Section 3　External Economic Policy

1　The Shift to the Floating Exchange Rate System and the Two Oil Crises

The Dollar Shock and the Smithsonian Agreement. On August 15, 1971 (August 16, Japan Time), the U.S. President Nixon announced the dollar defense package ("New Economic program") to cope with the worsening balance of payments and inflation of the United States, and ceased trading between gold and dollar. This was the end of the Bretton Woods international monetary system, 27 years after it was established, in July 1944. The exchange rate of 360 yen per dollar, which started in 1949, also ended. In and after September 1971, the major countries (G10) discussed the international currency adjustment issue, aiming at reconstructing the fixed exchange rate system, and an agreement was made at the Smithsonian Meeting (in Washington) on December 18. The agreement included: (1) a change in the exchange rate for foreign currencies; (2) the expansion of the fluctuation range of the exchange rates to 2.25% above and below the target rate (which was a 1% of range against parity); (3) the United States set the official price of gold at $38 per ounce (which was $35; the devaluation range of the dollar would be 7.89%); and (4) the United States suppressed its import surcharges. According to this agreement, the yen was appreciated to the dollar by 16.88%(7.66 % for gold), to ¥308 per dollar.

The Shift to the Floating Exchange Rate System. By the multilateral adjustment of the Smithsonian Meeting, the major currencies returned to a fixed rate, but the exchange market remained in confusion. The U.S. government had no strong intention to protect the new exchange rate (Central Rate) nor to intervene the exchange market.

In Europe, the EC countries started to unify. In April 1972, the EC made the fluctuation range of the currency in the region to half of the fluctuation range specified under Smithsonian Agreement, at 2.25%. The intervention was made for each EC currencies (the so-called "Snake in the Tunnel").

However, U.K. had to disengage from the Snake (joint floating of EC countries) and shift to an individual floating system on June 23, two months after the agreement. In 1973, a currency crisis reoccurred as the Italian lira adopted the dual exchange rate system on January 22 (an exchange rate system which applied the floating exchange rate only to capital transactions), while the Swiss franc changed to a floating exchange rate system on the following day, the 23rd. In early February, there was drastic speculation, with selling of dollars and buying of marks.

The U.S. government faced this situation and again moved towards the adjustment of the currencies. From February 7 to 12, 1973, Paul Volcker, the Under Secretary for Monetary Affairs of the U.S., traveled to Japan and European countries for discussions. Volcker visited Japan first and talked with the Minister of Finance, Kiichi Aichi. In the Aichi-Volcker talks on February 8, the United States proposed to raise the value of the yen by 9% and devalue the dollar by 9%, but Japan insisted in disagreeing with the yen appreciation, and therefore no consensus was reached on this issue. Volcker flew from Japan to Europe for discussions with the Finance Ministers of four European countries on February 11. Japan also closed the Tokyo Exchange Market on February 10 and dispatched a special advisor to the Ministry of Finance, Takashi Hosomi, to Europe. After a series of discussions, Japan agreed to the fluctuation rate in a range from 257 to 264 yen per dollar. On February 13, the Secretary of the Treasury Schultz announced a 10% devaluation of SDR parity to dollar. The Minister of Finance Aichi also announced the shift of the yen to the floating exchange rate system, effective February 14.

Even after the devaluation of dollar, the dollar crisis continued. This led to large-scale dollar selling on March 1, and closing of the exchange market of European countries on March 2 (it reopened on March 19; the Tokyo Exchange Market was closed during the same period). On March 9 and 16, talks between 14 countries, including G10, took place in Paris and the floating exchange rate system was agreed upon. Therefore, EC countries shifted to the floating system on March 19.

As stated above, the dollar devaluation under the Smithsonian Agreement was insufficient to stabilize the exchange market. The currency exchange adjustment was finally completed upon the shift to the floating exchange rate system in March 1973.

Examination of the Reform of the International Monetary System. After the termination of the exchange of U.S. gold reserves for dollars, countries gradually shifted to the floating exchange rate system, but various countries and the IMF tried to reconstruct the international monetary system.

In the Smithsonian Meeting, it was decided to study the reform of the international monetary system after the termination of the exchange of U.S. gold reserves for dollars from a long-term perspective, in the framework of the IMF. According to this, on July 28, 1972, the IMF decided to establish the Meeting of Committee of Twenty (C20) for the "reform of international monetary system" (effective September 28). The new organization known as C20 was established because developing countries were critical about international monetary problems being solved only by the industrialized countries and the U.S. was concerned about the large influence of the European countries in G10.

In the IMF Annual Meeting (Washington) from September 25 to 29, 1972, an agreement was made that the reform of international monetary system would be accomplished within three years, and countries started to work on the reform of international monetary system.

C20 prepared and submitted a first draft of the "Outline of Reform" to the IMF Annual Meeting. This draft proposed the basic plans to revise the system "based on stable but adjustable par values and floating rates recognized as providing a useful technique in particular situations" and with "SDR becoming the principal reserve asset", but a specific currency rearrangement system issue remained pending.

C20 was supposed to complete its efforts on the international monetary system by July 1974, but the schedule was delayed due to the Oil Crisis that occurred in October 1973. C20 Rome Meeting in January 1974 confirmed that its reform efforts would be completed by June. The summary was prepared and the "Outline of Reform" was submitted to C20 (Washington) conducted on June 12 to 13. The basic points were the same as the first draft submitted to the Nairobi Annual Meeting, and the controversial points remained unsolved, but it focused on measures for the immediate Oil Crisis.

The First Oil Crisis and Oil Money. The Fourth Middle-East War began on October 6, 1973 between Egypt, Syria and Israel. Arab oil-producing countries intended to use oil as a diplomatic measure, to lead an advantageous international situation for them. With the hike of crude oil, the price per barrel, which was $3.01 before the war broke out, reached $11.65, four times the previous price, in January 1974.

Due to the steep rise of crude oil, non-oil producing countries suffered from considerable trade deficits, due to which the international balance of payments pattern changed significantly. The developed countries' economies faced the trilemma of current account deficit, inflation, and economic slowdown. In 1974, OECD developed industrial countries recorded nearly $27 billion of current account deficit and the real growth rate of G7 countries (on average) dropped from 6.2% in 1973 to 0.2% in 1974 and -0.3% in 1975. The current account deficit of non-oil producing developing countries reached $24.5 billion and $38.5 billion in 1974 and 1975, respectively

In contrast, oil-producing countries (OPEC countries), which were mostly Arab oil-producing countries, enjoyed a current account surplus of $59.3 billion and $27.3 billion in 1974 and 1975, respectively, and achieved a tremendous amount of foreign currency revenues.

Therefore, it was essential to circulate the oil money obtained by the oil-producing countries smoothly in the international market to resolve the confusion of the world

economy.
Political circulation promotion measures were taken by the IMF and the OECD.

The IMF established an oil facility in order to circulate the oil money to developing countries with less debt capacity. This was a fund system to provide oil to the IMF countries who had a deficit in terms of their balance of payments in 1974 and 1975 (decided on June 13, 1974). From 1974 to early 1976, the oil facility of IMF was no more than 6% of OPEC's excess fund, which was estimated at about $10.2 billion, which was too small to play a key role in circulation of the oil money. Meanwhile, the mutual monetary support agreement (OECD Monetary Support Fund Agreement) of 23 OECD countries was established on April 9, 1975. The Japanese government was reluctant to use such deliberate circulation measures through an international organization, as they emphasized market-based circulation from the standpoint that there should be many options for circulating the oil money. Japan also stepped away from the United States, which was trying to unite the industrialized countries to fight against the oil-producing countries.

In reality, the circulation through the Euro Market and the U.S. Market was conducted more smoothly than expected.

The Kingston Accord and IMF Reform. It was difficult to design a scenario for the international monetary system from a long-term perspective after the first Oil Crisis, so G20 had to concentrate on short-term reform to cope with the floating exchange rate system.

C20's final report, "Outline of Reform", was submitted to the IMF Annual Meeting conducted in Washington from September 30 to October 4, 1974. It stated that the floating exchange rate system had to be maintained provisionally, while it was proposed to provide a stable and adjustable parity system, using SDR as the major reserve currency.

After the dissolution of C20, the reform of the monetary system shifted to the topic of an "Interim Committee of the Board of Governors on the International Monetary System" (the structure was the same as G20) and was agreed on January 8, 1976 (the Kingston Accord).

The Second Amendment of the Article of Agreement on IMF was adapted in April 1976, according to the accord above, and enforced on April 1, 1978. This amendment left countries to choose an exchange rate system using their free discretion, while gold reserves were demonetarized.

G5 and Summit. In the early 1970s, industrialized countries started to call for a new opportunity for talks.

G5 (Group of Five: Five major industrialized countries Minister of Finance Meeting) became the major opportunity for talks among the industrialized countries, in terms of international monetary and macro-economic policy. G5 started in April 1973 in the Whitehouse Library, to talk about the international monetary problems among the Secretary of the Treasury Schultz of the United States, Finance Minister Giscard d'Estaing of France and Finance Minister Helmut Schmidt of West Germany. Just before the IMF and the World Bank Annual Meeting in September 1973, the Minister of Finance Aichi proposed to hold a 5-country Minister of Finance Meeting, the motive of which was to hold the first Finance Minister talk of 5 countries (G5), with the participation of Japan, the United States, the United Kingdom, Germany and France) on November 24 to 26. The participants initially were the Finance Minister and deputies of Finance Minister, but later the Central Bank Governor started to participate in the talks. The meetings and discussions were kept secret, until they were announced at G5 in September 1985 of Plaza Accord. Talks for the international monetary problems among the industrialized countries were G10 (10-country Minister of Finance Meeting) and WP3 (OECD, Working Party on International Cooperation) but G5 (Italy and Canada joined in 1986, making it G7: 7-country Minister of Finance and Central Bank Governor's Meeting) played an extremely important role as an opportunity for policy coordination, especially after the Plaza Accord.

President Giscard d'Estaing of France and Prime Minister Schmidt of West Germany took the initiative to hold a Summit (Economic Summit) to discuss the issues of currency, trade, and energy related topics. The first summit was held in Rambouillet in France. After this, the summit was held annually, as an opportunity for the member countries to talk about economic issues.

"Locomotive Theory". In the process of recovery from the first Oil Crisis, the "Locomotive theory" represents the contrast of the successful recovery of Japan and West Germany and the delay in the recovery of the U.K., France, and Italy. The economies of the industrialized countries started to recover in the middle of 1975, but the road ahead was still rocky for the U.K., France and Italy, and their current accounts got worse in 1976. The economies of these countries finally recovered from autumn 1977 to 1978.

Although the United States moved towards economic recovery from early 1975, ahead of the other countries, inflation got worse in 1978 due to tax reductions, and economic stimulus policy, such as the expansion of fiscal expenditures. A high trade deficit was also recorded in 1977 and 1978. In contrast to these countries, Japan and West Germany showed favorable performance in terms of trade, the inflation rate and the growth rate. With such a gap between the economic recovery of the industrialized countries, there was criticism of Japan and Germany, which enjoyed a considerable surplus in their balance of payments.

In the foreign market in 1976, there was anticipation for yen appreciation, and in the United States, people talked about a “Dirty Float” (Japan’s intentional yen depreciation).

In the IMF and the World Bank Annual Meeting in September 1977, Japan and Germany were criticized because of their surplus. Other countries insisted that they should increase domestic demand by taking measures to stimulate the economy. Then, from autumn 1976, the “Locomotive Theory” was introduced. This theory stated that Japan, the United States and Germany should conduct their domestic demand expansion policy in order to be the driving force for the recovery of the global economy.

In the London Summit in May 1977, the coordination of Japan, the United States and Germany as the “locomotives” of the world economy was discussed. As Prime Minister Helmut Schmidt of West Germany was concerned about the inflation, he strongly opposed the expansion policy, and the specific figures on the growth rate were not reflected in the communiqué, but Japan and West Germany promised to make efforts to achieve the growth target. In the Bon Summit in July 1978, West Germany agreed to take an additional measure equivalent to 1% of GNP, while Japan made an official commitment to 7% growth.

President Carter’s Dollar Defense package. The dollar depreciation rapidly proceeded in the second half of 1978, and as concerns were raised about the U.S. economy, the United States started to take defensive measures for the dollar.

On November 1, 1978, President Carter announced a dollar defense package, as follows: (1) the United States would take cooperative intervention measures with West Germany, Japan and Switzerland. The Department of the Treasury and the Federal Reserve Bank would provide $30 billion for the exchange rate intervention ($15 billion for the swap line extension, $10 billion for foreign currency-bonds, and $5 billion for withdrawal of the IMF reserve tranche and SDR selling); (2) the Department of the Treasury would increase gold selling; and (3) the U.S. would raise the official discount rate and the deposit reserve requirement ratio (the official discount rate rose from 8.5% to 9.5%).

The Second Oil Crisis. While primary commodity prices started rising in the middle of 1978, a movement to usurp the king escalated in Iran. This led to the Islamic Revolution in February 1979. OPEC then decided to raise the crude oil marker price by 10% on average, in the middle of December 1978, against the political uncertainty of Iran, which triggered the second Oil Crisis.

In June 1979, OPEC raised the standard crude oil price to $18 per barrel. The United States froze the assets of Iran retained in the United States as after the occupation of the American Embassy by Islamic students on November 4. Both countries broke off economic relations, and the crude oil spot price reached $40 per barrel. The crude oil price rose to three times the regular price by 1981.

The Tokyo Summit (June 28 and 29, 1979) was an energy summit, where the countries spent most of the time discussing energy related issues. The biggest achievement of this summit was the agreement on a specific target for petroleum consumption and import savings per country.

2 Outline of the external economic policy

Current Account Deficit Caused by the Oil Crisis. Japan's current account had been in surplus since 1968, but experienced a deficit of $100 million in 1973 and $46 billion in 1974, respectively, because of the price hike in imported crude oil after the first Oil Crisis ($19 billion in 1972, $32.5 billion in 1973, and $53 billion in 1974) (Table 1-3-1).

Table 1-3-1 Balance of Payments (IMF basis)

($million)

Year	Current account	Trade Balance	Exports	Imports	Long term capital account
1970	1,970	3,963	18,969	15,006	△ 1,591
1971	5,797	7,787	23,566	15,779	△ 1,082
1972	6,624	8,971	28,032	19,061	△ 4,487
1973	△ 136	3,688	36,264	32,576	△ 9,750
1974	△ 4,693	1,436	54,480	53,044	△ 3,881
1975	△ 682	5,028	54,734	49,706	△ 272
1976	3,680	9,887	66,026	56,139	△ 984
1977	10,918	17,311	79,333	62,022	△ 3,184
1978	16,534	24,596	95,634	71,038	△ 12,389
1979	△ 8,754	1,845	101,232	99,387	△ 12,976
1980	△ 10,746	2,125	126,736	124,611	2,324
1981	4,770	19,967	149,522	129,555	△ 9,672
1982	6,850	18,079	137,663	119,584	△ 14,969
1983	20,799	31,454	145,468	114,014	△ 17,700
1984	35,003	44,257	168,290	124,033	△ 49,651
1985	49,169	55,986	174,015	118,029	△ 64,542
1986	85,845	92,827	205,591	112,764	△ 131,461
1987	87,015	96,386	224,605	128,219	△ 136,532
1988	79,631	95,012	259,765	164,753	△ 130,930
1989	57,157	76,917	269,570	192,653	△ 89,246
1990	35,761	63,528	280,374	216,846	△ 43,586

Source: MOF, Zaisei Kinkyu Tokei Geppo [Ministry of Finance Statistics Monthly]
No 186,199,244,255,278,290,521

Note: 1. SDR distribution for 1970 was $122 million, $128 million in 1971 and $160 million in 1972 included.
2. "Trade Balance" excludes processing deal expenses and commission trading (net acceptance) in and after July 1979
3. "Long Term capital account" excludes bond repurchase trading in and after 1979

Exports developed without problems in spite of the Oil Crisis. Therefore, the current account soon turned to a surplus. The current account deficit bottomed out during January to March 1974, and then it was improved. It showed a marked improvement in 1975, and turned out to have a significant surplus in 1976.

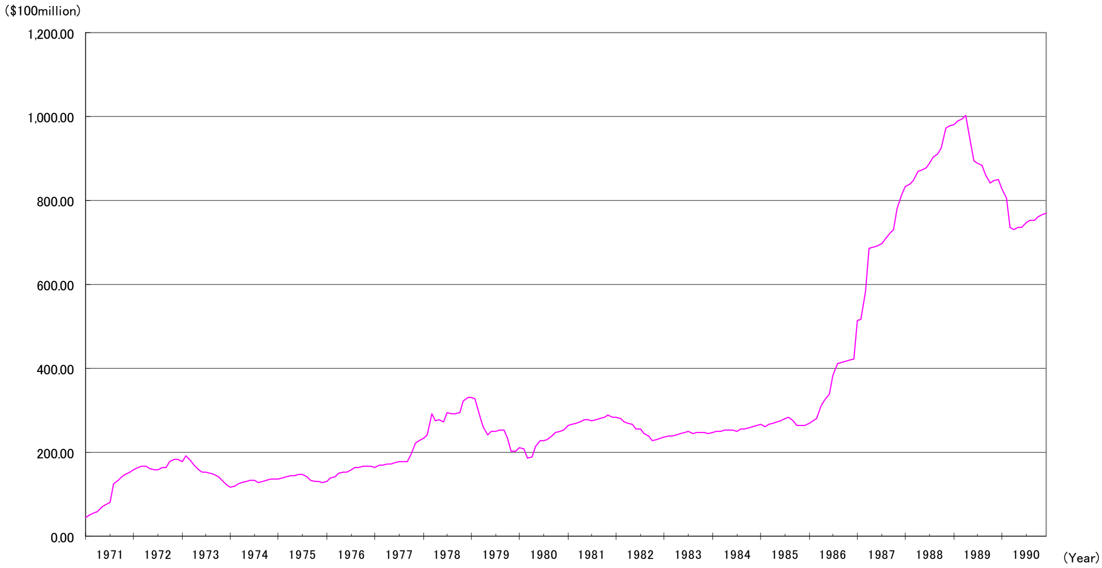
In 1976, the industrialized countries' economic recovery progressed, as Japanese exports of motor vehicles, electric appliances, steel and ships to the United States and European countries increased. Exports also increased substantially in 1977 and 1978, in spite of the drastic yen appreciation. The trade surplus was extended to $17.3 billion in 1977, and the current account also represented substantial surplus by 1978.

However, the second Oil Crisis occurred in December 1978, and a considerable current account deficit of $87 billion was recorded in 1979.

The long-term capital account recorded constantly excessive debt, but the scale shrunk to $270 million in 1975, because the capital outflow had been limited since November 1973. The capital outflow further worsened after 1976, and it recorded excessive overflow in 1978 and 1979.

Foreign Exchange Reserves and Foreign Asset Deficit Balance. Exchange reserves suddenly increased by 3.5 times during 1971, and recorded $15.2 billion by the end of the year (Figure 1-3-1). In particular, immediately after the Nixon Shock, large-scale dollar selling occurred, therefore the Bank of Japan conducted buying support

Figure 1-3-1 Foreign exchange reserves (1971-1990)



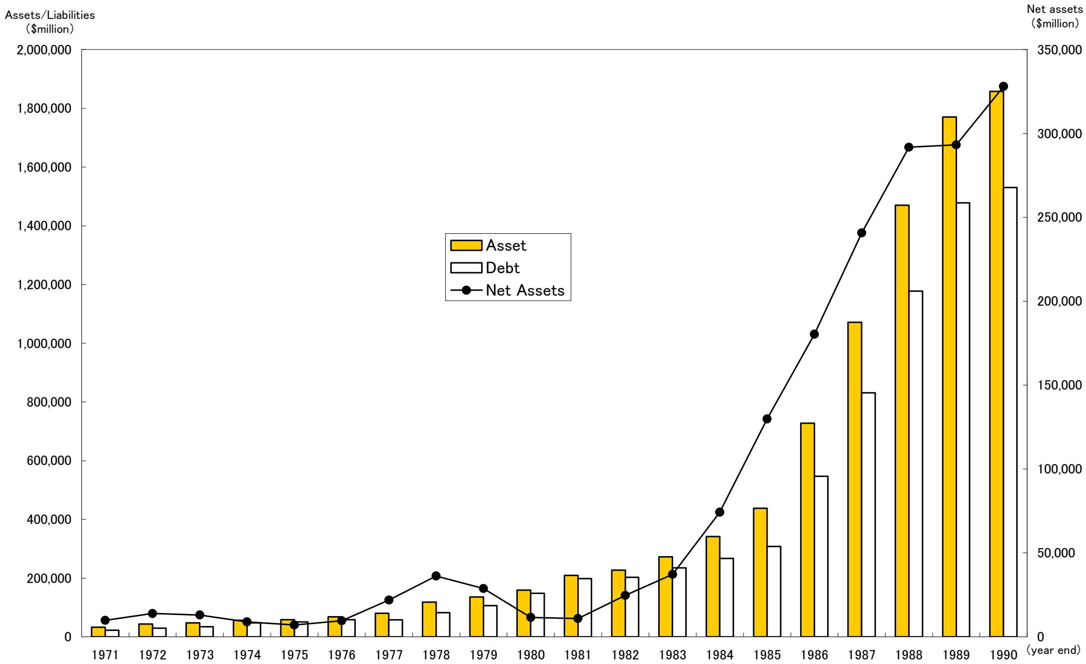
Source: *Ministry of Finance (MOF), Ōkurashō Kokusai Kinyūkyoku Nenpō* [Annual Report of International Finance Bureau, Ministry of Finance]

to the level of nearly $4 billion. In spite of the Smithsonian revaluation in 1972, exports recorded a substantial surplus while the exchange reserves reached $19 billion, by the end of February 1973 (the peak before the first Oil Crisis). In 1973, it rapidly declined, reaching the level of $11.5 billion by the end of January 1974. From 1976 to the end of 1978, there was a drastic increase in Japan's exports and buying support for the dollar by the foreign exchange authorities, the exchange reserve kept increasing. The exchange reserve reached $33.1 billion in January 1979, but it started to decrease due to the occurrence of the second Oil Crisis.

External assets increased 4.1 times from the end of 1971 to the end of 1979 (Figure 1-3-2). External liabilities increased 4.6 times in the same period. The amount of Net external assets (external assets minus external liabilities), decreased from 1973 to 1975 due to the Oil Crisis, but started to increase by 1978. However, it again decreased in 1979, due to the negative effects of the second Oil Crisis. Through this period, net assets increased 5.3 times from $9.7 billion at the end of 1971, to $28.7 billion at the end of 1979.

Regarding the external assets, long-term assets including loans and securities investment strikingly increased from 1976, and the composition of assets was changed, from short-term to long-term type. In contrast, the ratio of short-term liabilities gradually increased in the liabilities composition.

Figure 1-3-2 International Investment Position of Japan



(Source) Bank of Japan (BOJ) Kokusai Shushi Tokei Geppo [Balance of Payments Monthly], MOF, Zaisei Kinyu Tokei Geppo [Ministry of Finance Statistics Monthly] No. 508, 521

Trend in the Exchange Rate. The yen appreciation proceeded to reach ¥254/$ on July 9, 1974, after the shift to the floating exchange rate system in February 1973. After that, the Bank of Japan made an intervention at ¥265/$ under the agreement between Japan and the United States, as setting a proper rate in a range from ¥257 to 264/$. Then, the exchange rate was stabilized in a range from ¥260 to 270/$ (Figure 1-3-3).

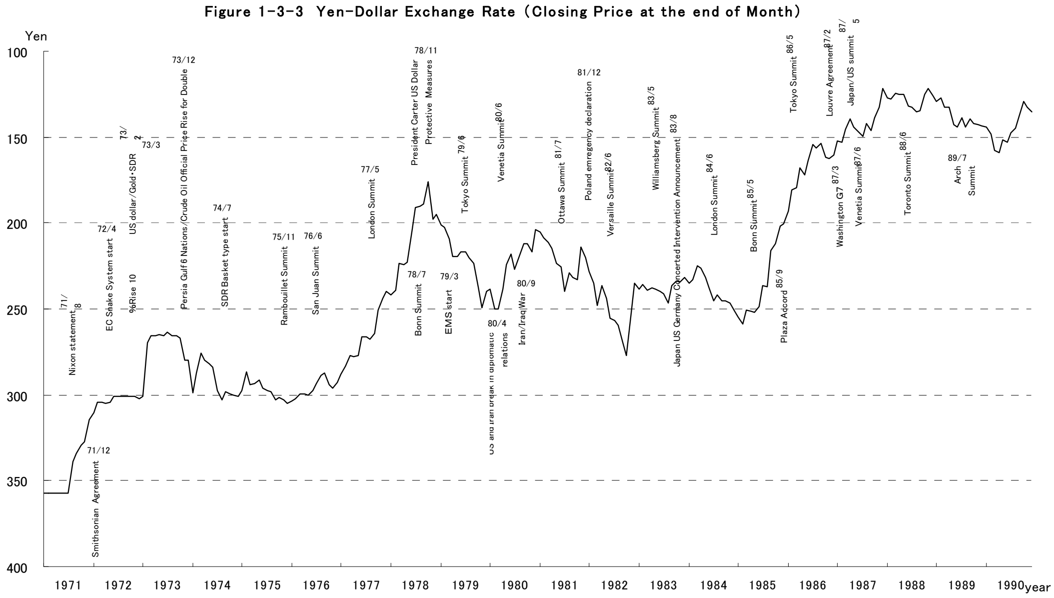
However, once the Oil Crisis occurred, large-scale yen selling and dollar buying started. Therefore, the yen was depreciated from ¥270/$ on November 1, 1973 to ¥300/$ on January 9, 1974, resulting in more than 10% in yen depreciation within 2 months, in spite of the active intervention by the Bank of Japan. The yen recovered to ¥273.50/$ on March 28, 1974, but reached a record low since the start of floating exchange rate system of ¥303.40/$ on August 22.

The yen bounced back to ¥285/$ on February 25, 1975, but Japan's exports became sluggish, while the United States' economy recovered. The yen depreciation gradually progressed to ¥306.85/$ on December 8, 1975, a record low since the start of floating exchange rate system. The yen bottomed out in December 1975, and started to move towards yen appreciation, but the pace was extremely slow during 1976.

Under these circumstances, Japan's exports to the United States suddenly increased, mainly in motor vehicles and electric appliances, in 1976. However, the United States claimed that this was because Japan artificially controlled the exchange rate for its export-led economic recovery.

A drastic yen appreciation occurred from early 1977 to the end of October 1978. In 1977, the trend of yen appreciation further accelerated and reached ¥238/$ on December 15, from ¥290/$ earlier in the year. The yen appreciation further accelerated in 1978, to reach ¥200 at the end of July, and reached the record high of ¥176 on October 31.

Figure 1-3-3 Yen-Dollar Exchange Rate (Closing Price at the end of Month)



Policies for Avoiding Yen Appreciation. Japan's external economic policy had to be changed, as was required to cope with the changes in the world economy in the 1970s, such as the shift to the floating exchange rate system and the two oil crises.

The target of Japan's external economic policy before the Oil Crisis was to avoid yen appreciation. With the mark revaluation in October 1969, the parity adjustment by other countries and the flexibility of the foreign exchange market were the key items on the agenda for the international society to consider. However, in Japan, there was a strong public view that it was necessary to avoid yen appreciation, which could have negative effects on the export industry, and therefore that the rate of ¥360/$ was desirable.

In May 1971, when the currency crisis occurred in Europe and the mark shifted to the floating exchange rate system in May 10, foreign exchange rate speculation became rife regarding yen revaluation. The government decided on its primary yen measures ("*Comprehensive Economic Measures*") on June 4, with an eight-point program for yen appreciation. The U.S. President Nixon then declared the termination of gold and dollar exchange on August 15, so that world currencies provisionally went into the floating exchange rate system (on August 28, for Japan).

After the reopening of the exchange market, Japan made an active market intervention, in order to minimize the yen devaluation. The Smithsonian Agreement in December 1971 devalued the yen parity by 16.88% to ¥308. However, this currency adjustment was not effective to restrain the current account surplus of Japan, so that there was a further demand for yen appreciation. Therefore, the government specified secondary yen measures, with a seven-point program on May 20, 1972, followed by a third set of yen measures the "five-point program" ("*External Economic Emergency Measures*") on October 20, to avoid the revaluation of yen.

On May 20, 1972, the secondary yen measures with the seven-point program ("On the active promotion of External Economic Policy") provided specific measures for the use of foreign currency, such as foreign currency deposits to foreign exchange banks and import finance and overseas investment finance expansion by the Export and Import Bank of Japan. Foreign lending facilities for Japanese residents with foreign currencies were established in August 1972 for the residents of Japan under the current law, which was to promote imports and external investment.

The third set of yen measures with the five-point program on October 20, 1972 consisted of: (1) an increase in imports; (2) making exports more appropriate; (3) liberalization of capital; (4) expanding economic cooperation; and (5) fulfillment of welfare. This five-point program aimed at promoting fiscal measures to progress the purposes of social capital and security, and the liberalization of trade and foreign exchange market. Laws associated with these programs were enacted on November 13 as the "Package Law for the adjustment of external economic relations". The third set of yen measures was to alleviate pressure on Japan from foreign countries and the exchange rate stabilized at ¥296-297/$.

The stable yen rate did not last long. On February 14, 1973, Japan shifted to the floating exchange rate system. The government still thought about returning to a fixed exchange rate system but tried to apply a managed floating system with a stable rate of around ¥265/$, by making thorough interventions in the market. As a result, the exchange rate stabilized in a range from ¥264-266/$, until the occurrence of the Oil Crisis.

The First Oil Crisis and Promotion of Capital Inflow. With international monetary instability, the government enhanced regulations on overseas short-term capital in February 1972, in order to avoid an inflow of speculative funds for potential yen appreciation. On February 25, the regulation on advance payments for exports was reapplied, and strengthened on June 29. The reserve requirement ratio for the free yen account rate was also raised on July 1. The scope of regulations on the conversion of foreign currency into yen was expanded to all exchange banks. For long-term capital, the issuance of foreign bonds by private enterprises was basically terminated in February 1971.

However, upon the occurrence of the Oil Crisis at the end of October 1973, when the exchange rate dropped sharply and the current account went into deficit, the government completely changed its exchange policy of restricting the inflow and promoting the outflow of foreign currencies, in the background of the balance of payments surplus.

After October 29, 1973, in order to prevent the depreciation of the yen after October 29, 1973, the policy authorities started market intervention by dollar selling. Yen conversion regulations were eased after an interval of six years, and the free yen account was not covered by the yen conversion regulations from December 17. The regulation on the fund for advance payments for exports was also abolished in February 1974. In December 1973, permission for foreign bond issuance was also resumed. Restrictions on the outflow of capital were also planned and foreign currency lending for Japanese residents was adjusted and downsized in December 1973.

Yen depreciation stopped provisionally until April 1974. However, the yen started to devaluate again from April 1974, and therefore the MOF introduced an "emergency yen defense package" from late July to August, including the deregulation of advance payments for exports, the expansion of the yen conversion regulations on foreign banks in Japan and the abolishment of the limitation of short-term government securities, which was almost the complete abolishment of the short-term regulations.

Because of the significant deregulation of short-term capital, Japanese banks started to compete for the Euro dollar. Euro dollars outstanding drastically increased from $6.7 billion in September 1973 to $19.1 billion in June 1974. In July and August 1974, the interest rate on a dollar from Euro Market by Japanese foreign exchange banks had a premium of 2% ("Japan Premium"). The MOF and the BOJ were afraid of the economic instability of the foreign exchange bank and issued guidance to the foreign exchange bank to restrain its loans (overseas loans) in foreign countries.

Dirty Float Theory. Japan enjoyed an economic recovery from mid 1975. It was supported by an increase in exports. The United States government criticized Japan, as if Japan was controlling the foreign exchange rate towards the yen depreciation ("Dirty Float Theory").

C.F. Bergsten (fellow of the Brookings Institute) criticized Japan's yen depreciation in Congress in June 1976, which triggered pressure on the foreign exchange rate for yen appreciation. In August 10, the Under Secretary for Monetary Affairs E.H. Yeo visited Japan and stressed the responsibility of surplus countries and encouraged the Minister of Finance, Masayoshi Ohira, and the Bank of Japan Governor, Teiichiro Morinaga, to make an exchange rate adjustment.

The Ministry of Finance opposed the yen appreciation, as the current account surplus was not because of structural reasons but provisional. However, in the Japan-U.S. summit talks in March 1977, the U.S. President Carter claimed that Japan should be liable for the exchange rate in the global politics. Even in the OECD Ministerial Council in June, Japan's yen depreciation was strongly criticized by other countries.

Promotion of Imports and Domestic Demand Expansion. The government proposed external economic polices one by one, to achieve a balance of the external economy and the economic growth from increase in domestic demand.

On September 3, 1977, the external economy related section of the "Comprehensive Economic Measures" was materialized as "On the Promotion to The External Economic Measures" in the Ministerial Conference for Economic Measures on September 20. It comprised the following: (1) active participation in the Tokyo Round Negotiations; (2) the promotion of imports; (3) the encouragement of reasonable exports related to industries; and (4) the promotion of capital transactions and economic cooperation.

In the IMF and the World Bank Annual Meeting conducted in late September, the managing director of the IMF Witteveen pointed out that Japanese domestic demand and the increase of imports were not sufficient, so other economy stimulus measures should be added to increase domestic demand, and internationally opinions were voiced that Japan should proceed with reforming its external economic policy. In the foreign exchange market, yen appreciation rapidly developed since late September and reached ¥240/$ in the Tokyo Market on December 15, 1977, for the first time.

Under these circumstances, Prime Minister Fukuda stated in November that the Japanese government was taking provisional measures as follows: (1) emergency imports of at least $3 billion to be conducted for uranium, crude oil and foodstuff for assistance; and (2) tariff-cut of computers, automobiles and color films, etc. On November 17, the MOF and the BOJ announced regulations against short-term fund inflows, in order to prevent the inflow of speculative funds, as follows: (1) termination of public offering of the government short term securities that induced speculation by foreign investors in the foreign exchange market; (2) increase in the deposit reserve requirement ratio against an increase of free yen deposits (50% of the reserve ratio would be applied to deposits of an amount above average in October).

In order to take active measures to open up the market, the Ministerial Conference for Economic Measures was held on November 29. The Ministerial Conference for Economic Measures determined on a policy of actively promoting the market opening and the basic policy of the "External Economy Measures (individual measures)" (eight points to reduce the surplus). The eight points included active participation in the GATT Tokyo Round Negotiations, expansion of the allocation of the remaining import restricted items, expansion of imports, and promotion of economic cooperation. On December 12, the Japan-U.S. trade negotiations were held (the Ushiba-Strauss talks), and a resolution was obtained in January 1978.

The foreign exchange market was stable for the time being, the but yen appreciated rapidly again in March 1978.

The government announced import promotion measures, with a four-point program on March 11, 1978, and the strengthening of regulations on short-term capital on March 15. And the government decided upon the "Comprehensive Economic Measures" by which a growth rate of 7% was achieved within FY1978 and the current account surplus was reduced to $6 billion (seven points program for domestic demand expansion and surplus reduction) on March 25.

From April 1978, the policy authorities' foreign exchange market intervention policy changed towards acceptance of yen appreciation. The BOJ did not make any interventions in the market from April to May. Prime Minister Takeo Fukuda committed to the following at the Bonn Summit on July 16–17: (1) achieving 7% growth in FY1978; (2) restraining exports in FY1978 below the level of the previous year; and (3) increasing Official Development Assistance (ODA) to double the level within three years.

On September 2, in order to achieve a 7% growth rate within FY1978, comprehensive economic measures were decided upon to compensate for the decrease in export quantities caused by yen appreciation, with a domestic demand expansion policy for ¥2.5 trillion yen. For the external economy, emergency imports and economic cooperation was to be promoted, and emergency imports of around $4 billion in total would be implemented in FY1978. Then, when the United States announced its dollar defense package on November 1, the tendency for yen appreciation was finally stopped.

3 Liberalization of Foreign exchange and External Finance/Security Services

Abolishment of the Foreign Exchange Concentrating System and the Establishment of the Dollar Call Market. As the exchange reserve increased, there was demand for relaxation of the foreign exchange management system. To meet such demands, the government abolished the foreign exchange concentrating system and opened the dollar/call market in 1972.

The foreign exchange concentrating system was established to enable the government to centralize and allocate a small amount of foreign currency in the postwar era for foreign exchange control. However, this system became gradually unsuitable to the conditions of the time in the early 1970s. Therefore, the foreign exchange concentrating system was abolished and Japanese residents were not required to sell foreign currencies obtained in external transactions to the foreign exchange bank etc., from May 8, 1972.

On April 17, 1972, the Tokyo Dollar Call Market was established. Before the market launch, the conventional exchange management system hindered financial institutions in Japan from trading the dollar freely and short-term foreign currency funds were only managed by the Euro Market or the U.S. Federal Fund market. This system contributed to the development of the Tokyo Foreign Exchange Market, as the foreign currency flow could be completed in a flexible manner between the foreign exchange banks.

Amendment to the Foreign Exchange Control Law. Almost 30 years had passed since the “Foreign Exchange and Foreign Trade Control law”(the so-called “Foreign Exchange Control Law”) was enacted in 1949, and the Foreign Capital Law was enacted in 1950. Therefore, it was not only obsolete under the situation of the times, but also gave the impression to foreign countries that Japan was still a very closed country with an old system. In January 1978, Prime Minister Takeo Fukuda announced his intention to revise the Foreign Exchange Control Law, from being “basically restricted and exceptionally free” to “basically free and exceptionally restricted” for international fund transaction, and with this the revision of the Foreign Exchange Control Law and the Foreign Capital Law was begun.

It progressed at a rapid pace: the new Foreign Exchange Control Law (the “Law concerning the partial amendment of Foreign Exchange and Foreign Trade Control

Law”) was promulgated on December 18, 1979 (enforced December, 1980). The Foreign Capital Law was abolished.

The new Foreign Exchange Control Law stated the principle of free external trade and minimum restrictions, which were to be executed only when they were required for the normal development of external trade. As current trading had been liberalized in 1964 when Japan became a member of the IMF, this new law liberalized capital trading. Capital trading was basically free in usual conditions, but the Minister of Finance would be entitled to implement “emergency restrictions” for abnormal conditions such as balance of payments disequilibrium or a drastic change in the foreign exchange market.

This law allowed free external lending and internal lending of funds in normal conditions. Securities’ trading became freely available through the designated securities companies. Securities issuance and offering could also be freely conducted with prior notice. Inward direct investment and technology contracts could also be freely conducted with prior notice. Trading of services was also free, with some exceptions. The restrictions on foreign currency deposits in foreign exchange banks in Japan by Japanese residents were abolished and they were allowed to use the service freely in normal conditions.

Likewise, most of the regulations on the foreign exchange control were abolished, except the exchange management through the foreign exchange bank (“Tamegin-Principle”) which would implement prompt and appropriate regulations for emergencies.

Establishment of Japanese Foreign Exchange Banks for the Overseas Market. Many Japanese banks started offering their services overseas in 1971 to 1974 but the pace of spreading overseas declined in 1975 and onward, due to the international monetary instability caused by the first Oil Crisis. At the end of 1979, there were 127 branches and 73 local corporations.

Foreign currency or yen-denominated based loans by Japanese foreign exchange banks to non-residents in Japan were called the external loans (or overseas loans). Since around 1970, quite a number of Japanese financial institutions started to go abroad. In around 1973, Japanese banks’ overseas branches and local corporations entered into the Euro Dollar Market and obtained funds from the Euro Market mainly for syndicate loans, (large loans by loan syndicate comprised of domestic and foreign banks) to actively provide external loans. Therefore, the loans of Japanese banks overseas branches started to focus on mid-term and long-term loans for non-residents, not short-term trading finance as in the past.

As Japanese banks competitively introduced Euro funds, there were issues raised in 1974 including the Japan Premium and worsening of the short-term fund position of foreign exchange banks. Thus, as the regulations on overseas loans were enhanced, overseas loans declined from 1975 to 1976 temporarily. However, the rules of the overseas loans of Japanese banks was deregulated from 1976 to 1977, and the overseas loans rapidly increased in 1978 and 1979, so that the local loan balance at the end of 1979 reached nearly $36 billion.

These developments relating to the overseas loans of Japanese banks temporarily suffered from a loss due to the outbreak of the second Oil Crisis. Due to the increase of funding risk and country risks related to expansion of debts of the non oil-producing countries, the business environments of Japanese banks were worsened. Therefore, the Ministry of Finance requested Japanese bank branches to restrain their overseas loans in October 1979, and eventually substantially banned mid-term and long-term foreign currency-denominated loans.

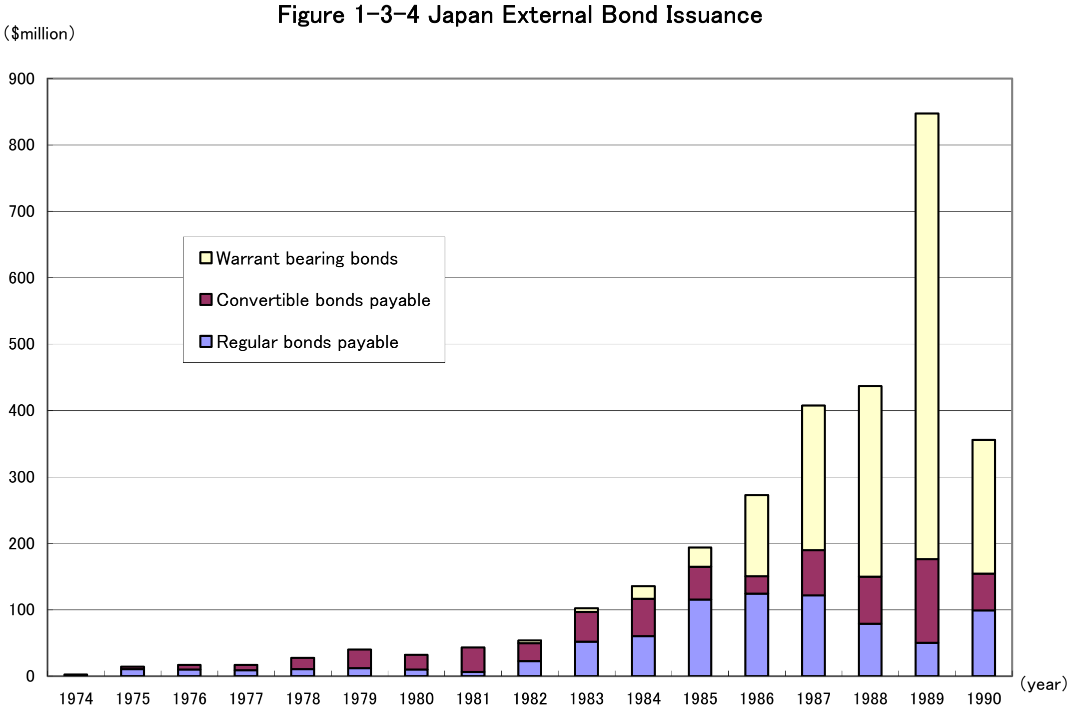
Increase in Foreign Bond Issuance by Japanese Private Enterprises. The balance of payments surplus surged in the late 1960s and the early 1970s. When external economic frictions occurred, the government considered external bond issuance by Japanese enterprises as not being favorable, as it might increase the exchange reserve. The MOF basically banned the issuance of foreign bonds by private enterprises in February 1971.

The banning of foreign bond issuance continued until December 1973.

When the balance of payments worsened due to the first Oil Crisis, the MOF gradually deregulated the issuance of foreign bonds. In December 1973, Japanese enterprises were permitted to issue foreign bonds only if the funds would be used for overseas business activities, and even permitted overseas funding of domestic business activities on a case-by-case basis, in November 1974. With the progress of the deregulation of foreign bond issuance, bond issuance by Japanese companies in foreign countries rapidly increased in 1975 to 1976 and 1978 to 1979 (Figure 1-3-4).

Japanese securities companies also started to open their bases overseas in around 1972 and 1973 thanks to the development of European Bond market. As of December 1979, 12 securities companies had 69 overseas bases.

Figure 1-3-4 Japan External Bond Issuance



(Source) Same for as Figure 1-3-1

Issuance of Yen-denominated Foreign Bonds and Euro/Yen Bonds. The first yen-denominated foreign bonds (Samurai Bonds) were the first Asia Development Bank bonds (¥6 billion) issued in December 1970. In 1972, Samurai Bond issuance was promoted as one of the policies for avoiding yen appreciation. Later, foreign bond issuance was limited temporarily, due to the outbreak of the first Oil Crisis, but Samurai Bond issuance resumed in 1975. In particular, when the Ministry of Finance deregulated the Samurai bond issuance level in May 1977, Samurai Bond issuance was activated in 1977 and 1978.

The issuance of Euro Yen bonds was approved in March 1977, and the first bonds were issued in May as European Investment Bank Bonds (EIB) for ¥10 billion. The Ministry of Finance considered that Samurai Bonds should be mainly issued in the Tokyo Market, so that issuance was available but limited to international financial institutions which experienced issuing bonds in the Tokyo Market for the time being.

Outward Direct Investment. Outward direct investment was fully conducted in the late 1960s, especially in FY1972, and the amount reached $2.338 billion - about 2.7 times of the amount of the previous year. Although it reached $3.494 billion in FY1973, it started to decline due to economic slowdown and regulations on the capital outflow after the first Oil Crisis. It was finally restored to the level of FY1973 in 1978 (Table 1-3-2).

Table 1-3-2 Outward/Inward Direct Investment

($100million)

Fiscal Year	Outward	Inward
1972	23.38	–
1973	34.94	1.67
1974	23.95	1.54
1975	32.80	1.67
1976	34.62	1.96
1977	28.06	2.24
1978	45.98	2.35
1979	49.95	5.24
1980	46.93	2.99
1981	89.31	4.32
1982	77.03	7.49
1983	81.45	8.13
1984	101.15	4.93
1985	122.17	9.30
1986	223.20	9.40
1987	333.64	22.14
1988	470.22	32.43
1989	675.40	28.61
1990	569.11	27.78

Source: Same for as Figure 1-3-1

Completion of the Liberalization of Direct Investment. “Capital Liberalization” (Direct Investment Liberalization was known as “Capital Liberalization” at that time) started in 1967. It started with the first liberalization in July 1967, and continued until the fourth in August 1971. The policy was changed in May 1973 from 50% to 100% liberalization in principle. Furthermore, the retail business was liberalized on June 1, 1975. When the renewal period of the 17 businesses was completed, on May 1, 1976, the liberalization of direct investment was thereby completed. (Inward direct investment was changed from the advance notice system to the after-the-fact system in 1992).

Inward direct investment after that was slow, even despite liberalization, and only remained at the level of no more than $1 billion until 1986. In late 1980, the scale reached $2-3 billion (Table 1-3-2).

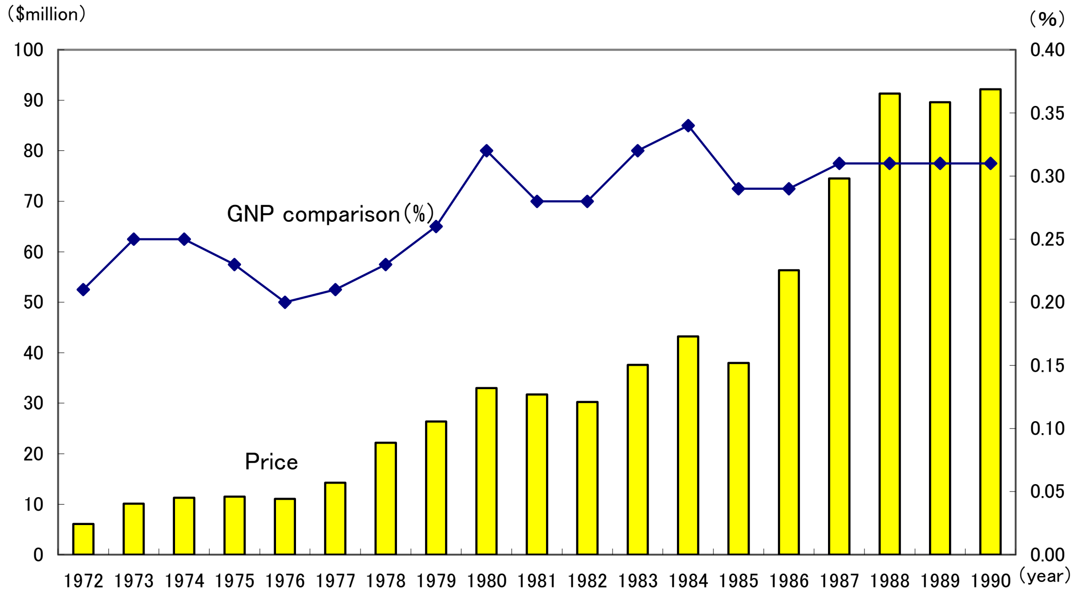
4 Foreign Exchange Cooperation gains Momentum

The "New International Economic Order" (NIEO). In the 1970s, developing countries started to have an influence on international society. This was led by the strong unity of developing countries in trying to overcome the economic gap (the so-called "North-South problem"), resource nationalism through the saving of resources after the Oil Crisis and the emergence of NIES (the "newly industrialized economies").

The perspective of the developing countries was clearly represented in the declaration of a "New International Economic Order (NIEO)", adapted in the sixth special session of the United Nations General Assembly for Resources on May 1, 1974. In addition, the 3rd 77-country ministers' conference (comprised of developing countries) conducted from January to February 1976, adapted the declaration and action plan based on the NIEO ("Manila Declaration").

First Medium-term Target for ODA. Japan's ODA (Official Development Assistance) increased 3.6 times from $611 million in 1972 to $2.215 billion in 1978. However, due to the worsening balance of payments after the first Oil Crisis, the total amount of ODA remained unchanged from 1974 to 1976, which again started to increase in and after 1977. GNP ratio of ODA declined from the peak in 1967. Therefore, GNP ratio of ODA in 1978 was only 0.23% (Figure 1-3-5).

Figure 1-3-5 Official Development Assistance



(Source)Same for as Table 1-3-1 No 362, 386, 436, 484

The Council of Foreign Exchange Co-operation submitted the report “On the Promotion of Development Cooperation in the Future” to Prime Minister Takeo Miki on August 18, 1975. This report stated that the development assistance policy’s direction and guidelines should be clarified, as Japan was increasingly dependent on developing countries in terms of energy, resources, and foodstuff.

After the submission of the report, the Council of Foreign Exchange Co-operation conducted a follow-up and submitted an opinion, “On the Radical Reform of Official Development Assistance”, to Prime Minister Miki on August 31, 1976. This opinion suggested that the government should promote foreign economic cooperation as Japan was being criticized for its delay in implementing economic cooperation in international society, and set the target of, by 1980, raising Japan’s ODA to 0.36%, which was the average of the 17 DAC countries.

On September 2, 1978, the Ministerial Conference for Economic Measures decided to double the level of official development assistance given in 1977 within 3 years, as the “First medium-term target for ODA”. Prime Minister Takeo Fukuda visited six Southeast Asian countries in August 1977 for the improvement of mutual relationships. On the last day of the visit to Southeast Asian countries (August 18), Prime Minister Fukuda announced “Japan’s Southeast Asian Policy” (the “Fukuda Doctrine”) in Manila. This “Fukuda Doctrine” showed the determination of Japan “keep peace and not to become a military superpower”. In establishing equal, cooperative relationships with ASEAN countries, Japan was determined to conduct a Southeast Asian policy aiming to contribute to peace and prosperity of the entire Southeast Asian region.

5 Multilateral Trade Negotiations in the Tokyo Round

A Uniform Tariff Cut in 1972. The Customs Tariff Council submitted the report “On the desirable form of the Tariff Policy in the Future” based on the topics of a “cooperative commercial trade relationship” and the “harmony of industry and welfare” in December 1972. This report contained topics including the promotion of an international lateral division of action, consideration of domestic price and pollution issues, rather than the domestic industry protection represented by the tariff reform in 1961, based on the fact Japanese industries had started to gain the international competitiveness.

From the viewpoint of reducing the surplus, the “third yen measures” on October 20 proposed actions to expand imports, including a flat rate tariff cut of 20%, and the improvement of preferential tariffs. Since November 22, the tariffs for 1865 items were cut, according to the tariff cut policy for steel and industry products and agricultural processed products. This was a large-scale reform to cover 80% of the entire taxable articles, or 45% of the total import amount, equivalent to 1925 articles in the Kennedy Round.

The Tokyo Round Talks Start. In the GATT Session in November 1971, Japan proposed holding a new international round. This was why the Tokyo Round negotiations were held following the Kennedy Round. On September 14, 1973, the “Tokyo Declaration” was adopted in the GATT Tokyo Minister’s Meeting, for the official launch of negotiations.

While the Kennedy Round (1964-67) was mainly concerning tariff cuts, the Tokyo Round negotiations were categorized into various topics, including tariff cuts, the mitigation/abolition of non-tariff barriers (NTB), and the reconsideration of safeguards.

The Tokyo Round Negotiations. It was difficult to proceed with the Tokyo Round negotiations as scheduled, to end within 1975, due to the first Oil Crisis occurring right after the start of negotiations.

At this time, the “Basic Policy for the Tokyo Round negotiations” was decided by the Cabinet in Japan for the facilitation of the negotiations. For smoother negotiations, a uniform tariff cut was made before the Tokyo Round negotiations were conducted, in FY1978 (so-called “advanced implementation of tariff reduction”).

On April 12, 1979, the Tokyo Round negotiations were successfully closed, and the results of the negotiations of the Tokyo Round were approved by the GATT Session held on November 26 to 29.

As the tariff-cut issue had already been discussed in the Kennedy Round and made favorable progress, the Tokyo Round negotiations were mainly to abolish non-tariff barriers. As a result of the talks, the total of eight codes (agreements/protocols) were prepared: (1) Agreement on subsidies and countervailing measures; (2) Anti-dumping code; (3) Standard agreement; (4) Agreement on technical barriers to trade; (5) Agreement on tariffs and trade; (6) Protocol to the agreement on tariffs and trade; (7) Agreement on import licensing procedures; and (8) Agreement on trade in civil aircraft.

Preferential Tariffs. As one of the solutions to issues relating to the gap between industrialized countries and the primary commodity exporting countries, a general preferential tariffs system was suggested. This would allow industrialized countries to apply for a low tariff rate or abolish tariffs without asking for mutuality, regarding commodities imported from developing countries. Many industrialized countries were not positive about the concept as it was against the basic principles of GATT, in terms of freedom, equality, and no discrimination. However, the final agreement was made in the UNCTAD in 1970, with the background of the worsened situation of the North-South problem. The EC, Japan and the United States started to implement the policy in and after 1971.

Japan introduced the preferential tariff system in August 1971, to reduce tariffs on agricultural products depending on the conditions of the domestic industry, and applied zero tariffs to most mining and manufacturing products. The preferential tariff system was updated annually, for the addition of items and the further reduction of tariff rates.