of the view that the commitments announced by the Treasury Department in the report, including follow-up steps, represent important efforts on the part of the U.S. to respond to Japanese concerns and will contribute to a stronger world economy.

In addition, the Working Group agreed that the report contains important reaffirmations by both sides to implement the principle of national treatment with respect to financial institutions.

The Working Group concluded that its meetings had enhanced mutual understanding between both countries and strengthened their economic and financial ties, and that their joint efforts would lead to a stronger and more open world economy.