

May 11, 2000

## **A Private-sector Perspective on the Internationalization of the Yen**

A Study on Japanese and Asian Stability and Growth

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### **1. Rethinking the Internationalization of the Yen**

#### **1.1. How we see the issue**

The Asian currency and financial crisis (1997) and the creation of the euro as a common European currency (1999) have sparked renewed policy interest in internationalizing the yen. In April 1999, the Ministry of Finance's Council on Foreign Exchange and Other Transactions released a set of recommendations entitled "Internationalization of the Yen for the 21st Century." This was then followed by various studies on what the government and private sector can and should do to promote the yen's internationalization.

The private sector finds the fact that Japanese companies and consumers alike have been buffeted by the sharp fluctuations in currency markets since the shift to floating exchange rates, especially since the 1985 Plaza Accord, to be problematic, and strongly hopes for currency stability.

There are, of course, a number of other issues besides the internationalization of the yen that need to be addressed in the interests of stabilizing currency exchange markets and the international financial system-among them reform of the IMF and other international financial arrangements, national policies on currency exchange systems, modalities of policy cooperation and joint intervention, and means to deal with excessive short-term capital volatility exacerbated by hedge and other funds of international investors. However, we believe that the internationalization of the yen can contribute to international

currency stabilization, even if only indirectly, and that it is important for the government and the private sector to do what they can to this end.

It is true that capital and financial markets are being increasingly deregulated and the yen is coming into greater use as a result of the Japanese "big bang." However, there are still many things that need to be done to improve the Japanese tax system and capital markets to enhance the yen's ease of use as an international currency.

As private-sector business people, we offer this paper in an attempt to bring a new perspective to the yen's internationalization and to complement the many other studies that have already been done. At the same time, we want to think about the internationalization of the yen in terms of how the yen can be used more by Japan's Asian neighbors, not only to Japan's advantage but to theirs as well.

## **1.2. Defining the internationalization of the yen**

The results of our Survey on the Internationalization of the Yen indicate that the yen's internationalization means different things to different member companies: 76.9% of them seeing it in terms of making the yen a more important international currency, 24.4% as making the yen a key currency, 37.2% as expanding the yen trading bloc in Asia, and 37.2% as expanding the yen trading bloc worldwide.

We have chosen to adopt the definition offered in the Ministry of Finance Council's recommendations as the basis of discussion: Increasing the use of the yen in Japanese cross-border transactions and overseas transactions and increasing yen holdings in non-residents' asset accounts, which is to say enhancing the yen's role in the international financial system, in ordinary and capital trade, and as a reserve currency.

## **2. Current State of the Internationalization of the Yen**

### **2.1. Lack of progress in the internationalization of the yen**

Working from the Council's definition, the yen has yet to be very internationalized. The usage of yen in current transactions, capital transactions, as a reserve currency, and other measures has not increased materially in recent years, and

there are even some areas in which it has receded. The same trends were apparent in our survey of member companies, in-depth discussions with member companies, and discussions with two Asian study missions.

## **2.2. Assessments by Japanese companies and Asian countries**

In the course of our studies, we have identified a difference in how Japanese companies and Asian countries see the current state of the yen's internationalization.

### **2.2.1. Assessments by Japanese companies**

Japanese companies are aware of the benefits of the yen's internationalization. They see internationalization as reducing currency risks and foreign-currency liquidity risks, and see the greater international use of the yen as translating into expanded business opportunities for Japanese companies and Japanese financial institutions. If possible, they would rather denominate their trade in yen than in foreign currencies, since they think that would contribute to better business stability. In fact, trade is often denominated in yen when Japanese firms have an absolute competitive advantage in products exported or when Japanese importers dominate the markets.

Yet with the yen's rapid appreciation following the Plaza Accord, exporting companies have been dollarizing many of their costs to match their dollar-denominated export earnings. Many companies with overseas manufacturing facilities and other globally active companies have resorted to using the dollar even in trading with their subsidiaries, assuming the dollar to be the standard currency for contract and settlement in international transactions. Many of these companies recognize that increasing the use of the yen under the current domestic and international political and economic frameworks is difficult.

### **2.2.2. Assessments by Asian countries**

Asian countries are not, overall, very interested in the yen's internationalization. It is true, in the immediate wake of the Asian currency and financial crisis, that there has been interest in accepting yen-denominated loans, moving to yen-denominated settlements, and taking other measures that would result in the yen's internationalization as a means of stabilizing the markets and

economies roiled by the crisis. Also, Asian countries realize that exchange rate volatility between the yen and their own currencies have had a major impact on their economic and trade performance.

There are, however, already well-established frameworks in Asia assuming the use of the U.S. dollar in international trade and there is no perceived imperative to increase the use of the yen. At the same time, some of these countries seem to wonder why Japan is so intent on internationalizing the yen as a matter of policy. There are even suspicions that Japan is attempting to shift the entire exchange risk to its trading partners, under the guise of internationalizing the yen. Likewise, some countries seem to be preoccupied with immediate needs, such as improving their own corporate governance and strengthening their financial systems, and do not have time to worry about what role another country's currency does or does not play.

That said, from the perspective of developing their own economies, countries in general have strong interest in and high expectations for strengthening economic cooperation with Japan and, having Japan better represent Asian interests in the international arena and contribute to the stabilization of global currency exchange.

Given this situation, it is unrealistic to set a simple but vague policy target such as enhancing the yen's role in economies around the entire world. Rather, we would like to focus our discussion here on increasing the use of the yen and yen-denominated instruments in nearby Asia.

### **2.3. Why the yen is not more international**

It is thus useful to look here at why the yen has been so slow to internationalize in Asia.

#### **2.3.1. Fears of exchange risk in yen-denominated trade**

Even though many Asian countries moved to floating exchange rates following the Asian currency and financial crisis, the fact that they had pegged their currencies to the dollar for so long means that they fear using the yen would entail new exchange risks. Some of these countries are still troubled by the memory of having been exposed to large exchange losses on yen debts and other yen-denominated borrowings, as the yen had appreciated fairly consistently ever since Japan went off the fixed exchange rate of ¥360/\$. Further,

because their trade with Japan has not far outweighed trade with the other industrialized countries, they have not felt a need to use the yen more. Likewise, the fact that the yen has been more volatile than the leading European currencies have been vis-a-vis the dollar has been another factor making the Asian countries shy away from using the yen more.

Seen from the perspective of all of Asia including Japan, there are still dramatic economic disparities within the region. This, coupled with historic circumstances, makes it difficult to develop a strong political center of gravity. All of these elements are factors in why the Asian countries are not anxious to see the yen play a leading role.

### **2.3.2.The slow progress of internationalization in Japanese financial and capital markets**

The Japanese economy's prolonged sluggishness in the 1990s has eroded the attractiveness of the yen. And the slow pace of internationalization in Japanese financial and capital markets has made yen-denominated assets and liabilities unattractive and inconvenient. In addition, even though many of the restrictions pertaining to cross-border transactions have been lifted, there are still considerable business-practice and systemic barriers making it difficult for non-residents to do business in Japan. These factors which obstruct the usability of the yen stem from Japan's own problems.

### **2.3.3.The dollar as the de facto standard**

The dollar's presence is another major factor. With dollar-denominated trading dominating international commodity markets and elsewhere, a de facto standard has been established that assumes the use of the dollar and there is no imperative to use the yen. Foreign exchange markets are also dominated by trading against the dollar, and it thus costs far less to use the dollar than it would to use the yen. In fact, to exchange the yen and the Korean won, it is cheaper to go between the yen and the dollar and the dollar and the won than it is to go directly between the yen and the won.

## **3. Prerequisites to the Internationalization of the Yen**

### **3.1. Extending the sphere of discussion from "expanding yen-denominated trading" to "strengthening Asian interdependence and intra-regional cooperation"**

There are a number of reasons why so little progress has been made in internationalizing the yen, and it will not be easy for government policy and private-sector initiatives to overcome these causes in a short period of time and to make major progress-as is clear from the fact that the yen's usage as an international currency has remained flat even though a number of policy measures have been put into place to make it more convenient and attractive. It is thus necessary to learn from experience and to realize that financial policy efforts to make the yen more usable are alone not sufficient to advance the internationalization of the yen, and have to be complemented by measures in the real economy that will heighten the need for the yen's greater use. It is difficult to internationalize the yen so long as this is approached simply as an effort to expand yen-denominated trade. Unless substantiated by the real economy, switching the trading currency from the U.S. dollar to the yen will merely mean increased trading costs. Private companies operate in pursuit of profit, and they cannot switch from the dollar to the yen so long as such a switch means greater exposure to exchange risks and higher trading costs.

Given an established de facto standard assuming the use of the dollar, it is difficult to make the yen more international simply by making it easier to use. Common sense tells us that conditions will be right for the yen's internationalization only when interdependence and cooperation are deepened throughout Asia including Japan. If such cooperative interdependence can be strengthened, there will be more intra-regional trade. It will be more important that intra-regional currency markets be stable, and consequently, conditions will come to favor the emergence of an intra-regional lead currency or anchor currency. Once conditions favor the adoption of fixed exchange rates or a common currency, the yen is a strong candidate to serve as the region's lead currency. This analysis is also substantiated by the mark's experience in the years leading up to Europe's adoption of the euro.

It must be stressed that success in steadily implementing measures needed to deepen the interdependence and cooperation in Asia is a prerequisite for the internationalization of the yen. It is thus critical to extend the focus of the discussion from the expansion of yen-denominated trade to the promotion of

Asian interdependence and cooperation. This will eventually contribute to economic stability and growth for Japan and for the rest of Asia.

### **3.2. The benefits of yen internationalization - A winning scenario for all**

It is now possible to put into perspective the advantages of stronger Asian interdependence and intra-regional cooperation, and the resultant internationalization of the yen.

#### **3.2.1. Advantages for Asia**

Having the yen come into greater use as a result of heightened interdependence and expanded intra-regional cooperation will contribute to the stabilization and development of Asian economies, and it is hoped that building stronger ties of co-dependence and co-prosperity with Japan will make the Asian economies more competitive.

At the same time, this will make it possible to procure stable yen capital from Japan, with its abundant capital surpluses, to meet the capital needs of Asian countries with their high growth potential. Creating a stable currency exchange market between the yen and the Asian currencies will also make it possible to alleviate the increased costs and other problems that were encountered in the past when the yen strengthened against the dollar, and it is hoped that the expansion of intra-regional trade will also lessen the region's vulnerability to yen-dollar exchange rate volatility.

Finally, in the event of another situation similar to the recent Asian currency and financial crisis, it should be possible to make flexible use of yen-denominated capital to head off a foreign currency liquidity crisis before it reaches crisis proportions.

#### **3.2.2. Advantages for Japan**

If greater Asian interdependence and intra-regional cooperation can result in the yen's playing a trade role commensurate with Japan's economic importance, this will be advantageous for Japanese corporations and consumers in terms of stability and growth. As many people have pointed out, some of the advantages to the yen's internationalization are that it reduces exchange risks, lessens the risk of foreign currency liquidity crunches, and expands the business

opportunities for Japanese corporations and financial institutions by giving the yen a greater usage share.

Such internationalization can also lessen the exchange risk exposure of those overseas net reserves built up as a result of Japan's substantial and sustained trade surpluses. In effect, it can contribute to the stable, effective management of Japanese savings—a major issue that is bound to arise with the advent of the aged society.

### **3.2.3. Advantages for the world**

An enhanced presence for Japan and Asia will give these economies more bargaining power vis-a-vis the United States and Europe. Assuming this results in more effective mutual surveillance, it will mean that all countries rein in their economic excesses to create a situation conducive to greater currency exchange stability among the dollar, the euro, and the yen and to greater stability in the global economy.

### **3.3. Policies and measures needed for the internationalization of the yen**

The measures that need to be taken to promote internationalization of the yen may be divided into those measures to be undertaken by Japan acting alone and those to be undertaken in cooperation with the other Asian economies. Although some of the recommendations here may overlap proposals already reported in the media or made by other institutions or individuals, they are mentioned here to highlight the themes that bear repeating from a business perspective.

#### **3.3.1. Measures to be taken by Japan alone**

Ensuring that the Japanese economy is more open and international, we have to make it deserving of Asia's trust in order to strengthen Japan's cooperative economic relations with the rest of Asia.

##### **3.3.1.1. Getting the Japanese economy back on track**

It is essential that an effort be made to get the Japanese economy back on the growth track and to restore trust in the economy by, for example, promoting structural reforms, -- as has been quite often pointed out -- maintaining sound macroeconomic policies, and working to rebuild a sound financial footing for the



government from a long-term perspective. These are all broad-stroke policies, but they are essential prerequisites to any effort to internationalize the yen in that they will help buttress international confidence in the yen.

### **3.3.1.2. Internationalizing the Japanese economy**

Japan has had some success in deregulating and eliminating many of the restrictions relating to cross-border transactions. Yet there are still systemic arrangements and business practices that make it difficult for non-residents to do business on equal footing with residents. There also are cases where it has become more difficult for non-residents to do business because of inconsistent or partial applications of global-standards to regulations in certain areas. It is necessary not only to liberalize cross-border transactions but to take measures to truly internationalize the entire system from within, such as making taxation and other systems more compatible with those in other industrialized countries.

#### **3.3.1.2.1. Internationalizing the financial and capital markets**

It is essential to steadily advance the financial "big bang" as a pillar of deregulation in Japan. Providing various investment and hedging instruments and forming an efficient yield curve, by making available a wide range of yen-denominated financial products that meet international standards is an essential prerequisite to making the yen more attractive to use. Enhancing the government bond market (including developing a medium-term government bond market, vitalizing the short-term government bond market, and allowing Separate Trading of Registered Interest and Principal of Securities [STRIPS] tradings) is especially important as an effective means of building an infrastructure conducive to yen use by non-residents, since government bonds are an important instrument of liquidity.

Another important issue is that of establishing more comprehensive and centralized settlement systems. It is imperative that Japan work to improve the domestic settlement systems (in the direction of Real-time Gross Settlement [RTGS], Delivery-versus-Payment [DVP] systems, and T+1 next-day settlement), to respond to the globalization of government bond settlement systems, to enable paperless securities transactions and settlements, and to effect the necessary revisions of related laws and regulations (including those to the Law concerning Government Bonds) so as to stay at the global forefront.

The establishment of yen-denominated international commodity markets for those commodities in particular for which Japan is a major importer is another effective means of internationalizing the yen.

#### **3.3.1.2.2. Review of existing systems**

With reference to the tax system, it is also hoped that, as well as prompt introduction of consolidated taxation and a reduction of corporate tax rates to Euro-American levels, progress can be made on eliminating withholding tax on dividend and interest income (abolishing distinctions between residents and non-residents) and simultaneously adopting comprehensive taxation (taxpayer identification numbers system) to make sure the system is fair. These are far-reaching issues that go to the very heart of the tax system, but they are essential to enhancing the market for government bonds which in turn will make the yen more convenient and attractive. They are also essential to making the tax system more transparent.

Looking at accounting practices, and from the perspective of Japanese companies that do business globally, it is important that the efforts now underway to align Japanese accounting practices with international standards be continued unrelentingly.

The judicial system also needs to be brought into line with global standards, including ensuring that there are more lawyers familiar with international law and speeding up of the judicial process.

#### **3.3.1.2.3. Infrastructure demands for internationalization**

The provision of world-class infrastructure is prerequisite to making Japan an international society open to the world, and this has to include physical infrastructure such as communications networks, office availability, housing, schools, and airports offering good quality at reasonable prices; human resources infrastructure such as lawyers, accountants, consultants, and other professionals able to offer their services in English; and social infrastructure which effectively draws upon foreign labor in various fields such as advanced IT and health care services.

#### **3.3.2. Measures to be undertaken by Japan in cooperation with Asia**

Both the government and the private-sector must make every effort to strengthen economic relations and intra-regional cooperation throughout Asia.

### **3.3.2.1. Structuring intra-regional cooperation in trade, investment, and finance**

Japan should work to create an Asia in which people, goods, money, and information move freely. Among the prime possibilities here are a Free Trade Agreement (FTA), direct investment agreements, currency stabilization agreements among monetary authorities, and the Asian Monetary Fund and similar institutions.

#### **3.3.2.1.1. FTA and investment agreements**

In parallel with preparations for the next round of World Trade Organization (WTO) negotiations, Japan shall proceed to enter into free trade agreements with individual Asian economies. In this, it is essential that specific trade and investment issues with the particular economies be fully discussed between the relevant governments and business sectors and that these discussions be incorporated in the agreement itself. On investment agreements, along with cooperating fully with the attempt to draw up comprehensive international investment rules in the OECD and other bodies, efforts should also be made to conclude and improve bilateral investment agreements.

#### **3.3.2.1.2. Currency stabilization agreements among monetary authorities**

Every effort should be made to build upon and strengthen the cooperative relationships created in the Executives' Meeting of East Asia and Pacific Central Banks and other fora. Given that short-term currency fluctuation has a deleterious impact on all economies involved, it is hoped that there will be further discussions on the policy pros and cons of establishing target zones and other arrangements.

#### **3.3.2.1.3. Asian lender of last resort**

Efforts should be made to identify realistic means and to put the necessary arrangements into place to create an Asian lender of last resort, e.g., by

establishing the Asian Monetary Fund (AMF), or expanding the functions of the Asian Development Bank.

#### **3.3.2.2. Promoting cooperation among capital and financial markets**

Initiatives to strengthen cooperation among the financial centers in Tokyo, Hong Kong, and Singapore should be explored, including the possibility of creating a pan-Asian settlement system for securities transactions. At the same time, cooperation and linkages should be further promoted among the region's financial and capital markets, including but not limited to Hong Kong, Singapore, and Tokyo.

#### **3.3.2.3. Developing forward markets for direct trading between Asian currencies**

Adequate provision of instruments for hedging the exchange risk of the yen is essential for the yen's wider use in the region, and interbank markets of forward exchange between Asian currencies should be promoted by private-sector financial institutions. At the same time, it is essential that the governments concerned cooperate with each other in establishing and improving the necessary infrastructure.

#### **3.3.2.4. Actively utilizing the New Miyazawa Initiative**

These efforts should not stop at the government-to-government credit support announced in the face of the Asian currency crisis, but should entail active support along the lines of Resource Mobilization Plan for Asia (what has been called the Second Stage of the New Miyazawa Initiative) of May 1999.

#### **3.3.2.5. Promoting intra-regional business cooperation and partnerships**

One policy for internationalizing the yen is that of expanding the supply of yen to Asia. Among the things that could be done to build a track record in areas of private business are promoting yen-denominated imports and other yen-based trading systems (e.g., tradings and other transactions entailing yen cash flows that can be in turn appropriated to the repayment of yen loans), making more use of the issuing market for yen-denominated bonds (e.g., more use of the Tokyo capital market by Asian issuers), inducing more investments in yen-based

venture capital to Asian start-ups, and promoting cooperation and partnerships between Japanese and Asian firms.

#### **4. Toward a Grand Design for the Asian Economy in the 21st Century**

There is still much that needs to be done to internationalize the yen, and it is essential that the private sector make a start on the things that can be done now, such as promoting yen-denominated imports. At the same time, it is also essential that government and business cooperate in setting forth a long-term vision for the international financial system in the 21st century.

In so doing, we would like to emphasize again that the starting point for advocating the yen's internationalization has to be rethought and this has to be argued not simply as expanding yen-denominated trade but rather as a consequence of strengthening Asian interdependence and intra-regional cooperation.

That said, there are still several points that need to be taken into account. One is the importance of ensuring that the real economy and the money economy are complementary. If trade, foreign direct investment, and other activities result in heightened intra-regional interdependence, regional currencies, including the yen, will be used more in intra-regional transactions. The reverse is also true. This has to be kept in mind.

The other point to be remembered is the importance of balancing regionalism and globalism. While regional cooperation is important, promoting this in discriminatory, exclusionary, and closed ways could well invite retaliation from outside of the region. Asia's economic development was possible only through the openness and liberalism of the global economy, and extra-regional retaliation would have a seriously adverse impact. Care must constantly be taken to ensure compatibility with the IMF, WTO, and other global multilateral systems.

Asia is a region of great diversity. This makes it all the more important to continue to look for Asian common interests and to work to deepen Asian interdependence and intra-regional cooperation. Such policies also contribute to economic stability and growth for Japan and all of Asia. Likewise, Asia's diversity means that the effort should not try to build intra-regional cooperation involving all Asian players right from the start but should begin with those economies that are similarly structured where cooperation will be easier. Asian populations are

large, and even just two countries cooperating could well create an economy of a size that the EU and NAFTA cannot afford to neglect. The benefits even of such bilateral cooperation should not be small.

Keeping these principles in mind, if we can create the economic conditions that will lead to the optimal currency sphere over the long run through building governmental and private-sector cooperation between Japan and the rest of Asia for co-dependence and mutual prosperity, it should then be possible to work out a grand design for Asia's economy in the 21st century.