

# Sequencing of Capital Account Liberalization – Japan's experiences and their implications to China–

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## Abstract

This paper reviews Japan's experiences with the liberalization of capital accounts, and tries to identify their implications to China.

Liberalization of capital accounts proceeded very gradually in Japan from the adoption of a system of general prohibition of foreign exchange and capital transactions in 1949 through the shift to a generally liberalized system in 1979. Meantime, Japan was exposed to the turbulent international financial markets due to the move from a peg to a float system of its currency and two oil crises. In response to the massive short-term capital flow in and out of the country caused by these shocks, Japan, which was generally headed for the liberalization of the capital accounts, was frequently forced to resort to foreign exchange and capital control measures to stabilize the market.

These experiences by Japan seems to give valuable implications to China, for which significant enhancement of the flexibility of its exchange rate movement under the recently revised formal exchange rate regime and the liberalization of capital accounts continue to be important policy agenda in the years to come.

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## I. Introduction

This paper reviews Japan's experiences with the liberalization of capital account transactions, and tries to identify their implications to China<sup>1</sup>.

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<sup>1</sup> This paper is based on a paper presented to a joint workshop held by the Chinese Academy of Social Sciences (CASS) and Policy Research Institute (PRI) of Japan's Ministry of Finance on May 21, 2004 in Beijing. The author is thankful to the comments given to the early version of the paper from MR. Kenji Matsuyama, Mr. Yasuto Suzuki, Mr. Yoshimochi Kuwata, and Mr. Hajimu Yamashita and also to the assistance extended by the PRI, particularly by Mr. Tomoyuki Ota, and the Japan Bank for International Cooperation Institute (JBICI), to which the author then belonged. The views expressed in this paper are solely those of the author's, and do not reflect the views of any organization to which he belonged in the past.

While the countries that were most severely affected by the Asian currency crisis had relatively liberal capital accounts, those with strictly regulated capital accounts, such as China and Vietnam, managed to escape direct impacts of the crisis. In view of this fact, it was argued that hasty liberalization of capital accounts might have played an important role in the outbreak of the crisis. And through subsequent examinations of this issue, the international community gradually formulated a consensus that rapid and unprepared liberalization of capital accounts carries a great risk, and that appropriate sequencing of liberalization is of vital importance. However, views have not converged yet, as to specifically in what steps a country, particularly a developing country, should proceed with the liberalization of capital accounts.

Until quite recently, China had maintained an exchange rate regime of de-facto peg to the US dollar under the strictly regulated capital accounts. However, with the continued high economic growth coupled with a huge external surplus and an accumulation of large foreign reserves, it is widely argued that China should reform its exchange rate regime and enhance the flexibility of the RMB movements. Against this background, the Chinese government had been examining possible revisions to the regime and on July 21, 2005, it announced that China's exchange rate regime would move to a managed floating system based on market supply and demand with reference to a basket of currencies under which the rate would be allowed to float within a band of 0.3 % (i.e., same as before) around the central parity to be announced daily by the People's Bank of China and that the RMB rate vis-a-vis US dollar would be adjusted to 8.11 RMB per dollar (i.e., about 2% revaluation). However, the RMB exchange rate has shown very limited movements since then, and it appears that there is in practice little change to the de facto peg system of the RMB so far<sup>2</sup>. On the other hand, on the capital account front, China had been partially relaxing its strict capital account regulations so as to alleviate the upward pressure on its currency and contain the sharp increase in its foreign reserves, and gradually putting into practice such reforms that would allow enhanced inward and outward cross boarder capital flows including portfolio securities investment. However, prior to the recent revision to the exchange rate regime, regulations on external borrowings by foreign owned enterprise was tightened as from April 2005<sup>3</sup>, showing a policy development opposite to the relaxation oriented general policy stance in the previous years. This particular development may have been due to concerns about possible impacts on short-term capital flows of the revision of exchange rate regime under consideration at that time under the persistent expectation for the RMB revaluation in the market. But this episode suggests that, while it seems unlikely that China has already developed a grand design on how to proceed with the liberalization of capital

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<sup>2</sup> It is rather difficult to foresee how the RMB exchange rate will move in the periods to come as the rate developments will be crucially dependent on how the Chinese government will administer the new system, taking into account such factors as cross border capital flows under the new regime, domestic economic developments and internal and external economic and political environments. In essence, that is a political decision.

<sup>3</sup> It is reported in the media that the Chinese government is examining some relaxation of the tightened regulation enforced from April 2005 (Nihon Keizai Shinbun, September 2, 2005)

accounts as a whole, it is quite possible that China's path for capital account liberalization in the coming years may be accompanied by frequent policy reversals, reflecting the developments in economic and political environments over time.

Against such background, this paper aims to identify relevant implications for China so as to help it to cope with this complex issue as smoothly as possible, by reviewing the process Japan followed in the liberalization of its capital accounts, with a focus on the period from the 1960s, when Japan started substantively liberalizing its foreign exchange management and capital controls, to the 1970s, when the yen moved from a peg system to a float system following the so-called "Nixon Shock."

The paper is structured as follows. Chapter 1, as an introductory part of the paper, reiterates the lessons learned from the Asian crisis, and briefly explains some important findings by the studies conducted by the IMF on the liberalization of capital accounts. Chapter 2 describes Japan's experiences mainly in the 1960s and 1970s in three parts; first, the treatment of capital accounts in the sequencing of liberalization of Japan's economy as a whole; second, the order of liberalization of capital accounts by type of capital transaction; and third, use of foreign-exchange management and capital control measures to regulate short-term capital flows during the period of instability in international financial market. Lastly, Chapter 3 discusses China's current capital account regulations and the implications of Japan's experiences to China.

## II. The Lessons Learned from the Asian Crisis, and Some Findings by the Studies Conducted by the IMF on the Liberalization of Capital Accounts

### II.1. *Lessons from the Asian Crisis Regarding Capital Account Liberalization*

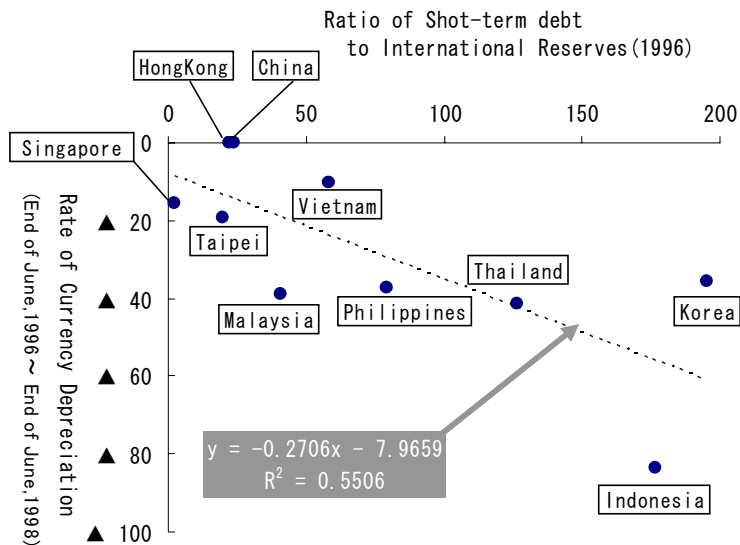
Among the most important lessons learned from the Asian crisis is the huge risk posed by unstable movements of short-term capital. Figure 1 shows the relationship between two figures for 10 Asian economies, including 5 crisis-hit economies. The first figure on the horizontal axis is the ratio of short-term debt to international reserves as of 1996, and the second figure on the vertical axis is the rate of currency depreciation in one year period from end-June 1997 to end-June 1998. It is clearly shown that there is a negative relationship between these two figures, that is, the greater a country's short-term debt relative to its international reserves, the more severely the currency depreciated, indicating the risk of short-term debt<sup>4</sup>.

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<sup>4</sup> Under one new line of argument on the mechanisms of currency crises, called the "balance sheet approach", a country's resilience to various shocks, including financial ones, is considered to depend greatly on the structure of its assets and liabilities, particularly on the structure of foreign liquid assets and liabilities of the country (or that of each of its sectors, including the financial, public, and corporate sectors). The line of thoughts that treats the ratio of short-term debt to foreign reserves as a proxy indicator of vulnerability to external shocks shares a common understanding of the cause of the crisis with the balance-sheet approach.

Since the outbreak of the Asian crisis, Japanese government pointed out the important role played by the instability of short-term capital flows and insisted that hasty liberalization of capital accounts should be avoided and that capital controls may be required under the crisis situation. Initially, there was not much international support for this view, but through a series of turmoil in the international markets which followed the Asian crisis including the Russian crisis in the summer of 1998, the near-collapse of a major US-based hedge fund, called the Long-term Capital Management, and a massive capital outflow from Latin America, the view gradually gained wider international supports. In June 1999, the G7 Finance Ministers' meeting agreed on a report entitled "Strengthening the International Financial Architecture." The report stated that huge risk is involved in excessive debts, particularly foreign currency denominated debts; that it is necessary to proceed with the liberalization of capital accounts carefully and in an orderly manner; that controls on capital inflow may be justified in a transitory period until the domestic financial system is strengthened; and that control on capital outflow may be justified under exceptional circumstances. These are substantially different from the previously internationally dominant view which supported free movements of capital.

Figure 1 Short-term Debt / International Reserves and Currency Depreciation



Note) Short-Term debt for Vietnam excludes interests arrears  
 Source) World Bank "Global Development Finance", ADB "Key Indicators 2001"

## II.2. *Studies by the IMF*

The IMF and the US, which strongly supported the IMF, insisted that the Asian crisis was caused by structural problems in the crisis countries including vulnerable financial sectors and argued that structural reform was essential for overcoming the crisis. As the crisis spread and deepened and criticism of the IMF's prescriptions mounted, the IMF gradually changed its views and came to emphasize the role of overly hasty capital account liberalization in causing the crisis. This section first describes the IMF's traditional stance toward capital account liberalization and its recent change and then explains major conclusions reached by recent research work in the IMF on the sequencing of capital account liberalization.

### II.2.1. *The IMF Articles of Agreement and Capital Account Liberalization*

The IMF Articles of Agreement generally prohibit member countries from placing restrictions on payments for trade and other current transactions, but this prohibition does not apply to transactions whose purpose is the movement of capital. Article 6, Para. 3 of the IMF Articles of Agreement states: "Members may exercise such controls as are necessary to regulate international capital movements..."

Under such basic framework, the IMF did not (and could not) formally promote liberalization of capital accounts through such actions as indicating members a general guidance on the liberalization of capital accounts, but it rather took a reserved approach to express its views on a case by case basis, on such occasions as Article 4 consultations. Furthermore, as for the developed countries, not the IMF but the OECD through its capital liberalization code acted as a driving force for the liberalization of capital accounts. With regard to developing countries, however, although it is claimed that the IMF took such a case-by-case approach, the IMF appears to have basically taken a positive attitude toward liberalization of capital accounts by welcoming measures by developing countries to liberalize regulations on capital accounts and discouraging strengthened regulations. For example, some IMF occasional papers point out that the IMF regarded a combination of fiscal, financial, and exchange-rate measures as an appropriate response to a massive inflow of capital, and generally discouraged strengthening of regulations on the movement of capital, and that the IMF showed a general distaste for the re-introduction of capital controls to cope with balance of payments deterioration<sup>5</sup>.

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<sup>5</sup> See Age Bakker and Bryan Chapple, "Advanced Country Experiences with Capital Account Liberalization," IMF Occasional Paper, 214 pp 1-2, and Peter J. Quirk, Owen Evans et al., "Capital Account Convertibility - Review of Experience and Implications for the IMF Policies" 1995, IMF Occasional Paper 131 pp.5-10, 22-26

### II.2.2. *The Change in the IMF's Stance After the Asian Crisis*

After entering the 1990s, with the proliferation of liberalized capital accounts even among developing countries and the globalization of financial markets, it came to be argued that the IMF should play a more formal role in the liberalization of capital accounts. In April 1997, the IMF Interim Committee agreed to revise the IMF Articles of Agreement and make the promotion of the liberalization of capital accounts a goal of the IMF, based on the understanding that the free movement of capital would benefit the world economy. However, in the midst of the Asian crisis, which broke out immediately after this agreement, a more cautious view on the risk of the liberalization of capital accounts gradually obtained a wider supports, and the momentum for the revision of the Articles was lost at least for the time being.

After the G7 Finance Ministers meeting report of June 1999 mentioned previously was published, the IMF itself gradually shifted its stance on the liberalization of capital accounts towards a more cautious one. The IMF's new line of argument is that, while keeping intact the previous basic stance that the liberalization of capital accounts has great benefits, it admits that it is necessary to carefully manage and sequence the liberalization process in order to minimize concomitant risks. The IMF's role in this regard is to clarify and help prepare the necessary conditions for the liberalization of capital accounts. From this viewpoint, the IMF started to encourage countries to upgrade policy and institutions through dissemination of internationally recognized standards and codes relating to various fields including the financial sector, so as to prevent crises<sup>6</sup> At the same time, it has made efforts to understand the issues involved in the liberalization of capital accounts by reviewing the experiences of its members with the use and liberalization of capital controls. In particular, in response to the instruction in May 2000 by then Managing Director Horst Köhler to his staff to come up with practical advice relating to the sequencing of capital accounts liberalization, and the similar request by the International Monetary and Financial Committee (previously the Interim Committee), the IMF undertook studies of mode of orderly liberalization of capital accounts.

### II.2.3. *IMF Papers Relating to the Sequencing of the Liberalization of Capital accounts*

The IMF has not so far indicated its formal view on the practical guidance for sequencing of capital account liberalization, but among the papers published to date, what appears to be most relevant is the one entitled "Capital Account Liberalization and Financial Sector

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<sup>6</sup> The IMF claims that the main lesson learned from the recent crises is that the core task of the IMF is crisis prevention. It is currently trying to promote the "Financial Sector Assessment Program," which assesses the overall financial systems of its members and also the Reports on Observance of Standards and Codes program that promotes adoption of internationally recognized good practices. On the other hand, it is a problem that there has not been much progress in the study of crisis resolution.

Stability”<sup>7</sup> published in 2002 based on a paper submitted to a seminar of the IMF directors. The paper presents the following observations on sequencing of capital account liberalization, based on the analysis of 9 countries’ experiences<sup>8</sup>:

- (1) There is no unique approach to the sequencing and coordination of the liberalization of capital accounts with other policies.
- (2) It is not possible to independently analyze capital-account liberalization and other policies, due to their complex and substantially uncertain interaction.
- (3) Consequently, the design of an actual plan for sequencing must be based on a careful assessment of each country’s circumstances and requires judgments.
- (4) In most cases, a gradual approach may be required, but a gradual approach does not guarantee an orderly liberalization.
- (5) If the macroeconomic situation of a country changes, or its vulnerability increases, the country must be prepared to change the sequencing plan.
- (6) In some cases, it may be appropriate to adopt a contingency plan to delay further liberalization until the situation improves.
- (7) Care is required when applying an approach that has been successful for one country to another country<sup>9</sup>.

These observations are very much different from the frequently stated orthodox views that capital account liberalization contributes to a more efficient international allocation of capital and is thus beneficial to the world economy. This indicates that internal discussion of the issue within the IMF has shifted toward a more practical approach.

In relation to the topic of this paper, i.e., identification of implications to China from Japan’s experiences, the above observations indicate that, when interpreting a country’s experiences, it is necessary to sufficiently understand the external environment, domestic economic situation, and policies and institutions of that country, and carefully assess their applicability to other country. Keeping this in mind, the following Chapter reviews the process of Japan’s liberalization, while briefly looking at environments at respective points in time.

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<sup>7</sup> A Staff Team led by Shogo Ishii and Karl Habermeier, “Capital Account Liberalization and Financial Sector Stability” 2002, IMF Occasional Paper 211. Note that an Occasional Paper generally reflects the views of its authors, and does not necessarily reflect those of the IMF. Nevertheless, this paper was written by staff in a section assigned to follow the current state of regulations on capital accounts of member countries, and as mentioned above, was based on a paper presented to an IMF directors’ seminar. Thus, it is likely that work experiences at the IMF and the way of thoughts of IMF staff are reflected in the paper.

<sup>8</sup> The ‘nine countries’ are four countries that have liberalized their capital accounts without financial crises (Australia, Hungary, South Africa, and the United Kingdom), and five countries that experienced financial or external crises (South Korea, Mexico, Sweden, Turkey, and Paraguay).

<sup>9</sup> The paper also argues that the liberalization of capital accounts has both positive and negative impact on the stability of the financial system (p7); that a large inflow of capital increases domestic demand, expanding the current account deficit, and often causing a steep rise in domestic bank loans (p8); and that after capital-account liberalization, it is possible for asset prices to deviate from their equilibrium price (p9).

### III. Japan's Experiences

This Chapter summarizes the sequencing of Japan's capital-account liberalization after the war, and identify its characteristics.

This Chapter is divided into three parts. Part 1 describes the sequential treatment of the liberalization of capital accounts in the liberalization of Japan's economy as a whole. Part 2 describes sequencing of capital account liberalization by type of capital transactions. Part 3 does not address the issue of sequencing itself but rather describes the way how Japan used foreign exchange management and capital control measures to respond to the massive short-term capital flow in the late 1960s and the 1970s, amidst the confusion in the international financial markets due to the so-called Nixon Shock, the subsequent switch to the float system and the oil shocks. This part provides important lessons on the relationship between sequencing of liberalization by type of transactions and the concomitant risks and on the way how measures should be applied to cope with such risks.

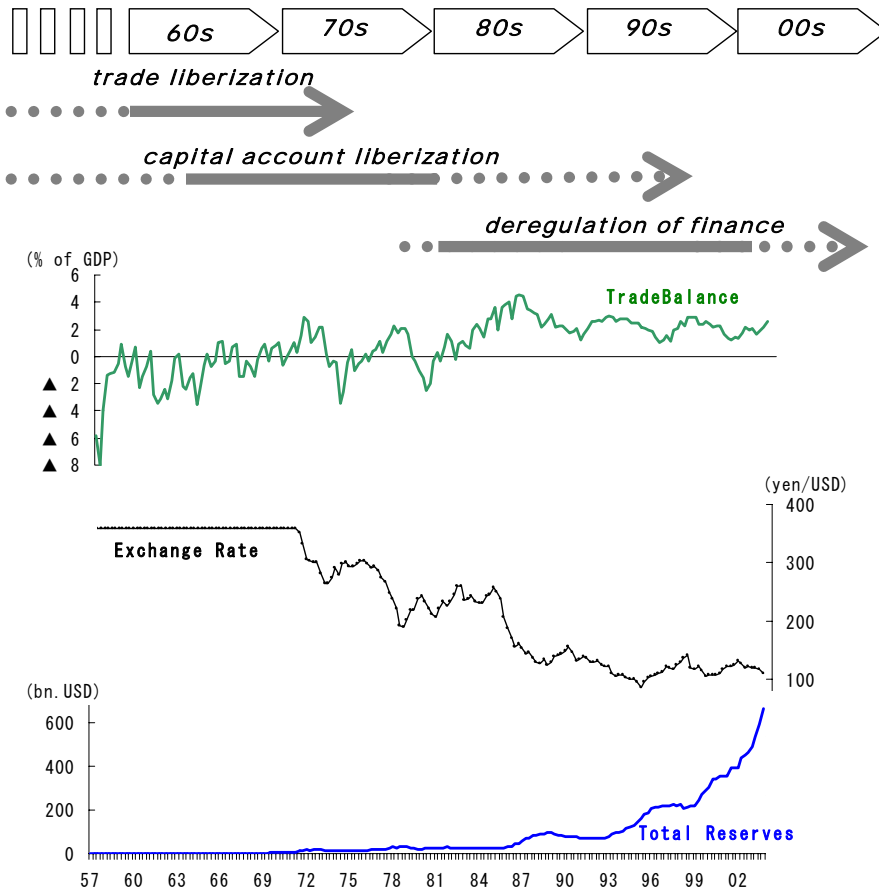
#### III.1. *The Sequence of Capital Account Liberalization in the Liberalization of the Economy as a Whole (Figure 2, Table 1)*

##### III.1.1. *Overview*

First, let us examine the treatment of capital-account liberalization in the liberalization of the economy as a whole. Table 1 shows the sequencing of liberalization in three main areas: trade (imports), capital transactions, and finance. In the period immediately after the end of the war, Japan regulated each of these areas very strictly, but subsequently Japan liberalized imports, then capital transactions and finally financial sector. More specifically, (1) Japan first substantially liberalized imports from the late 1940s to the early 1970s, especially from the early to mid-1960s. The trade balance was basically in deficits up to mid-1960s. (2) It then liberalized regulations on foreign exchange and capital transactions from the early 1960s to the late 1990s, especially during the period from the mid 1960s to the late 1970s. This period is characterized by unstable international financial markets. The trade balance started to frequently register surplus from mid-1960s and the yen was revalued and then appreciated after switching to a float system following a large increase in trade surplus in the early 1970's. After that, however, the trade balance deteriorated and the yen depreciated in the first oil shock and then again in the second oil shock. (3) Then finally, it liberalized financial sector from the late 1970s to the 1990s. In this period, the trade balance constantly recorded a large surplus and the yen followed an upward trend until mid-1990's. These processes are described in detail below.



Figure 2 Japan: Sequencing of Economic Liberalization



Source) IMF, International Financial Statistics  
 note) \*Total Reserves\* are total reserves minus gold

Table 1 Sequencing of Japan's Economic Liberalization

Time Period	Trade liberalization	Liberalization of foreign exchange and capital account transactions	Liberalization of finance	Remarks
1940s (after the war)	<p>Complete management of trade by government (nation-managed trade) (Dec. 1945)</p> <p>Enactment of the Foreign Exchange and Foreign Trade Management Law (promulgated Dec. 1949, implemented 1950) (Comprehensive management of both foreign exchange and trade)</p> <p>(1) Adoption of principle of liberalized exports, change from system of government imports to <u>private imports under approval system</u>; and adoption of <u>foreign-currency budget system for imports</u> (restrictions on amounts of imports and items that can be imported).</p> <p>(2) <u>Principle of general prohibition on foreign exchange and capital transactions</u> with freedom as exceptions</p> <p>(3) <u>Adoption of foreign currency concentration system</u></p> <p>(4) <u>Use of authorized foreign-exchange banks as mechanism for managing foreign exchange</u></p>			Establishment of single exchange rate (\$1 = ¥360) (Apr. 1949)
1950s		<p>Enactment of the Law Concerning Foreign Capital (May 1950) (promotion of introduction of high-quality, long-term foreign capital)</p> <p>Establishment of uniform 'standard methods of payment' (payment methods for which no approval is required) (Nov. 1950)</p>		Restoration of convertibility of European currencies (end-1958)
1960s	<p>Cabinet adopts "Basic Plan for Liberalization of Trade and Foreign Exchange" (Jun. 1960) (aimed at raising import liberalization rate (40% as of Apr. 1960) to roughly 80% within 3 years (roughly 90%, if petroleum and coal are liberalized))</p>	<p>Same as left (Jun. 1960) (As for foreign exchange, liberalization of current account transactions within two years, and on capital accounts "gradually ease regulations, while paying attention not to cause negative impact on the development of domestic economy)</p> <p>Liberalization of use of yen for external payments (Jul. 1960)</p> <p>Introduction of non-resident free yen accounts (Jul. 1960)</p>		

Time Period	Trade liberalization	Liberalization of foreign exchange and capital account transactions	Liberalization of finance	Remarks
	<p>Note: The "import liberalization rate" is the ratio of the amount of imports as of 1959 of those items that have been liberalized (meaning removal of quantitative restriction on imports) to the total amount of imports in 1959</p> <p>Liberalization rate of 93% achieved (Apr. 1964) (level of Western countries reached)</p>	<p>Permission of short-term foreign-currency borrowings from authorized foreign exchange banks by private enterprises on case-by-case examination basis (Nov. 1960)</p> <p>First issuance in the US of foreign currency denominated bond by private enterprise after the war (1961)</p> <p>Overseas issuance of stocks (in the form of DR) by private enterprises started (1961)</p> <p><u>Japan moves to IMF Article 8 status (Apr. 1964)</u></p> <p><u>Abolishment of foreign-currency budget (Apr. 1964)</u></p> <p>Establishment of non-resident special accounts for securities with major securities companies, in order to facilitate investment in securities by non-residents (starting May 1964)</p> <p>"First foreign capital liberalization package" (Jun. 1967) (<u>start of major liberalization of inward foreign direct investment</u>. Automatic authorization for up to 50% holdings for 33 industries (category 1), and up to 100% for 17 industries (category 2))</p> <p><u>Easing of regulations on portfolio investment in Japanese stocks (Jul. 1967)</u> (The upper limit on combined holdings by non-resident investors as a whole under automatic approval for stock acquisition raised from 10% to 15% for restricted industries, and from 15% to 20% for non-restricted industries, and the limit per investor raised from 5% to 7%. Subsequently, the limits were again raised in Sep. 1970 and Aug. 1971. In May 1973,</p>		<p>Japan becomes a member of Organization for Economic Cooperation and Development (OECD) (Apr. 1964)</p> <p>Japan makes reservations with regard to 18 items of OECD's capital-liberalization code (including direct investment) ( Apr., Sep. 1964)</p>

Time Period	Trade liberalization	Liberalization of foreign exchange and capital account transactions	Liberalization of finance	Remarks
		<p>investment in stocks was in principle liberalized up to 100% (however, this is only when there was an agreement by the issuing company))</p> <p>Introduction of restrictions on conversion to yen (“yen conversion limit”), (Feb. 1968) (restrictions on conversion into yen of foreign currency by authorized foreign exchange banks obtained through overseas borrowings or the like)</p> <p>“Second foreign capital liberalization package” (Mar. 1969) (Category 1 increased from 33 to 160 industries, and category 2 from 17 to 44)</p> <p><u>Start of liberalization of outward foreign direct investment</u> (Oct. 1969) (In Jun. 1972, outward foreign direct investment was in principle liberalized)</p>		
1970s	<p>Import liberalization rate of 95% achieved (Apr. 1972) (<u>import liberalization substantively completed</u>)</p>	<p><u>Start of liberalization of outward portfolio investment in securities</u> (Apr. 1970) (Totally banned prior to this measure. In Apr. 1970, the inclusion of foreign securities in security investment trusts was authorized, and subsequently, the purchase of foreign securities by institutional investors and general investors (via securities companies) was gradually liberalized through the mid 1970s)</p> <p>“Third foreign capital liberalization package” (Sep. 1970) (Category 1 from 160 to 447 (including banking and insurance industries), and category 2 from 44 to 77)</p> <p>Start of issuance in Japan of yen-denominated foreign bond by non-residents (Dec. 1970) (issued by Asian Development Bank)</p>		<p>Turmoil with European currencies, and float of West German and Dutch currencies (May 1971)</p> <p>“Nixon Shock” (15 Aug. 1971)</p> <p>UK, Italy, Nordic countries, Switzerland and others float their currencies (Aug. 1971)</p> <p>Yen tentatively moves to float (27 Aug. 1971)</p> <p>Smithsonian Agreement (18 Dec. 1971); \$1 set to ¥308 (19 Dec. 1971) (band expanded to ±2.25% (i.e., from ¥301.07 to ¥314.93))</p>

Time Period	Trade liberalization	Liberalization of foreign exchange and capital account transactions	Liberalization of finance	Remarks
		<p>Foreign capital liberalization for automobile industry (automobile industry included in category 1) (Apr. 1971)</p> <p>“Fourth foreign capital liberalization package” (Aug. 1971) (category 1 changed to negative list (7 industries made subject to case by case examination), category 2 from 77 to 228)</p> <p><u>Abolishment of foreign currency concentration system</u> (May 1972)</p> <p>“Fifth foreign capital liberalization package” (May 1973) (100% liberalization with exception of five industries, including agriculture, forestry and fisheries, and retail)</p> <p>Liberalization of retail industry (Jun. 1975) (100% liberalization excluding 4 exception industries. <u>Completion of liberalization of inward foreign direct investment</u>)</p> <p>Some liberalization and simplification of capital account transactions (Jun. 1977 &amp; Jan. 1978)</p> <p>Comprehensive revision of Foreign Exchange and Foreign Trade Management Law (promulgated Dec. 1979, implemented Dec. 1980)</p> <p>(1) <u>Shift to the principle of general liberalization of capital account transactions</u> (prior notification system) (e.g. external borrowings, and inward and outward portfolio securities investment placed under prior notification system)</p> <p>(2) Minister of Finance can introduce approval requirements for capital</p>		<p>Resurgence of European currency crisis (Jan. 1973)</p> <p>Yen floated (14 Feb. 1973)</p> <p>All major currencies floated against US dollar (Feb.–Mar. 1973)</p> <p>First oil shock breaks out (Oct. 1973)</p> <p>Second oil shock (Dec. 1978)</p>

Time Period	Trade liberalization	Liberalization of foreign exchange and capital account transactions	Liberalization of finance	Remarks
		<p>account transactions in cases where the transaction in question could cause large movements of capital, a sudden and violent change in the exchange rates, or the like. (emergency measures)</p> <p>(3) For certain notified capital account transactions, if the transaction would have adverse impact on Japan's financial markets or the like, the Minister of Finance can recommend or order the capital account transactions to be modified or canceled (this applies to overseas lending, cross-boarder issuance of securities domestically and abroad, inward and outward foreign direct investment, etc.)</p>	<p>Introduction of CDs (with liberalized interest rate) (May 1979) (<u>start of deposit interest rate liberalization</u>)</p>	
1980s		<p>Elimination of actual demand rule relating to forward exchange transactions (Apr. 1984)</p> <p>Elimination of yen conversion limit (Jun. 1984)</p>	<p>Issuance of euro-yen bonds by non-residents (Dec. 1984) (thereafter, euro-yen transactions gradually liberalized)</p> <p>Introduction of Money Market Certificates (MMC) (Mar. 1985)</p> <p>Yen-denominated BA market established (Sep. 1985)</p> <p>Liberalization of interest rates for large time deposits (Oct. 1985)</p> <p>Tokyo offshore market established (Dec. 1986)</p> <p>Introduction of CPs (Nov. 1987)</p>	<p>Yen dollar committee report (May 1984)</p> <p>Plaza Accord (Sep. 1985)</p>

Time Period	Trade liberalization	Liberalization of foreign exchange and capital account transactions	Liberalization of finance	Remarks
1990s (And later)		<p>Revision of Foreign Exchange Law (promulgated May 1997, implemented Apr. 1998)</p> <p>(1) <u>Authorization/prior notification requirements for capital account transactions in principle eliminated.</u> Changed to after-the-fact report system (the word "Management" removed from the title of the law)</p> <p>(2) <u>Liberalization of foreign exchange business (abolishment of authorized foreign exchange bank system. Substantial reduction in the foreign exchange management function of banks)</u></p> <p>(3) <u>Conditions instituted for introduction of approval requirements by Minister of Finance, so as to achieve flexible implementation of economic sanctions and the like.</u></p> <p>(4) <u>Introduction of reporting obligation</u></p>	<p>Establishment of Law Relating to the Reform of the Financial System (Jun. 1992) (<u>enables banks, securities firms, and trust banks to enter each other's businesses through establishment of subsidiaries</u>)</p> <p>Complete liberalization of interest rates for time deposits (Jun. 1993)</p> <p>Liberalization of interest rates for liquid deposits (Oct. 1994)</p> <p>(<u>completion of liberalization of interest rate (with exception of current deposits (interest prohibited)))</u>)</p> <p>Ordinary banks and others able to accept mid to long-term deposits of five years duration (Oct. 1994)</p> <p>Ordinary banks allowed to issue bonds (Oct. 1999) (<u>abolishment of separation system between long-term and short-term financial institutions</u>)</p> <p>Elimination of restrictions on business by securities subsidiaries established by banks and others, and trust subsidiaries established by banks and securities firms (Oct. 1999)</p>	

References: Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From the End of WWII to Pacification – 15. International Finance and Trade," 1976, Toyo Keizai Shinpo-sha Inc.; Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From 1952 to 1973 – 12. International Finance and Foreign Relations (2)," 1992, Toyo Keizai Shinpo-sha Inc.; Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From 1952 to 1973 – 18. References (6) International Finance and Foreign Relations," 1998, Toyo Keizai Shinpo-sha Inc.; Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From 1952 to 1973 – 19. Statistics," 1999, Toyo Keizai Shinpo-sha Inc.; Ministry of Finance, Policy Research Institute, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From 1974 to 1988 – 6. Finance," 2003, Toyo Keizai Shinpo-sha Inc.; Ministry of Finance, Policy Research Institute, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From 1974 to 1988 – 11. References (4) International Finance, Foreign Relations and Customs Administration," 2003, Toyo Keizai Shinpo-sha Inc.; Various issues of the Ministry of Finance Banking Bureau's "Annual Finance Report of the Banking Bureau"; Various issues of the Kinzai Institute for Financial Affairs, Inc.'s "Annual Report of the Ministry of Finance Securities Bureau"; Various issues of the Kinzai Institute for Financial Affairs, Inc.'s "Annual Report of the Ministry of Finance International Finance Bureau"; INUDA Akira, "Japan's Postwar Foreign Exchange Management Policy and Easing of Regulations on Long-term and Short-term Capital Transactions: A 30-year Look Back from The General Prohibition of the Foreign Exchange Law (1949) to General Liberalization of the Revised Foreign Exchange Law(1979)," 2000, Chuokoron Jigyo Shuppan; KOHAMA Hirohisa and WATANABE Machiko, "Sengo Nihon Keizai no 50-nen (50 years of Japan's Postwar Economic Development – From a developing Country to a Developed Country)," Nippon-Hyoron-Sha Co., Ltd., 1996; Institute for Monetary and Economic Studies, Bank of Japan, "New Edition: Japan's Finance System," 1995; Institute for Monetary and Economic Studies, Bank of Japan, SAKAI Yoshikiyo and SHIKANO Yoshiaki, "Financial Systems," 2000, Yuhikaku Aruma



### III.1.2. Trade Liberalization

After the end of World War II, Japan was under the control of the General Headquarters (GHQ) of allied forces. Based on America's "Initial Policy Relating to Japan" (September 22, 1945) and other relevant policies, Japanese residents were in principle entirely prohibited from conducting external economic transactions including imports and exports and foreign exchange transactions, immediately after the end of the war. These activities were only allowed under the authorization of the Japanese government, which was given with the prior approval of the GHQ<sup>10</sup>. However, as there was an urgent need to import materials for Japan's economic reconstruction, including materials needed to combat hunger right after the war, exports were needed in order to pay for these imports. Thus in December 1945, the Japanese government established with the approval by the GHQ, the Trade Agency as an organization for the centralized management of Japanese trade, and started the nation-managed trade<sup>11</sup>. Starting in August 1947 private-sector exports were gradually resumed (at the time, however, all imports were still being conducted by the government). Then with the start of the cold war, the US policy toward Japan changed, and the US adopted a policy of encouraging a rapid return of Japan to the international economy and its economic self-dependence through trade. Under this policy, in 1949 a single exchange rate of 360 yen to the US dollar was established (April 1949), and the Foreign Exchange and Foreign Trade Management Law (the "Foreign Exchange Law" hereafter) was enacted (promulgated December 1949), which was aimed at fostering sound private-sector trade. The Foreign Exchange Law comprehensively managed both foreign exchange and trade, and in the area of trade, the following principles were adopted in accordance with the law and related regulations including cabinet and ministerial ordinances: (1) the principle of freedom of exports was employed to a great degree, relaxing the across-the-board prior approval system for all exports. But at the same time, (2) the system of import moved from the system of the government-conducted imports to the privately conducted imports under an approval system, and (3) a foreign-exchange budget system (regulating the amounts and items that could be imported)<sup>12</sup> was adopted in order to make effective use of

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<sup>10</sup> Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era - From the End of World War II to Pacification - 15. International Finance and Trade," 1976, Toyo Keizai Shinpo-sha Inc., pp 3-5. The rest of this section is based largely on this source.

<sup>11</sup> Foreign exchange transactions relating to trade were handled by foreign banks set up in Japan with the approval of the GHQ, and the GHQ directly controlled all foreign currency.

<sup>12</sup> Under the foreign exchange budget system, the ministerial council (head: Prime Minister) established at the cabinet based on the article 3 of the Foreign Exchange Law, formulated, for every pre-determined period (quarterly from January 1952 to March 1952, and half-yearly from April 1952 to March 1964), a budget which sets a ceiling on the maximum amount to be approved of the payment of foreign exchange on a currency-by-currency basis for each item or category of imports. The government agencies were prohibited from giving approval to the use of foreign exchange under their jurisdiction in an amount in excess of such ceiling, unless authorization by ministerial council was obtained. Such foreign exchange budget system was in operation for 14 years and 3 months from January 1952 and was abolished by March 31, 1964, on Japan's transition to the IMF article 8 status on April 1, 1964. (Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed. (1976) pp261-355)

foreign currency<sup>13</sup>.

From 1950, Japan returned to the international economy under these basic systems of regulation. Japan's economic performance, however, was lackluster. Throughout the 1950s, Japan usually had a large trade deficit (the current account balance fluctuated greatly due to foreign assistance and other factors), and from 1953–1954 and in 1957, rapid decrease in foreign reserves forced the government to adopt a tightening policy (it was said that a ceiling was imposed on domestic economy by the weak balance of payments position), and take loans from the IMF and others. In light of Japan's vulnerable balance of payments position, imports were extensively regulated throughout the 1950s (quantitative restrictions). Japan's import liberalization rate<sup>14</sup> was 22% in 1956, and was just 33% in 1958.

The major liberalization of trade and foreign exchange began in the 1960s. The background to these actions was the restoration of convertibility of European currencies (which made Japan become fearful of being left behind in the world economic growth), Japan's improved external position, including a positive trade balance in 1958 and 1959 due to a surge in exports, and demand on Japan from the United States for liberalization at GATT. On 24 June 1960, the government approved the Basic Plan for Liberalization of Trade and Foreign Exchange, making clear its commitment to actively liberalize trade and foreign exchange. The plan called for an increase in the import liberalization rate from 40% in April 1960, to about 80% within three years<sup>15</sup>. The liberalization plan was accomplished ahead of schedule, and by the time of transition to an IMF "Article 8" country in April 1964, Japan's import liberalization rate had reached the level of Western countries<sup>16</sup>.

To summarize, although the liberalization of trade (imports) proceeded gradually after the war, major steps were started in 1960 with the government plan, and by the mid 1960s trade liberalization had reached a par with the Western countries.

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<sup>13</sup> The system of regulations under the Foreign Exchange Law and related ordinances and statutes employs several key principles relating to the control of foreign exchange. In addition to the foreign-exchange budget system, it includes a general ban on foreign exchange and capital transactions; the adoption of concentration system of foreign currency; and use of foreign-exchange banks as an instrument for controlling foreign exchange. These points are discussed in the next section.

<sup>14</sup> The import liberalization rate is the ratio of the amount of imports of liberalized goods (i.e., goods exempt from quantitative restrictions on import) in 1959 to the amount of total imports in 1959, excluding materials imported by the government.

<sup>15</sup> Although the liberalization of trade and foreign exchange was led by the government, these efforts had the active support of the private sector, from the standpoint of improving their own efficiency (Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed. (1976) p37).

<sup>16</sup> At the time, however, some 136 goods were still subject to import restrictions, including agricultural, forestry, and fisheries products, as well such as key industrial products as passenger cars, machine tools, power generators, computers, and the like. After that, import liberalization took a further step forward. In October 1965, passenger cars were liberalized; in April 1970, machine tools and power generators were liberalized; and in June 1971, automobile engines were liberalized. In this way, by April 1972, a liberalization rate of 95% was achieved, and the number of goods with import restrictions was reduced to 33 (24 agriculture, forestry and fisheries products, and 9 machine-tool products). (KOHAMA Hirohisa and WATANABE Machiko, " Sengo Nihon Keizai no 50-nen (Japan's Postwar Economic Development – From a developing Country to a Developed Country)," 1996, Nippon Hyoron-sha, pp 156–160). Note that the import of integrated circuits (ICs) was liberalized for ICs having fewer than 200 components in April 1973, and for those having 200 or more components in December 1974. Similarly, the import of electronic calculating devices and their components was liberalized in December 1975 (Ibid. p 158).

### III.1.3. Liberalization of Foreign Exchange and Capital Account Transactions

After the end of the war, the aforementioned Foreign Exchange Law (promulgated December 1949), the Law Concerning Foreign Capital (the "Foreign Capital Law") (promulgated May 1950), which is a law containing special measures relating to the Foreign Exchange Law, and related ministerial ordinances and other forms of regulations, regulated foreign exchange and capital account transactions. The main features of this regulatory system relating to foreign exchange and capital account transactions were: (1) the use of a foreign-currency budget system relating to imports was adopted as mentioned above, (2) a principle of general prohibition with liberalization for exceptions regarding foreign exchange and capital account transactions was adopted,; (3) the government centrally controlled all foreign currency (in 1952, there was a move to a system whereby authorized foreign exchange banks and certain other entities could retain a certain amount of foreign currency); (4) authorized foreign exchange banks were used as a mechanism for controlling foreign-exchange and capital account transactions; and (5) from the perspective of securing an inflow of cash from exports, and preventing the capital flight<sup>17</sup>, the government adopted the standard method of payment for making and collecting payments abroad (stipulating standardized payment periods, currency, payment conditions, etc.); so long as payments are to be made in accordance with this standard method there was no need to obtain approval from the government.

Meanwhile, the Foreign Capital Law only authorized the inflow of long-term, high-quality foreign capital that would contribute to the self-dependence of the Japanese economy, its sound growth, and the improvement of the balance of payments. The law guaranteed, for the authorized foreign capital, overseas transfers of both profits and the invested capital that was recovered.<sup>18</sup>

As the next section describes in detail the liberalization of capital accounts, broken down by type of transaction, the present section only touches upon the major developments in the liberalization. The substantive liberalization of capital accounts began in the 1960s, more specifically by the aforementioned Basic Plan for Liberalization of Trade and Foreign Exchange (June 1960), which called for the general liberalization of current-account foreign exchange transactions within two years. The plan, however, showed a cautious stance on capital account transactions stating: "Regulations shall be eased gradually, while taking care so as not to give

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<sup>17</sup> Ministry of Finance, Office of History of Fiscal and Monetary Policies (1976), p 52 gives the following reasons for the creation of this system: prevention of the worsening of transaction terms (e.g. demand for up-front settlement for payments), and prevention of extreme fluctuations in foreign-currency reserves due to leads and lags.

<sup>18</sup> As for stocks, initially only dividend transfers were guaranteed and guarantees on transfers of recovered principle were started in July 1957, under certain conditions. "Guaranteed" here means that the required amount of foreign exchange is registered in the foreign-currency budget and there is no need to obtain authorization for transfers.

adverse impact on domestic economic development <sup>19</sup> and thus did not specify contents or timing of liberalization. The main subsequent liberalization measures include general liberalization of current account foreign exchange transactions in April 1964, on Japan's acceptance of IMF Article 8 status, and the abolishment of foreign-currency budget at the same time. Starting in the latter half of the 1960s, certain types of investment such as inward foreign direct investment and inward and outward portfolio securities investment were liberalized step by step. In May 1972, the centralized foreign-currency management system was abolished, and the possession of foreign currency by residents was liberalized. In December 1980, the Foreign Exchange Law was thoroughly revised, incorporating the Foreign Capital Law. Under the revised law, the regulatory principle for capital account transactions underwent a major change, from general prohibition to general liberalization, by, for example, shifting overseas borrowing and inward and outward portfolio securities investment from under the previous approval system to under the prior-reporting system. Then in May 1997, a number of drastic revisions were made by another revision of the Foreign Exchange Law, including the general abolishment of the system of authorization/prior reporting of capital account transactions and a shift to a system of after-the-fact reporting, as well as the liberalization of foreign-exchange business (abolishment of authorized foreign exchange bank system). In this way, all the main features of postwar foreign-exchange and capital controls mentioned earlier have been eliminated (or substantially modified in the case of the use of banks as a management instrument): the foreign-currency budget system (eliminated in 1964); the system of general prohibition on foreign exchange and capital account transactions (eliminated by 1980 revision); foreign currency concentration system (eliminated in 1972); and use of authorized foreign exchange banks as management instruments (the elimination of the authorized foreign exchange bank system in 1997 in effect greatly reduced the level of control through the banks). To summarize, the liberalization of foreign exchange and capital account transactions began in the early 1960s, and was pursued particularly actively from the mid-1960s through the 1970s, and the revisions to the law in 1980 significantly changed the way these were managed.

#### III.1.4. *Liberalization of Finance*

Japan's postwar financial system was characterized by regulations on deposit interest rates, and a specialized financial institution system. The liberalization of regulations on deposit

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<sup>19</sup> At the beginning of the 1960s, the Ministry of Finance maintained a cautious posture with regard to capital account liberalization. In a testimony before the Diet in February 1962, then Minister of Finance SATO Eisaku stated that: (1) as for the order of liberalization, the current account should be liberalized first, followed by the liberalization of non-resident capital account transactions, then finally by the liberalization of resident capital account transactions; and (2) the effects of international capital account transactions would be long and deep and therefore care needs to be paid to their treatment (Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed., 'Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era - From 1952 to 1973 - 12. International Finance and Foreign Relations (2)', 1992, Toyo Keizai Inc., p 127)

interest rates began in 1979, with the introduction of CDs, which are a product with liberalized interest rates. Then after the introduction of Money Market Certificates (MMC), the interest rate of which changes with market interest rate, and the liberalization of interest on large time deposit in 1985, the liberalization of deposit interest was completed with the exception of current deposits, for which interest was prohibited, by the complete liberalization of time deposits in 1993 and the liberalization of interest on liquid deposits in 1994.

The system of specialized financial institutions was characterized by principles of division of labor/specialization such as the separation between banking and securities industries, and also between long-term and short-term financial institutions. However, the Law Relating to the Reform of the Financial System, which passed the Diet in 1992, enabled financial institutions to enter other sectors of financial business through the establishment of subsidiaries. Furthermore, in 1999 ordinary banks were authorized to obtain long-term financing through the issue of corporate bonds, which was previously permitted only to long-term credit banks and trust banks. With this reform, the separation of long and short-term financing vanished. In this way, the liberalization of finance began in the late 1970s, gained momentum in the 1980s, and continued into the 1990s.

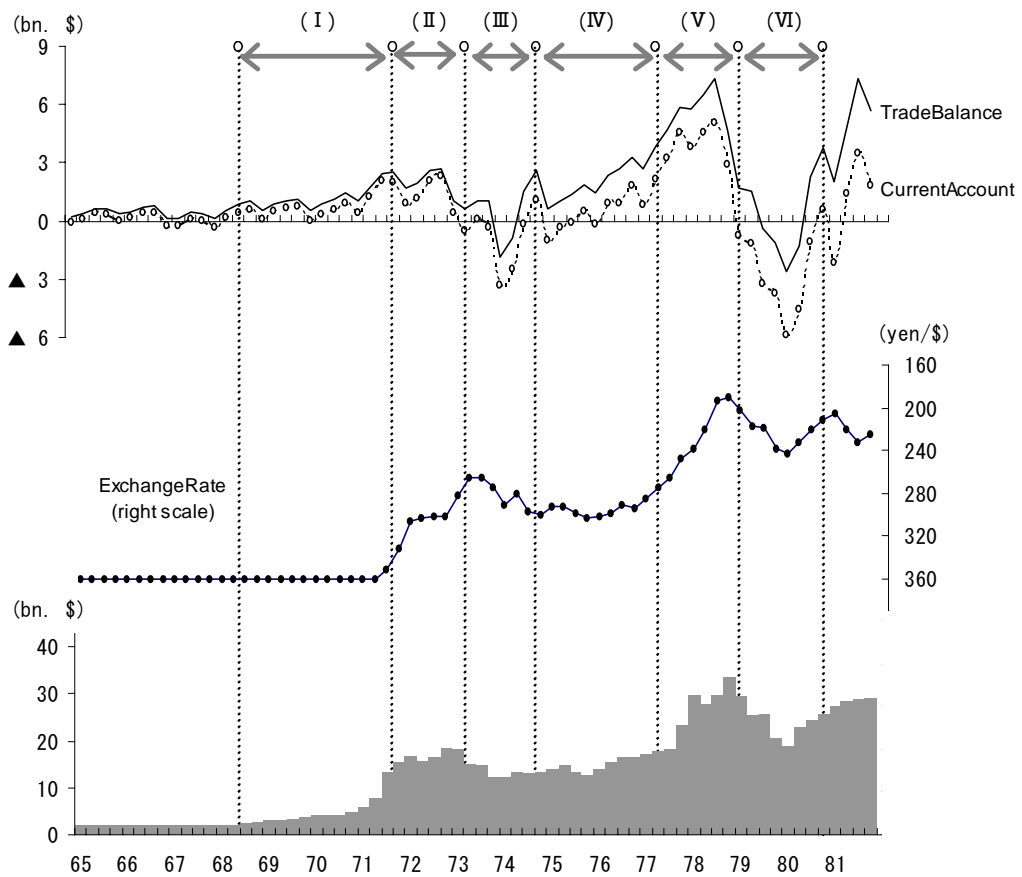
### *III.2. The Sequencing of Capital Account Liberalization by Transaction Type (Table 1)*

Next, let us examine the types of capital account transactions that were given priority in liberalization, and the types whose liberalization was delayed. As liberalization proceeded over a long period of time, via a complex process,<sup>20</sup> it is difficult to come to a clear conclusion. The following trends, however, are recognizable.

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<sup>20</sup> According to INUDA Akira in 'Japan's Postwar Foreign Exchange Management Policy and Easing of Regulations on Long-term and Short-term Capital Account Transactions: A 30-year Look Back from The General Prohibition of the 1949 Foreign Exchange Law to General Liberalization of the 1979 Revisions to the Foreign Exchange Law,' 2000, Chuokoron Jigyo Shuppan, p 9, in the 30 years after the enactment of the Foreign Exchange Law and Foreign Capital Law, cabinet and ministerial ordinances and other regulations under these laws were revised over 100 times.

Figure 3 Japan: Short-term Capital Controls and Developments in Exchange Rate and Balance of Payments, 1965-81



Source) MOF "Balance of Payments", IMF "International Financial Statistics"

Note 1) Sub-periods are characterized as below:

- I: Switch to inflow restrictions around the Nixon shock (late 60s to around mid-71)
- II: Easing of regulations after the Smithsonian Accord and subsequent re-strengthening (end-71 to around mid-73)
- III: Change to inflow promotion after the 1st oil shock (end-73 to 74)
- IV: Easing of regulations under the relatively stable international financial market (75 to around mid-77)
- V: Return to inflow restrictions under the yen appreciation (end-77 to 78)
- VI: Re-switching to inflow promotion under the yen depreciation (79 to 80)

2) Trade balance in this figure is on the balance of payment basis and different from that in Figure 2, which is on the trade statistics basis.







Time Period	Regulations on authorized foreign exchange banks		Inward and outward portfolio securities investment	Borrowings of foreign currency by private enterprises and cross-border securities issuance by residents and non-residents	Others
	Non-resident free yen accounts	Foreign exchange position			
Accord (Dec. 1971 to Jan. 1972))		(return to monthly average balance basis) (Dec.) Abolishment of foreign debt balance restrictions (Dec.) Abolishment of restrictions on overseas local loans and guarantees (the one introduced in May) (Dec.)			
1972  (With inflow of short-term capital, foreign exchange control re-strengthened)	Abolishment of restrictions on free-yen balance (the one introduced in Aug. 1971) (Jan.) Reserve rate (25%) newly set for increased amount of free-yen account (June) Reserve rate raised to 50% (July)	Abolishment of restrictions on balance of external short-term debt (the one introduced in July 1964) (Jan.) Yen conversion limit re-strengthened (from monthly average balance basis to daily balance basis) (May) Application of general reserve requirement system to foreign currency denominated debt (implementation was from June 1977) (Mar.) Abolishment of reserve requirement on foreign	Abolishment of regulations on balance of non-resident special accounts for securities (the one introduced in Sep.) (Jan.) Introduction of yen conversion limit to non-resident special accounts for securities (June) Amount of stocks and bonds to be acquired by non-residents limited to respective amount of stocks and bonds that have been sold (zero net inflow) (Oct.) Abolishment of ban on		Abolishment of regulations on acceptance of export prepayments (the one introduced in August) (Jan.) Reintroduction of regulations on acceptance of prepayments for exports (those in excess of \$10,000 requires authorization) (Feb.) Abolishment of foreign currency concentration system (May) Opening of foreign-currency deposit accounts by ordinary residents allowed (May) Opening of foreign-currency deposit accounts by non-residents allowed (May) Regulations on acceptance of

Time Period	Regulations on authorized foreign exchange banks		Inward and outward portfolio securities investment	Borrowings of foreign currency by private enterprises and cross-border securities issuance by residents and non-residents	Others
	Non-resident free yen accounts	Foreign exchange position			
		<p>currency denominated debt (June)</p> <p>Change from blanket authorization of mid and long-term overseas local loans (longer than 1 year) to case-by-case authorization (Oct.)</p>	<p>acquisition of non-listed bonds by non-residents (excepting short-term bonds (1 year or shorter)) (Oct.)</p>		<p>prepayments for exports strengthened (those in excess of \$5,000 requires authorization) (June)</p> <p>Authorization required for charter contracts relating to exported used ships, etc. (Oct.)</p> <p>Maximum authorization limit by authorized foreign exchange banks for overseas travel removed and purchases of foreign currency for travel of any amount made possible under authorization of authorized foreign exchange banks (authorization not required for amounts of \$3,000/trip or less) (Nov.)</p>
<p>1973</p> <p>(With the worsening of the balance of payments and outbreak of the first oil crisis, policies switched to encouraging inflows and containing outflows of capital (Nov. 1973 to Feb. 1974)</p>	<p>Reduction in reserve rate for increase in free-yen accounts (50% to 10%) (Dec.)</p>	<p>Abolishment of yen conversion limit for free-yen accounts, with exception of main-office/branch accounts (Dec.)</p> <p>Easing of regulations on mid and long-term overseas local loans (Dec.)</p>	<p>Restriction on acquisition of certain short-term foreign-currency denominated securities (those with remaining duration to maturity of 6 months or shorter) by residents (Nov.)</p> <p>Abolishment of restrictions on acquisition of securities by non-residents (the one introduced in Oct.)</p>	<p>Re-start of issuance by residents of "out-out" foreign bond (Dec.)</p> <p>Restrictive treatment of issuance in Japan of yen-denominated bond and foreign currency-denominated securities by non-resident (Dec.).</p>	<p>Easing of restrictions on export prepayments (maximum amount exempt from authorization raised from \$5,000 to \$10,000) (Nov.)</p> <p>Curtailment of system of foreign-currency loan to residents (Dec., Jan.)</p> <p>Reintroduction of maximum authorization limit by authorized foreign exchange banks on foreign currency purchases for overseas travel (amounts of \$3,000 or more must</p>

Time Period	Regulations on authorized foreign exchange banks		Inward and outward portfolio securities investment	Borrowings of foreign currency by private enterprises and cross-border securities issuance by residents and non-residents	Others
	Non-resident free yen accounts	Foreign exchange position			
			1972) (Nov.-Dec.)		be approved by Bank of Japan) (Dec.) Maximum limit on small-sum wire transfers lowered (\$3,000 to \$1,000) (Dec.)
1974 (Measures to encourage capital inflows implemented following "foreign-currency crisis" due to instability of Euro market in the summer of 1974, and the "Japan rate" problem)	Elimination of reserve requirements for increase in free-yen accounts (Sep.)	Introduction of bank-specific ceiling on short-term overseas local loans and prohibition in principle of mid to long-term overseas local loans (Jul.)	General restrictions on acquisition of short-term foreign-currency denominated securities, inclusive of those with remaining duration to maturity of longer than 6 months, by residents (Jan.)  Abolishment of restrictions on acquisition of short-term government securities and non-listed bonds by non-residents (Aug.)	Flexible introduction of impact loans (Jan.) Re-start of issuance by residents of "out-in" foreign bond (Nov.)	Easing of restrictions on export prepayments (amount exempt from authorization raised from \$10,000 to \$100,000) (Jan.) Introduction of restrictions on outstanding balance of resident foreign currency deposit accounts (Feb.) Maximum limit for authorization by authorized foreign exchange banks for purchases of foreign currency for overseas travel lowered (\$3,000 to \$1,500) (Apr.) Maximum limit on small-sum wire transfers lowered (\$1,000 to \$200) (Apr.) Easing of restrictions on export prepayments (amount exempt from authorization raised from \$100,000 to \$500,000) (Jul.) Official borrowing of \$ 1 billion by Japanese Government from Saudi Arabia (Aug.)

Time Period	Regulations on authorized foreign exchange banks		Inward and outward portfolio securities investment	Borrowings of foreign currency by private enterprises and cross-border securities issuance by residents and non-residents	Others
	Non-resident free yen accounts	Foreign exchange position			
1975 (Easing of restrictions on capital outflows in response to increased capital inflows)		Permissible limit for short-term overseas local loans increased (Mar./Apr.)		Re-start of issuance of yen-denominated foreign bonds by non-residents (Jul. 1975)	
1976 (Partial relaxation of foreign-exchange controls against a turning into surplus of balance of payments)		Partial relaxation of mid to long-term overseas local loans (not allowed in principle from Jul. 1974) (up to the amount of reduction in loan balance)(Nov.)			Maximum limit on amount of foreign currency to take overseas on travel raised (\$1,500 to \$3,000) (Jun.) Maximum limit on small-amount wire transfers raised (\$200 to \$1,000) (Jun.)
1977 (Partial liberalization of capital account transactions in the relatively stable international financial environments)		Abolishment of yen conversion limit, and move to regulations on spot position (Over-sold spot position prohibited on daily balance basis. Main office-branch free-yen balance subtracted from spot foreign-currency assets) (Jun.)  0.25% reserve rate set for foreign debt and free-yen deposit balance (Jun.)	Easing of restrictions on acquisition of short-term foreign-currency denominated securities by residents (Jun.)		Abolishment of restrictions on balance of non-resident foreign currency deposit accounts (Jun.)

Time Period	Regulations on authorized foreign exchange banks		Inward and outward portfolio securities investment	Borrowings of foreign currency by private enterprises and cross-border securities issuance by residents and non-residents	Others
	Non-resident free yen accounts	Foreign exchange position			
(Measures to contain short-term capital inflows following massive inflows starting in Oct. 1977)	Increase in reserve rate for increases in non-resident free-yen accounts (from zero to 50% of the amount in excess of October average balance) (Nov.)	Elimination of ceiling regulations on short-term local overseas loans (May)  Easing of regulations on mid to long-term overseas local loans (allowed up to the amount that are financed abroad) (Jul.)	Temporary suspension of public offerings of short-term government securities (Nov.) (lifted Mar. 1978)		
1978 (Strengthened regulations on short-term capital inflows)	Increase in reserve rate for increases in non-resident free-yen accounts (from 50% to 100%) (Mar.)		Non-residents banned from acquiring yen-denominated bonds with the remaining duration to maturity of 5 years and 1 month or shorter (Mar.)		

Time Period	Regulations on authorized foreign exchange banks		Inward and outward portfolio securities investment	Borrowings of foreign currency by private enterprises and cross-border securities issuance by residents and non-residents	Others
	Non-resident free yen accounts	Foreign exchange position			
1979 (With weakening of the yen starting in 1979, restrictions on inflows eased or removed)	Reduction in reserve rate for increases in non-resident free-yen accounts (from 100% to 50% (Jan.), then to 0% (Feb.))		Easing and elimination of restrictions on acquisition of yen-dominated securities by non-residents (From 5 years and 1 month or shorter to 1 year and 1 month or shorter (Jan.), then elimination of regulation (Feb.))	Increased flexibility in introduction of short-term and mid to long-term impact loans (Jun.)	Abolishment of regulations on acceptance of prepayments for exports (May) (authorization no longer required even for amounts in excess of \$500,000)
1980 (Measures to encourage capital inflows following sharp depreciation of the yen)	Increased flexibility for introduction of foreign capital through main-office/branch account of authorized foreign exchange banks (Mar.)  Official free-yen accounts by foreign governments and others exempted from Temporary Interest Rates Adjustment Law, and interest rates liberalized (Mar.) (increase in interest rates made possible)		Removal of yen conversion limit from non-resident special accounts for securities (Dec.)	Increased flexibility in overseas issuance of privately offered yen-denominated foreign bond by residents (Mar.)	

References: Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From the End of WWII to Pacification – 15. International Finance and Trade," 1976, Toyo Keizai Shinpo-sha Inc.; Ministry of Finance, Office

of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From 1952 to 1973 – 12. International Finance and Foreign Relations(2)," 1992, Toyo Keizai Shinpo-sha Inc.; Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From 1952 to 1973 – 18. References (6) International Finance and Foreign Relations," 1998, Toyo Keizai Shinpo-sha Inc.; Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From 1952 to 1973 – 19. Statistics," 1999, Toyo Keizai Shinpo-sha Inc.; Ministry of Finance, Policy Research Institute, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From 1974 to 1988 – 6. Finance," 2003, Toyo Keizai Shinpo-sha Inc.; Ministry of Finance, Policy Research Institute, Office of History of Fiscal and Monetary Policies Ed., "Showa Zaiseishi (History of Fiscal and Monetary Policies in Japan's Showa Era – From 1974 to 1988 – 11. References (4) International Finance, Foreign Relations and Customs Administration," 2003, Toyo Keizai Shinpo-sha Inc.; Various issues of the Ministry of Finance Banking Bureau's "Annual Finance Report of the Banking Bureau"; Various issues of the Kinzai Institute for Financial Affairs, Inc.'s "Annual Report of the Ministry of Finance Securities Bureau"; Various issues of the Kinzai Institute for Financial Affairs, Inc.'s "Annual Report of the Ministry of Finance International Finance Bureau"; INUDA Akira, "Japan's Postwar Foreign Exchange Management Policy and Easing of Regulations on Long-term and Short-term Capital Transactions: A 30-year Look Back from The General Prohibition of the Foreign Exchange Law (1949) to General Liberalization of the Revised Foreign Exchange Law (1979)", 2000, Chuokoron Jigyō Shuppan; FUJITA Tsuneo, "Japan's Recent Foreign Exchange Policy (Vols. I, II, and II of three-part series)," Ministry of Finance Finance, Jul.–Sep. 1971.

### III.2.1. *Current Account Liberalization*

First, as mentioned above, the major liberalization of foreign exchange and capital account transactions was started by the 1960 Plan for Liberalization of Trade and Foreign Exchange. Under this initiative, the first policy issue was the liberalization of current-account foreign exchange transactions, in order to move to the IMF Article 8 status in April 1964. As described above, the foreign-currency budget system was eliminated in 1964, simultaneously with the move in status<sup>21</sup>.

### III.2.2. *Liberalization of Inward Foreign Direct Investment and Other Forms of Inward Investment*

The next major move toward liberalization was related to inward foreign direct investment. While the IMF's Articles of Agreement allow controls on capital account transactions, the OECD make it a principle to liberalize capital accounts. Consequent to its membership in the OECD in April 1964, Japan faced the need to remove its capital controls. At this time, Japan was also under rapidly increasing pressure from Western countries to liberalize capital transactions. In June 1967, the Cabinet adopted a decision on the Liberalization of Inward Foreign Direct Investment ("the First Capital Liberalization Package"), and began liberalizing inward foreign direct investment. By May 1973, the Japanese government had adopted and implemented a total of five capital liberalization packages, in addition to the automobile liberalization in 1971. By May 1976, when transitional treatments extended to some industries expired, inward foreign direct investment had been completely liberalized, excluding 4 exception industries.<sup>22</sup>

Regarding other inward investment, acquisition by non-residents of up to a certain share of a Japanese company's stock had been allowed (automatic approval was granted), as long as the purpose of the acquisition was not to participate in the management of the company. In parallel with the liberalization of inward foreign direct investment starting in 1967 mentioned above, this maximum share was gradually increased.

### III.2.3. *Liberalization of Outward Foreign Direct Investment and Other Forms of Outward Investment*

The easing of restrictions on outward foreign direct investment was slightly delayed to the easing of restrictions on inward direct investment. Its liberalization began in October 1969, and outward foreign direct investment was generally liberalized in June 1972.

The liberalization of outward portfolio securities investment was further delayed. While

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<sup>21</sup> One of the issues for transition to Article 8 status was restriction on foreign travel. Although the IMF requested strongly that restrictions on travel for tourism be lifted, in the end the restrictions were left in place, with a special exception granted by the Board of Directors of the IMF.

<sup>22</sup> The four exception industries are agriculture, forestry and fisheries, mining, petroleum and leather and leather product manufacturing.



residents had previously been completely prohibited from purchasing foreign securities, in April 1970 an investment trust was authorized to include foreign securities in its portfolio for the first time. From this point until the mid 1970s, the purchase of foreign securities was gradually liberalized for certain institutional investors such as life insurance companies and securities firms, and also for ordinary investors (via securities firms).

#### *III.2.4. Overall Tendency – Inward First and Outward Followed –*

Thus, after the liberalization of current accounts, transactions leading to the inflow of capital, such as direct investment into Japan, were first liberalized, and the liberalization of transactions leading to the outflow of capital followed with some delay. Note that capital flows other than those mentioned above, such as so-called "impact loans" (foreign currency denominated borrowings by private enterprises with no pre-specified limitations on its use) and the issuance of securities overseas by resident enterprises and the issuance of securities in Japan by non-residents were subject to case-by-case examination, with the result that they were handled encouragingly or discouragingly (or in some cases prohibitively) under the policy stance adopted by the overseeing authorities at the time.

#### *III.2.5. Creation of Non-resident Free Yen Accounts*

One salient feature of Japan's capital-account liberalization that stood out from this general sequence was the establishment of non-resident free yen accounts in July 1960, at a very early stage in Japan's liberalization process. These accounts could be used by non-residents to deposit those yen that they received, when (1) a resident made payments in yen for a current account transaction such as importation to Japan; or (2) those payments for which foreign currency transfer is permitted (i.e. dividend payments approved under the Foreign Capital Law) were made in yen by residents. And it was allowed to convert these yen into foreign currency at any time. This decision on the introduction of free yen accounts was paired with the decision to allow the use of yen for foreign payments (the adoption of yen-denominated foreign exchange), and may have been considered as conducive to the promotion of yen-denominated trade in the future. However, the establishment of non-resident free yen accounts opened the path for the inflow of short-term capital for the first time. This was made possible as, in addition to the funds of (1) and (2) above, (3) non-residents were authorized to deposit in their free-yen accounts, those yen that they obtained through the sale of foreign currency to banks. The government was concerned with "hot money" flowing in through free-yen accounts and therefore only authorized their creation in authorized foreign exchange banks located in Japan, so that the authorities could monitor them. At the time, however, the authorities did not foresee a particularly large inflow of short-term capital to such accounts, and thought that short-term

capital would be beneficial so long as they were controlled. But in reality, the flow of capital through free-yen accounts made up one of the major portions of the short-term capital flowing through the banks in later years, and handling of this became an important issue (this point will be taken up in the following section).

### *III.2.6. Use of Banks as a Mechanism for Foreign Exchange Control*

Another key characteristic of Japan's capital account liberalization was that the role of authorized foreign exchange banks in controlling foreign exchange was maintained until the very late stage of liberalization. In other words, under the Foreign Exchange Law, authorized foreign exchange banks played a major role in tracking overseas transactions, and verifying their legal appropriateness. These functions were basically maintained even after the reforms of 1980; it was only after the reforms of 1997 which eliminated the authorized foreign exchange bank system, liberalizing foreign exchange business, that the requirements on banks and other institutions which conduct overseas money transfers and other types of foreign-exchange transactions to confirm the legal appropriateness of such conduct were greatly reduced. Thus, authorized foreign exchange banks also played a major role in carrying out foreign exchange control measures to regulate short-term capital to be discussed in the following section.

### *III.3. Instability in International Financial Markets and Regulations on Short-term Capital Flow from the Late 1960s through the 1970s (Figure 3, Tables 2)*

#### *III.3.1. Overview*

This section describes the regulatory measures on foreign exchange and capital transactions taken by the Japanese government in response to the major external shocks from the late 1960s through the 1970s: The so-called "Nixon Shock" of 1971; the transition to a general float in early 1973; the turmoil in the international financial markets following the oil shocks of 1973 and 1979; and the massive movement of short-term capital. This period can be divided into six sub-periods: (I) A switch of regulatory stance from the traditional inflow promotion to inflow restrictions around the time of the Nixon Shock (late 1960s to around mid-1971); (II) Easing of such regulations immediately following the Smithsonian Accord, and their subsequent re-strengthening (end-1971 to around mid-1973); (III) A change to a policy of encouraging capital inflow after the first oil shock (end-1973 to 1974); (IV) Easing of regulations under the relative stability of the international financial markets (1975 to around mid-1977); (V) A return to a strengthening of inflow restrictions, consequent to the continuing appreciation of the yen (end 1977 to 1978); and (VI) A re-switching of policy toward encouraging capital inflow, in response to the independent fall of the yen consequent to the second oil shock (1979 to 1980).

Below is a brief review of each of these sub-periods and their environments.

### III.3.2. *Developments in six sub-periods*

(I) A switch of regulatory stance to inflow restrictions and regulations on short-term capital around the time of the Nixon Shock (late 1960s to around mid-1971)

From the end of the war, Japan basically had a trade deficit for a long time and the traditional policy stance regarding capital flow was to promote its inflow. However, the basic trend of its trade balance changed to surplus from around mid-1960s and there was a sharp rise in foreign reserves toward the end of the 1960s. With this change of Japan's external position, its policy stance also changed greatly from around the late 1960s to the 1970s. In order to stem the growth of foreign reserves, measures against the inflow of short-term capital became a major policy agenda<sup>23 24</sup>.

Table 2 shows major short-term capital regulations between the 1960s and 1970s for the four main short-term capital flow channels: (1) via authorized foreign exchange banks, such as acceptance of deposits and borrowing; (2) inward portfolio security investment; (3) foreign-currency borrowings by enterprises and resident/non-resident cross-border borrowing through the issue of securities; (4) other categories. The description below is based largely on this table.

As authorized foreign exchange banks provided one of the main channels for short-term capital inflows, one of the key regulatory measures on short-term capital had been via the regulation of authorized foreign exchange banks. In the early 1960s, there were already regulations on the foreign currency position of authorized foreign exchange bank, stipulating requirements for foreign-currency reserves on external short-term debt, regulations on outstanding balance of foreign short-term borrowing, and the like. Then in February 1968, regulations on yen conversion of foreign assets were put into place alongside the existing regulations, setting a maximum limit on the value of foreign currency assets that could be converted into yen ("the yen conversion limit"). In February 1972, this regulation was further strengthened, with conversion into yen totally prohibited in principle (foreign currency taken

<sup>23</sup> In October 1971, the Ministry of Finance stated the following: 'Japan's foreign exchange system is structured in such a way as to discourage outflows, and encourage inflows. From around November of last year, however, we have been administering the system so as to encourage outflows and discourage inflows, without changing the law... In the future as well ... we will continue to make a move from "heater" policy to "cooler" policy through administration of the system.' (Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed. (1992) p 419)

<sup>24</sup> The Ministry of Finance, Office of History of Fiscal and Monetary Policies (1992) p 337 states that it was in 1969 when the need to stem increases in foreign reserves was first clearly recognized as policy agenda. This recognition arose from international criticism of Japan's trade surplus as well as the destabilizing effect on the foreign exchange and financial markets, as indicated in this document, i.e. (1) a need to avoid such increases in light of international sentiment – while many countries around the world were suffering from dwindling foreign-currency reserves, those of Japan were surging; and (2) one of the main causes of the surge in foreign-currency reserves was the inflow of short-term capital, which was beginning to have a destabilizing influence not only on foreign exchange markets, but on domestic financial markets.

from abroad needed to be used in the form of foreign-currency assets)<sup>25</sup>. In September 1968, companies were also completely banned from taking so-called impact loans (short-term foreign currency loans without restrictions on use).

While these restrictions on inflow were being implemented, measures started to be introduced to encourage the outflow of capital, including the liberalization of outward direct investment in October 1969, and the liberalization of outward securities investment in April 1970.

Despite these measures, however, there was a sudden surge in the flow of short-term capital into Japan, due to a sharp fall in interest rates abroad starting in the fall of 1970, and the European currency instability of May 1971. This inflow generally took three forms: (1) opening of free-yen deposit accounts; (2) purchase of public/corporate bonds by non-residents; and (3) a massive flow of export prepayments<sup>26</sup>. As for (1) above, the maximum limit was imposed on the outstanding balance of free-yen deposits, prohibiting the balance on or after 28 August 1971 from being greater than their balance as of 27 August 1971, which was just after the so-called Nixon Shock (in coordination, a banks as a whole was prohibited from having external debt balances greater than their balance as of 18 August). As for item (2), a de-facto ban was implemented on the acquisition by non-residents of short-term government securities in March 1971 and of non-listed public/corporate bonds in May 1971. As for (3), a request was made in May 1971 for voluntary restraints on overseas local loans by authorized foreign exchange banks, which were thought to be financing prepayments<sup>27</sup>. After the Nixon Shock, however, there was also a massive surge in prepayments, and thus on 19 August, the Ministry of Finance conducted an examination of the state of prepayments, investigating authorized foreign exchange banks and trading companies<sup>28</sup>. The Ministry of International Trade and Industry also requested

<sup>25</sup> Regulations on conversion to yen were first adopted with the goal of preventing short-term capital entering the country from being converted to yen, and providing a means of circumventing domestic financial tightening (it was attempted to direct foreign currency entering the country to its use in the form of foreign currency such as import financing and overseas local lending), amidst a need to accept more short-term capital in order to cooperate with the US dollar defense. Starting in 1969, however, the motivation seems to have changed toward strictly regulating the inflow of short-term capital in order to minimize the increase of foreign-currency reserves (Ministry of Finance, Office of History of Fiscal and Monetary Policies Ed. (1992) p 213).

<sup>26</sup> According to NAKAYAMA Takashi, "Transition to a Floating Rate System and Restrictions on the Inflow of short-term capital," *International Finance*, issue 478, 15 Oct. 1971, during the month of August 1971, Japan's foreign-currency reserves grew by just under \$4.6 billion, over half of which was via export prepayments. The volume was incredibly large in light of the fact that the total amount of inter-bank spot foreign exchange transactions during the whole year of preceding 1970 was just \$ 4.8 billion.

<sup>27</sup> In May 1971, the total prepayment inflow reached \$450 million, nearly 10 times the customary monthly pace of about \$50 million (NAKAYAMA Takashi (1971)).

<sup>28</sup> The investigations turned up a substantial number of transactions with destinations marked as "the US or Canada" or "Europe," the only product name given as "general merchandise," and the shipping date listed as "soon" or "prompt," with no firm date given (OHASHI Hiroshi, "Strengthening Regulations on Short-term Capital," *International Finance*, 1 Oct. 1971, Issue 477). While the exemption threshold was subsequently raised, one Ministry official later wrote, "When we performed the foreign exchange investigation, at the time when the regulation was for \$100,000, we saw a huge increase in products being sold for \$99,000 per shipment" (FUJIOKA Masao, "40 Years of Internationalization - Japan's Path," 1994, The Institute of Foreign Exchange and Trade Research, p 101).

trading companies to implement voluntary restraints. The massive inflow continued, however, and so on 31 August, a complete ban was placed on the conversion into yen of foreign currency received as prepayments (sums valued at \$10,000 or less were exempt). This almost completely put a stop to the inflow of prepayments<sup>29</sup>.

(II) Easing of regulations immediately following the Smithsonian Accord, and their subsequent re-strengthening (end-1971 to around mid-1973)

When the Smithsonian Accord was reached in December 1971, the Ministry of Finance phased out, between December and January, those restrictions put in place after the Nixon Shock, including the outstanding balance limit on free-yen deposits (the one adopted in August) and restrictions on export prepayments (the one adopted in August). However, restrictions on the acquisition of non-listed public/corporate bonds by non-residents were left in place; additionally, the yen conversion limit was maintained as a cornerstone of regulations.

In early January 1971, however, the amount of short-term capital flowing into Japan became massive again, and the control of foreign exchange was re-strengthened. In June 1972, a new reserve-deposit system with a required reserve rate (25%) was put in place on the amount of increase of free-yen accounts. In July, this rate was raised to 50%. The yen conversion limit was also strengthened (in May from a monthly average balance basis to a daily balance basis). As export prepayments also flew in massively immediately after the restrictions were lifted, the restriction was re-introduced in February requiring approval for export prepayments of greater than \$10,000 per transaction. In June, the amount eligible for exemption was lowered to \$5,000. Another form of capital inflow was for a shipping company to export a used ship, immediately convert the acquired foreign currency into yen, and then charter the ship back, paying back the charter fee over a long period. In order to discourage this type of foreign-exchange manipulation, a regulation was put into effect in October requiring the individual approval by the Bank of Japan for each ship and aircraft charter agreement<sup>30</sup>. Also, acquisition of stocks and bonds by non-residents was limited to the respective amount of stocks and bonds that have been sold (zero net inflow).

At the same time that these restrictions on inflow were being put into place, in and after 1971, measures aiming at increasing the demand for foreign currency were implemented, including relaxation of restrictions on taking foreign currency outside the country on travel and liberalizing the possession of foreign currency in the private sector. In January 1973, however, the European currency crisis flared up again, and all major currencies, including the yen, moved

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<sup>29</sup> In the case of a dollar-denominated export agreement, there is normally no reason for the other party to pre-pay, even if there is fear that the value of the yen will rise. Prepayment was a defensive measure taken by Japanese export companies when dealing with overseas branches or subsidiaries; at the time, this type of transaction accounted for about 60% of Japan's exports.

<sup>30</sup> INUDA Akira (2000), p 326. This is a hedging operation through which a shipping or airline company that expects to receive dollar denominated revenue for the periods to come creates dollar denominated liabilities, i.e., dollar denominated payment obligations, thereby hedging for exchange rate risk.

to a float against the US dollar in February to March 1973.<sup>31</sup>

(III) The change to a policy of encouraging capital inflow after the first oil shock  
(end-1973 to 1974)

After the move to a float, Japan's balance of payments worsened substantially, amidst rising inflation caused by a policy of economic expansion which had been pursued to that time under a rising yen. In the third and fourth quarters of 1973, Japan had a trade deficit. In October of that year, the six OPEC members announced a large increase in crude oil prices. This sparked the first oil crisis (so-called 'oil shock'); due to the subsequent severe sell-off of the yen and buying up of the dollars, the yen depreciated greatly.

In order to respond to this development, the government changed again the direction of foreign exchange management policy by 180 degrees from the one discouraging inflow and encouraging outflow to the one encouraging inflows and discouraging outflows from November that year to February in the following year. Measures taken to encourage the inflow of capital included lowering the deposit reserve rate for increases in free-yen deposit balances (from 50% to 10%), suspension of application of yen conversion limit to free-yen account balances (excluding main office/branch accounts), increase in the exemption threshold of restrictions on export prepayments (from \$5,000 to \$10,000, then to \$100,000), a policy of flexible approval of impact loans and abolishment of restrictions on net increases in securities holdings by non-residents (the one adopted in October 1972). Measures taken to discourage the outflow of capital included discouraging the issue of securities in Japan by non-residents. Despite these foreign exchange control measures, however, the December 1973 announcement of a further hike in the price of petroleum rekindled the concern with Japan's balance of payments, and the yen sharply depreciated until early 1974.

Then in June 1974, West Germany's Herstat Bank was ordered to suspend its operations after a failed foreign exchange speculation. This brought the instability of the euro markets to the surface, and it gradually became more difficult for Japan's authorized foreign exchange banks to obtain euro-dollars. July saw the emergence of the "Japan rate" problem, where Japanese banks were being charged a rate of 1 to 2% above average. For this reason, the government took a number of measures to encourage the inflow of capital; it eliminated the deposit reserve requirement on increases in free-yen accounts; it eliminated restrictions on the acquisition of short-term government securities by non-residents; it re-started the issuance of "Out-In" foreign bonds by residents; it eased restrictions on export prepayments; the measures included a public loan from Saudi Arabia by the Japanese government itself. It also took measures to discourage outflow, including lowering the limit on foreign currency that could be taken

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<sup>31</sup>This was performed as a 'managed float.' From the re-opening of the market on 19 March, until the first oil shock in Oct. 1973, the yen rate stayed in the 264-266 range.

overseas on travel. Partly due to these measures, entering the month of September, the "Japan rate" was nearly eliminated.

(IV) Easing of regulations under the relative stability of the international financial markets (1975 to around mid-1977)

In the latter half of 1974, the Japan's current account almost restored the balanced position, and Japan's economy finally got out of the international financial crisis since the Nixon Shock. With the subsequent relative stability of the international financial situation, regulations were eased, including the elimination of the yen conversion limit and a transition to regulations on spot foreign exchange position limit. Meanwhile, restrictions on the outflow of capital were also eased, including easing of restrictions on overseas local loans by authorized foreign exchange banks, easing of restrictions on the acquisition of foreign securities by residents, and re-start of securities issuance of non-residents in Japan. This could be called a foreign exchange management policy targeting at expanded equilibrium, responding to an increased inflow of capital with measures to encourage the outflow of capital<sup>32</sup>.

(V) A return to a strengthening of inflow restrictions, consequent to the continuing appreciation of the yen (end-1977 to 1978)

From October 1977 until the following year (1978), however, there was another massive inflow of short-term capital. Foreign-exchange controls and regulations on capital transactions were again strengthened, including imposition of a deposit reserve rate of 50% on increases in non-resident free yen accounts (increased to 100% in 1978), and such strict measures as a temporarily suspension of public offerings of short-term government securities.

(VI) A re-switching of policy toward encouraging capital inflow, in response to independent fall of the yen consequent to the second oil shock (1979 to 1980)

Conversely, when the second oil shock occurred in 1979, the yen independently followed a downward path, and measures were taken in 1979 and 80 to encourage the inflow of capital, including lowering the deposit reserve rate for increases in free-yen accounts (100% to 50%, then to 0%), and easing of restrictions on the acquisition of bonds by non-residents. Other measures to encourage inflow included greater flexibility in approving impact loans, and of issuing foreign debts by residents.

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<sup>32</sup> This is the assessment of INUDA (p 343).

### III.3.3. Subsequent situations

Thus, from the end of the 1960s through the 1970s, the government was engaged in a dizzying series of policy reversals on foreign exchange control and regulations on capital account transactions, in order to prevent the short-term capital flows from destabilizing the market during times of drastic change in the international financial markets. But this policy was also a subject of much criticism domestic and abroad.<sup>33</sup> With the capital account liberalization promoted by the comprehensive revisions to the Foreign Exchange Law (1980), and with Japan's continued growth and its further strengthened external position, such policy ceased to be observed after entering the 1980s<sup>34</sup>.

### III.3.4. Effectiveness of Foreign Exchange Controls and Regulations on Capital Account Transactions

Although a quantitative analysis of whether the goals of these foreign exchange measures were achieved is beyond the scope of this paper, at the very least the relevant government agencies at that time were confident in their ability of managing capital flow via foreign exchange measures<sup>35</sup>. Regarding its response to the Nixon Shock, it was later stated by a senior official of the Ministry of Finance which was in charge of the matter that "The following three measures were powerful and effective; restrictions on non-resident free-yen balances, restrictions on foreign debt balances by banks, and restrictions on export prepayments"<sup>36</sup>. To be sure, the August 1971 restrictions on export prepayments stopped these prepayments nearly completely. Additionally, the yen rate was relatively stable from September until mid-November 1971 after the Nixon Shock, and also from the general float in March 1973 until the oil shock of October of the same year. Even allowing for the effect of interventions, it is likely that controls on foreign exchange had a certain stabilizing effect on the market under the conditions prevailed

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<sup>33</sup> FUJIOKA (1994) p 100 argues that "After the oil crisis was overcome, there was a wave of criticism, both at home and abroad, of the alternating use of 'heater' and 'cooler' foreign exchange controls."

<sup>34</sup> One possible exception was a series of measures to ease restrictions on the outflow of capital by the Ministry of Finance starting in the summer of 1986, after a major appreciation of the yen following the Plaza Accord. This measure liberalized investment in foreign securities by insurance companies and other financial institutions, and is described as follows: "Some argue ... that this was an attempt to halt the rise of the yen under the current conditions of the foreign exchange rate," but "the measure in question was part of a series of moves by the Ministry of Finance to liberalize finance and capital account transactions" (KONDO Takehiko, "Easing of Regulations on the Outflow of Capital," Ministry of Finance, *Finance*, Oct. 1986).

<sup>35</sup> For example, FUJIOKA (1994) p. 35 states that Japan got through the severe convulsions in international finance shortly after it began its internationalization through a masterful use of world-class foreign-exchange control.

<sup>36</sup> FUJIOKA (1994) p 35. At the same time, however, FUJIOKA states that there are limits to what foreign exchange controls can accomplish after the economy has grown and internationalization has progressed. The greater the scale of trade, the more difficult it is to respond to leads and lags with foreign exchange controls; restrictions on foreign debt balances by banks and on non-resident free-yen deposit balances are criticized both in Japan and abroad, and as internationalization of the economy progresses, it becomes impossible to apply these measures (ibid, pp 100-101).



at that time, even if they did not produce major reversals in the direction of the market<sup>37</sup>.

### III.4. Summary

The followings are the key points of Japan's experiences described above.

- (1) The liberalization of the economy took place in the following order: trade liberalization, capital account liberalization, and the liberalization of finance.
- (2) Capital accounts liberalization proceeded very gradually over a few decades.
- (3) With regard to the type of capital account transactions, liberalization of inward investment in Japan, including inward direct investment, generally preceded liberalization of outward investment.
- (4) Non-resident free-yen deposit accounts were introduced at an early stage, which later became one of the key channels for the inflow of short-term capital.
- (5) Portfolio securities investment and trade-related payments also became key channels for the short-term capital flow.
- (6) Foreign exchange controls and regulations on capital transactions were frequently adopted in order to manage short-term capital flows and are thought to have had effectiveness of a certain degree in preventing market instability.
- (7) Almost throughout the liberalization process, the authorized foreign exchange banks were used as an effective foreign exchange management mechanism.

## IV. China's Capital Account Regulations and the Implications from Japan's Experiences to China

This Chapter explores the implications of Japan's experiences for China.

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<sup>37</sup> FUJIOKA (1994) pp 100-101 wrote about an episode in which he defended Japan's foreign exchange controls which was a subject of criticism from Western countries by stating: 'Germany is championing liberalization, but they have a history of defeats to currency crisis.' In fact, after setting an exchange rate of 4.20 marks to the dollar in January 1953, in March 1961 it raised the value of the mark by 4.19%, to 4.00 marks to the dollar, in an attempt to stem a trade surplus and discourage the speculative inflow of capital. Then in 1969, it twice closed its foreign-exchange markets due to massive inflows of short-term capital amidst expectations of a revaluation of the mark, and after temporarily (30 Sep. to 24 Oct.) discarding the tolerable range of exchange rate movements, it revalued the mark by 9.3%, to 3.66 marks to the dollar on 26 October of the same year. Subsequently, in May 1971, it was forced to move to a float amidst a massive inflow of capital. As background to this, West Germany was early to liberalize its foreign exchange control, and in the latter half of the 1960s, it had almost no regulations on capital account transactions. Subsequently, however, it strengthened its regulation in order to control the flow of capital, and by around end-1973, it had the most extensive capital controls in Europe. The capital controls that West Germany adopted in this period included not only such indirect measures as reserve obligations for foreign borrowings, but also such direct regulations as a de-facto ban on the acquisition of bonds by non-residents, and on the payment of deposit interest to non-residents by placing them under approval requirements.

Table 3 Regulations on Capital Account Transactions in China

		Outward Investment (Outflow of Capital)	Inward Investment (Inflow of Capital)	
Direct investment		- Authorization system (authorization by Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and State Administration of Foreign Exchange)	- Authorization system (authorization by Ministry of Foreign Trade and Economic Cooperation (MOFTEC))	
Investment in securities	Issuance of stocks and bonds	(Issuance of stocks/bonds in China by non-residents) - Prohibited	(Overseas issuance of stocks by residents) - Authorization system (authorization by China Securities Regulatory Commission) (Overseas issuance of bonds by residents) - Authorization system (authorization by State Administration of Foreign Exchange)	
	Sale and Purchase of stocks and bonds	(Stocks) - Prohibited in principle (allowed only under special authorization of the State Council of the People's Republic of China)  (Bonds) - Possible only by financial institutions and other entities approved by the People's Bank of China (prohibited from investing foreign currencies obtained through conversion of RMB)	(Stocks) - Prohibited in principle (investment in B stocks liberalized)  (Bonds) - Prohibited	
Giving/taking loans in foreign currency		- Possible only by financial institutions and other entities approved by the MOFTEC (after-the-fact report required)	Local financial institutions and enterprises	- Authorization system (long-term loans: longer than 1 year) - Authorization by State Administration of Foreign Exchange - To be implemented in accordance with Foreign Capital Utilization Plan[1] (short term loans: 1 year or less) - Financial institutions are free to take short-term loans within balance limit approved by State Administration of Foreign Exchange (Although there is no need to gain approval for each transaction, after-the-fact report is required)
			Foreign enterprises	- Free (Note, however, that registration with State Administration of Foreign Exchange required after the fact)

Original note [1] Every year, the State Development Planning Commission formulates a 'Foreign Capital Utilization Plan,' which determines the total sum of foreign debt and the policy for the use of foreign capital including direct investment.

Original Source: IMF, 'Exchange Arrangements and Exchange Restrictions (2001)'

Source : AKAMA Hiroshi, MIFUNE Jun, and NORO Kunihisa, 'The Chinese Foreign Exchange System,' 2002, Bank of Japan Monthly Survey, May 2002 Issue

#### IV.1. China's Capital Account Regulations<sup>38</sup>

Table 3 gives an outline of China's main regulations on capital accounts. In comparison with the Japanese experience particularly over 1960's and 1970's described in the preceding Chapter, the following observations can be made of China's regulations:

##### IV.1.1. Commonalities in Basic Framework

- (1) China employs, as Japan did before 1980, a principle of general prohibition, with freedom given to exceptions, under which capital transactions are extensively regulated and authorization is awarded individually. China's approach to liberalization through the selective easing of regulations is also similar to Japan's response before the comprehensive reforms of 1980.
- (2) Japan strictly regulated foreign transactions by residents other than financial institutions, so that the effectiveness of the control of foreign exchange is ensured via oversight of financial institutions, and this mechanism also appears to exist in China.

##### IV.1.2. Commonalities in Substance of Regulations and Liberalization

- (1) Until Japan switched to restrictive policy on capital inflows under short-term capital inflows before the Nixon Shock, its basic policy was to encourage the inflow of capital and discourage its outflow. Direction of China's basic policy seems to have been the same. Recently, however, a partial easing of regulations on the outflow of capital is being implemented in China.
- (2) In Japan, inward direct investment was first liberalized in the process of liberalization, and this point is also common to China<sup>39</sup>.
- (3) Japan sought to separate domestic and foreign financial markets through such means as restrictions on the conversion of foreign currencies into yen, in order to prevent the inflow of foreign currency through the banks from impacting domestic financial markets. China as well in principle prohibits the conversion of borrowed foreign currency into the RMB without individual approval.

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<sup>38</sup> Description of China's foreign-exchange controls and regulations on capital transactions are based on AKAMA Hiroshi, MIFUNE Jun, and NORO Kunihisa, "China's Foreign Exchange System," 2002, *Bank of Japan Survey Monthly*, May 2002 Issue, KUWATA Yoshimochi "China's Foreign Currency Controls Relating to Foreign-owned Enterprises: A practical manual for companies investing in China, 2003 edition," Mizuho Research Institute, and WATANABE Toshio, Ed., "China's Economy in the Midst of Dilemma," 2003, Toyo Keizai Inc.

<sup>39</sup> In terms of actual inflows of FDIs, there is a big difference; while China has accepted a large amount of foreign direct investment, it was at a very low level in Japan at the time.

#### IV.1.3. Differences

- (1) The biggest difference between Japan's liberalization and that of China is the two countries' stance toward the internationalization of their currencies. Although Japan permitted the use of the yen in foreign settlements in 1960, China now prohibits the use of the RMB in international transactions.
- (2) Reflecting such difference in policy, while Japan introduced the non-resident free-yen deposit account in 1960, no such system exists in China (however, starting in February 2004, individuals in possession of Hong Kong IDs were authorized to open RMB denominated deposit accounts in Hong-Kong banks).
- (3) Since Japan authorized the Asian Development Bank to issue yen-denominated bonds in Japan in 1970, it has authorized each year anywhere from a dozen or so, to as many as 60 to 70, yen-denominated bond issues by non-residents in Japan, although during the first oil shock, it had a policy of discouraging the issues. In contrast, China has not yet authorized any non-resident to issue a RMB denominated bond in China<sup>40</sup>.
- (4) Another salient difference is the handling of inward portfolio securities investment. Although Japan gradually eased restrictions on inward securities investment in parallel with inward direct investment, China generally prohibits inward portfolio securities investment (however, a QFII scheme, under which investors that satisfy certain conditions (Qualified Foreign Institutional Investors: QFII) are allowed to invest in domestic equities (A shares) has also recently been started in China, and liberalization is beginning)<sup>41</sup>.
- (5) Before the abolishment of foreign currency concentration system in 1972 (at the same time general residents were allowed to hold foreign-currency deposit accounts), the possession of foreign currency by residents other than banks was not allowed, with the exception of possession of a limited amount by trading companies, overseas shipping companies, and the like. In contrast, China allows certain export companies to possess up to a given amount of foreign currency, and does not place any limits on the amount of foreign currency that can be held by individuals. In other words, the possession of foreign currency by residents is more widespread in China.
- (6) One Chinese regulation not seen in Japan is allowing foreign-owned companies to engage in activities not authorized for local companies ("supranational treatment" rather than national treatment). For instance, foreign-owned companies are allowed to borrow abroad (after-the-fact registration is required).

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<sup>40</sup> It has been reported that the start of issuance of RMB denominated bond in the China's domestic market by the International Finance Corporation (IFC) of the World Bank group and the Asian Development Bank will be approved shortly. (Nihon Keizai Shinbun, September 29, 2005)

<sup>41</sup> As for outward portfolio securities investment, Japan began its liberalization shortly after the inflow of short-term capital became an issue and by the mid-1970s, liberalization progressed encompassing general investors (via securities firms). The purchase of bonds by financial institutions approved by the People's Bank of China using foreign currency in possession has already been approved (stock investment is, however, prohibited in principle).

## IV.2. *Implications from Japan's Experiences to China*

Based on the above-mentioned similarities and differences, let us examine the relevancy of Japan's experiences in the 1960s and 70s to China's policy for liberalization of capital accounts.

### IV.2.1. *Commonalities in Basic Context*

- (1) From the latter half of 1960s, Japan rapidly increased its international presence against the background of continued strong economic growth and strengthened current account position, and capital account liberalization started to be recognized as a next foreign economic policy agenda after trade liberalization. As China currently maintains high economic growth, and is proceeding with trade liberalization following the accession of WTO membership, under generally favorable external position, there is a basic commonality of context between present China and Japan in the 1960's and 1970's.
- (2) Japan's capital account liberalization process was made to be an extremely complex one due to major shocks occurred during this process, particularly by a change in the foreign exchange rate system (from a peg to a float), and a substantial currency revaluation. In this respect too, Japan's experiences are very relevant to China as, while China's formal exchange rate regime was announced to have been changed, actual enhancement of the flexibility in the rate movements reflecting market developments remains to be seen and also as China is still faced with expectations for a further revaluation of its currency.

### IV.2.2. *Differences in Environment*

- (1) On the other hand, there are major differences in the international environments between Japan at the time, and China today. One difference is the penetration of the idea of liberalization across the globe. Decades ago, foreign exchange restrictions and capital controls were not something uncommon even among the developed countries. By contrast, today, the developed countries have almost completely liberalized their capital accounts, and while there have been some strengthening of regulations following the Asian crisis, many developing countries have substantially liberalized their capital accounts.
- (2) The international flow of capital is much greater today than it was decades ago. This increases the risk of a reversal of capital flow<sup>42</sup>.

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<sup>42</sup> Former IMF Economic counselor and Research Department Director Kenneth Rogoff has published a paper with three other IMF staff, providing a comprehensive survey of the recent empirical studies on the effects of integration into the international financial market by developing countries through capital account liberalization (Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence," International Monetary Fund, 2003, IMF Occasional paper 220). The paper concludes, based on the results of the survey, first that there is no strong support for a theoretical argument that integration with the international financial market through capital account liberalization brings high growth through more efficient distribution of capital, and second that financially integrated developing countries suffer the negative influence on their macro-economic stability (measured as relative instability of consumption).

#### IV.2.3. *Implications to China in light of Japan's Experiences*

##### (1) Appropriateness of gradualism

Japan employed a policy of gradualism. It took about 20 years from 1960, when the Basic Plan for Liberalization of Trade and Foreign Exchange was adopted, to 1980 when the wholly revised and drastically liberalized Foreign Exchange Law was implemented. And nearly another 20 years had passed before foreign exchange business was liberalized in the late 1990's. Capital account liberalization was considered to be an issue with "long and deep effects," and therefore a cautious approach was adopted. Meantime, it is sure that certain liberalization measures including introduction of the non-resident free yen account provided channels for short-term capital flows. However, such episodes are not regarded as a case where liberalization measures of capital accounts played a major role in triggering serious external crises. In this sense, Japan's gradualism performed well particularly in the turbulent period of international financial market in the 1960's to 70's. Considering the following points, an approach based on gradualism seems to be appropriate for China as well.

First, risk of large and abrupt capital flows may be already high for China. This is partly due to the change in the general environment, i.e., increase in the volume of international capital flows. But in addition to that, we should take note of the fact that current account related capital flows have become rather large in China. As examined above, during the Nixon Shock, one of Japan's largest channels for the inflow of short-term capital was through prepayments for exports (the upper chart in Figure 4). A similar trend (while in opposite direction) can be found in the movement of trade credit in China during the Asian crisis in 1997 and 1998 (the lower chart in Figure 4). There may have been leads and lags under a devaluation expectation of the RMB; collection of export payments was delayed (increase in export credit assets), and import payments were paid early (decrease in import credit liabilities)<sup>43</sup>. Furthermore, under a devaluation expectation, it may happen that residents try to retain funds abroad via the under-reporting of export earnings and the over-reporting of import payments. In short, it should be recognized that even under the current regulatory system, there is already a great risk of short-term capital flow including trade related flows when expectations grow for a change of exchange rate or for an instability in the balance of payments position. These risks are bound to increase as trade expands. As hedging and speculative activities relating to current transactions may increase in the future, the effectiveness of regulation could be also reduced.

Second, in relation to the first point, it must be noted that over a term of few years, it is

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<sup>43</sup> As of the end of 1996, China's short-term debt balance was \$25.40 billion (7.4% of foreign debt balance), and remained relatively low at the end of 1997, at \$31.50 billion. During the Asian crisis, however, there was a huge outflow of "other capital", amounting to -\$25.50 billion in 1997, and -\$43.70 billion in 1998. Therefore, if there had not been a major inflow of FDI during this period, it is likely that the RMB would have been subject to a major downward pressure.

possible for the direction of capital flow to change by a 180-degree. As described earlier, Japan had several major capital flow reversals, from a period of inflow prior to the Nixon Shock, to a period of outflow starting around the first oil shock, to a period of inflow from 1977 to 1978, and then again to a period of outflow following the second oil shock. The Asian crisis showed a destructive power of capital flow reversals. China also must proceed with the possibility of a period of capital outflow clearly in mind.

Third, the risk of capital flight must also be taken into account. Japan's 1980 revision eliminated the limit (¥3 million) on the amount of foreign currency, acquired through the conversion of yen into foreign currency, that could be held by residents in foreign-currency deposits, allowing an unlimited amount to be held. But the balance of foreign currency deposit stays at a low level; as of the end of 2003, they accounted for only 1.6% of deposit balances in domestic banks, while they are increasing in recent years. In contrast, resident foreign-currency accounts make up around 8% of all deposit balances in local domestic banks in China<sup>44</sup>. The fact that possession of foreign currency is more widespread in China than it is in Japan indicates the higher orientation in China toward foreign currency holdings, which is noteworthy. It should be also noted that while in Japan, the ratio of M2 to GDP was about 133% as of end-2002, it is quite high in China at nearly 200% as of end-2003<sup>45</sup>.

Fourth, as is often pointed out, the Chinese financial sector is far from resilient; domestic banks suffer from problems regarding soundness of their balance sheet with bad loans to state owned enterprises and insufficient regulatory and supervisory framework. Therefore, if capital accounts liberalization was implemented before these problems are corrected, it is possible that weak financial institutions increase their dependence on external capital, raising vulnerability to external shocks. So, capital account liberalization need to proceed taking into account such factors as improvements in the soundness of domestic financial institutions and the degree of effective functioning of domestic financial markets<sup>46</sup>.

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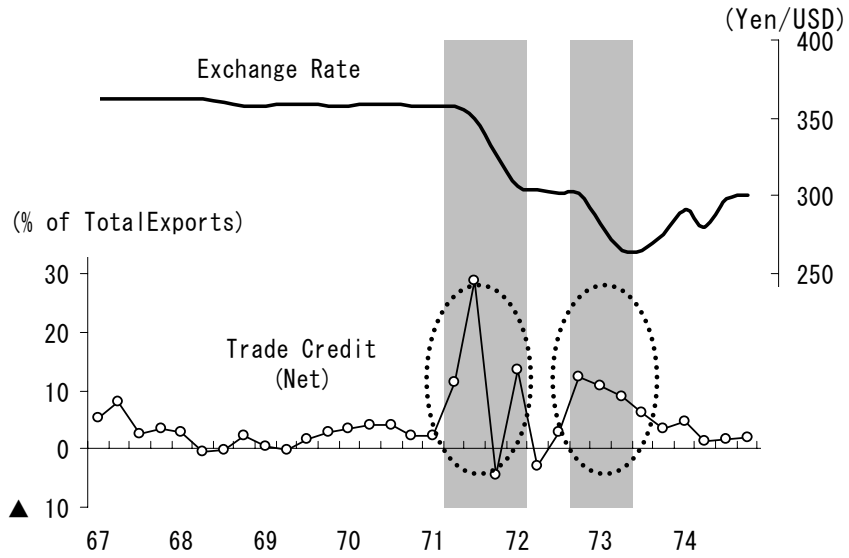
<sup>44</sup> See WATANABE Toshio Ed. (2003) p 162.

<sup>45</sup> XFN, 14 Apr. 2004

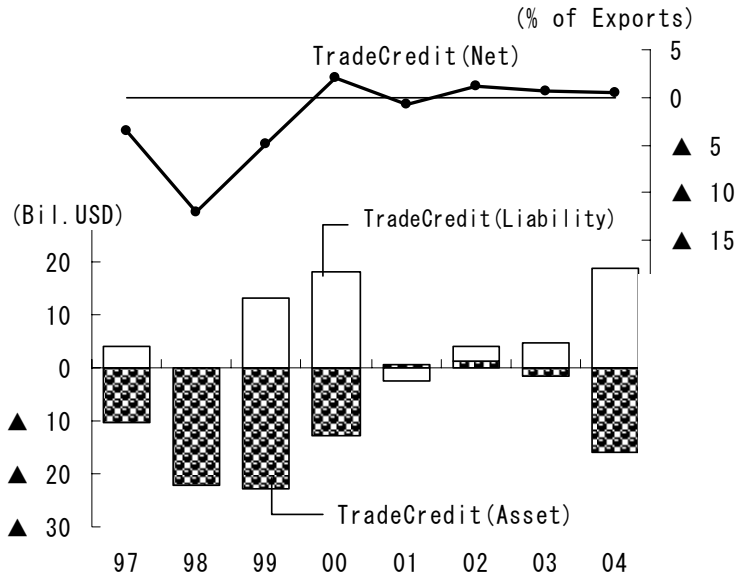
<sup>46</sup> As described in the text, in Japan, the capital account was liberalized before financial liberalization took place. The reason why such sequencing did not bring about serious problems such as excessive domestic lending financed by foreign capital and a rise in external vulnerability may include the fact that financial institutions were generally sound in the 1960's and 70's reflecting strength of the borrowing corporate sector at that time and that bank supervision was rather strict as shown in the very strict foreign exchange position limit for the banks.

Figure 4 Japan and China: Trends of Trade Credits

Japan: late 60s to early 70s



China : 1997 to 2004





## (2) Points to be noted in the formulation of a practical liberalization program

Under a gradual approach, a practical liberalization program may need to incorporate following considerations.<sup>47</sup>

First, it is vital to take into account the concomitant risks arising from liberalizations of each type of transaction, and liberalize those with the least risk first (e.g., foreign direct investment) and those with greater risk late (e.g., short-term loans). We should remember that non-resident free yen accounts, which was introduced as early as in 1960, provided an important channel for short-term capital in the period of turbulence in the market.

Second, it seems to be appropriate to start with experimental liberalization, and then proceed to general liberalization based on the experiences of the experimental liberalization.

Third, it may be necessary to be prepared for a flexible revision to the initial liberalization schedule or for a temporary halt to liberalization process in response to a change in circumstances.

Fourth, it seems to be important to retain emergency measures for the event of a crisis.

Fifth, if it is the case that Japan's control of foreign exchange had a certain effect in ensuring market stability, it is likely because Japan tended to limit those capital transaction that were conducted by other entities than banks, and tried to effectively control capital flow through supervision of banks. It is also useful for China to utilize the control mechanism through the banking system in its own liberalization<sup>48</sup>.

## (3) Appropriate timeframe and avoidance of risk of policy reversals

While cautious approach may be preferable, the following two points need to be noted.

First, while it is recommended to proceed gradually, controlling risks, the effectiveness of regulations must also be taken into account. For example, in the 1990s, Chile and Columbia made it obligatory to maintain an interest-free reserve deposit for foreign borrowings, in order to restrict the inflow of short-term capital. In order to plug loopholes, the countries subsequently expanded the regulations to other potential channels for the inflow of short-term capital (Chile in particular applied this requirement even to FDI of speculative nature). Thus, the development of financial techniques and the increased scale of capital flow may make regulations less effective than they were in the 1960s and 70s<sup>49</sup>. The longer the control measures are in force, the less effective they may become. Considering this factor, it is unrealistic to take

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<sup>47</sup> Points presented in IMF Occasional paper 211 were taken into account in this part.

<sup>48</sup> Even if banks may be expected to perform its function of management, as trade and other international activities expand, the administrative burden relating to foreign exchange on the banks may be rapidly increasing. Thus for the sake of effectiveness of banks function in vital areas, non-essential tasks must be streamlined.

<sup>49</sup> See ARIYOSHI Akira et al, 'Capital Controls: Country Experiences with Their Use and Liberalization,' 2000, IMF Occasional Paper 190 pp. 6-18.

in liberalization as long a period as decades as Japan did. A substantially shortened period need to be considered.

Second, Japan frequently implemented foreign exchange and capital control measures in response to capital flows, or took steps backward in its liberalization in response to the situation. However, unlike the 1960s and 70s, the idea of liberalization has penetrated today, and many countries, both developed and developing, have made considerable progress toward liberalizing their capital accounts. Additionally, unlike Japan at the time, there are currently a large number of foreign-owned banks and other foreign-owned enterprises in China, and these enterprises have many affiliates worldwide. In light of these facts, negative reactions to backward measures, if implemented, could be very strong. It is thus important to move ahead steadily, without any major "backward steps" in liberalization to the maximum extent possible, and it is better to respond to changes in the situation by halting further liberalization and using emergency measure that are reserved.

#### (4) Appropriateness of de facto change in the exchange rate regime before the major liberalization

While the China's foreign exchange rate regime has been formally changed recently, how the formal change leads to a de facto change in the rate determination yet remains to be seen. On the relationship between such de facto change and liberalization of capital accounts, it must be noted that the liberalization of capital account regulations generally increases the amount of capital that can move when a shock occurs. It makes no difference whether liberalization is for the promotion of outward flow or inward flow. For example, liberalizing outward portfolio securities investment will initially promote the outflow of capital. However, in due course, balance will build up, and their sale could function as an inflow factor (This consideration cannot be irrelevant to the outward investment in foreign bond recently started by the approved financial institutions). Consequently, if there is a concern about the impact on capital flow by a substantial change in the (de fact) foreign exchange rate management, it is better first to see the extent and nature of the effects of such change in the exchange rate on capital flows and not to undertake major liberalization of capital accounts before such change.

It was argued in the above that strengthening of the domestic financial sector need to be realized before the capital account liberalization is implemented. If liberalization of finance lagged behind the liberalization of capital accounts, the movement of capital between regulated domestic financial markets and free overseas markets could be accelerated. In the case of Japan such pressure may have been mitigated by a floated exchange rate. If the flow of capital to and from a regulated domestic financial market is liberalized under a fixed exchange-rate system, then it can amplify the volume of capital flow. This risk is maybe far greater now than in decades ago, since the absolute volume of capital flow is also greater. Therefore, it is very risky to

enhance integration between domestic and international financial markets without flexible exchange rate movements.

#### (5) Other considerations

Some elements that were not present in Japan are: (A) the existence of RMB deposit accounts by Hong Kong ID holders; (B) preferential treatments of foreign enterprises; (C) a different treatment between foreign-owned and local banks. Factor (A) could become a channel for the inflow of short-term capital, which is quite similar to what non-resident free-yen deposits brought about in Japan<sup>50</sup>. As for (B) and (C) above, if it is not possible to maintain unequal treatment of domestic and foreign capital in the future, the policy option is whether to treat foreign capital in the same way as a domestic capital (strengthening of regulations on foreign capital), or to bring the treatment of domestic capital in line with that of foreign capital (this means relaxation, and therefore, the overall schedule for capital account liberalization would become constraints).

## V. Conclusion

This paper tried to summarize the process of capital account liberalization by Japan from the period immediately after World War II to the 1990's and to identify relevant points for China's capital account liberalization.

The internal and external conditions that China faces today have, on the one hand, common elements with Japan in the 1960's and 70's (e.g. high economic growth, balance of payments surplus, increasing foreign-currency reserves, and upward pressure on the currency), and, on the other hand, different elements (e.g. worldwide trend toward capital accounts liberalization, and the increase in scale of cross-border capital flow). Additionally, although there are many similarities between two countries in the basic mechanisms of foreign exchange and capital controls (e.g. a principle of general prohibition, fundamental stance of encouraging capital inflow, and management through the banks), there are also differences (e.g. stance toward internationalization of the domestic currency and special treatment of foreign enterprises).

Compared to the 1960s and 70s, when Japan experienced a change in its foreign exchange rate system and a major revaluation of its currency, the size of the flow of cross-border capital and therefore, their potential impact is much greater now. On the other hand, the acceptance of capital controls by the international community is much lower. Thus in general, the environment

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<sup>50</sup> According to newspaper reports, on March 10, 2004, Hong Kong authorities announced that 35 banks were handling Renminbi (Yuan) accounts with deposit balances greater than 2 billion Yuan. Additionally, the majority of the Renminbi accounts were converted from Hong Kong dollars, and of the new accounts opened at HSBC and others, roughly 75% were converted from Hong Kong dollars, with cash deposits at only about 25% (The Nikkei Financial Daily, 1 April 2004).

today is much less hospitable for China, which has to have, on its policy agenda, a practical change to their exchange rate management and the liberalization of capital accounts. Nevertheless, a great deal is at stake with the liberalization of capital accounts as was shown in the Asian crisis. From such a view point, this paper tried to draw implications to China based on Japan's experiences as clearly as possible.

Major relevant points for China examined in this paper are as below.

- (1) Considering relevant factors that China now faces such as the risk of huge capital movements, potential risk of capital reversals and lack of soundness of domestic financial sector, it seems appropriate for China to employ a gradual approach to the capital account liberalization as was employed by Japan in the past.
- (2) In the formulation of a liberalization program, it seems to be important to liberalize those with the least risk first and those with greater risk late, to start with experimental liberalization, and then proceed to general liberalization, to flexibly revise the initial liberalization schedule in response to a change in circumstances, to retain emergency measures for the event of a crisis and to utilize the control mechanism through the banking system.
- (3) However, as the effectiveness of regulations may have diminished and their long use may lead to a further reduction of their effectiveness, the time frame for China cannot be as long as decades as in the case of Japan and a substantially shortened period need to be considered for liberalization process.
- (4) On the relationship between the change in the foreign exchange rate determination mechanism and liberalization of capital accounts, as capital accounts liberalization measures, no matter whether they are originally intended to promote inflows or outflows of capital, are bound to increase the amount of capital that can move in the event of a crisis, major liberalization measures of capital accounts should be considered only after impact on capital flows of a de facto change in the foreign exchange rate determination is examined.
- (5) While liberalization of finance came after the liberalization of capital accounts in Japan, the move to a floating exchange rate regime alleviated pressures for cross boarder capital movements. By contrast, if the integration of domestic and international financial markets is implemented in China while maintaining a de facto fixed exchange rate system, the risk of abrupt and large capital flows between regulated domestic markets and liberalized international markets will be amplified.
- (6) It is important to properly handle those Issues that are specific to China such as RMB deposit accounts by Hong Kong ID holders and different treatments between foreign and local capital.

As the China's weight in the global economy is rapidly increasing, it is vitally important not

only for China but also for Japan and the world economy that China will properly proceed without assuming excessive risk to the integration with global financial markets which is characterized by potential instability. As was shown in this paper, experiences of Japan of the decades ago with which present China seems to have a lot of factors in common can provide useful inputs for the policy selection for China in the periods to come.

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