

**Study on the Measures to Promote
the Internationalization of the Japanese Yen
from the Perspective of
Japanese Financial Institutions
and Multinational Businesses**

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Foreword

This report was compiled by the Institute for International Monetary Affairs (IIMA) concerning the “Study on the Measures to Promote the Internationalization of the Japanese Yen from the Perspective of Japanese Financial Institutions and Multinational Businesses,” commissioned by the Ministry of Finance of Japan in 2005.

Internationalization of the Japanese yen, by which is meant the promotion of the use of the Japanese yen in cross-border transactions, could have the effect of reducing foreign exchange risks and foreign currency settlement risks for Japanese businesses and financial institutions. This would be expected to make the Japanese economy as a whole less susceptible to foreign exchange fluctuations. It would also contribute to invigorating the Tokyo financial market as an international financial center and help the Asian economies diversify the risks they face. In view of such positive effects that the internationalization of the yen could have, Japan has been taking measures to increase the share of the use of the Japanese yen in trade, capital, and foreign exchange transactions. Thus far it has seen some progress, although limited.

When we look at Asia, economic interdependency within the region is becoming continuously stronger as can be seen by the increase in the share of intra-regional trade. Striking evidence for this is the fact that China surpassed the United States as the largest trading partner for Japan in 2004. Regional financial cooperation is also gathering momentum in Asia. In light of these facts as well as learning from the Asian currency crisis, the promotion of Asian currencies including the Japanese yen will be beneficial in many ways. In this region where interdependency is becoming increasingly important, it will contribute to the growth and stability of the economies, as well as regional financial activities. If Japan continues to take steady steps to encourage the internationalization of the Japanese yen, and if other Asian countries develop and improve their domestic markets to make them more user-friendly, there would be a better environment for the use of Asian currencies including the Japanese yen in the region. Such efforts and developments would also greatly contribute to the growth and stability of economies and financial markets in the region.

Recognizing these facts in the current situation, it would first of all be essential to support the business activities of the Japanese financial institutions and multinational businesses in various Asian countries. As they are familiar with the use of the Japanese yen and have a need to use the local currencies in the region as well, this support will facilitate the internationalization of the Japanese yen.

If we take a look at their activities in Asia, Japanese financial institutions made progress in penetrating the Asian market before the Asian currency crisis of 1997-98. After the crisis, most of them made a drastic retreat from those markets. Now that the problem of domestic non-performing loans in Japan has come a long way to be solved, there are demands from Japanese corporations as well as local companies for Japanese financial institutions to resume and expand their business activities in Asia. Even though it has been eight years since the eruption of the crisis, they have not resumed their operations seriously except in China. On the other hand, Japanese multinational corporations are aggressively expanding their business in China and in other countries in the region, in order to decrease production costs and to penetrate the consumer markets that are expected to expand rapidly. They are increasing their business dealings not only with Japanese banks but also with major local banks as well as European and US financial institutions.

However, there is a wide range of financial regulations restricting the business activities of foreign financial institutions in Asia. Some examples are regulations on paid-in capital from parent companies, legal lending limits on large borrowers, adequate levels of liquidity to be maintained, and the number of expatriate employees that can be accepted from the home country (visa restrictions). Also, foreign exchange controls (including non-internationalization of the currency) and withholding tax on interest payments on borrowing from abroad are other examples. These regulations sometimes restrict the activities of Japanese financial institutions, although the degree of restriction differs across the countries. Japanese multinational corporations, among which especially the major trading companies, electric-appliance manufacturers, and automobile manufacturers, are well experienced and run sophisticated businesses in the region. They have operating networks in East Asia, establish regional subsidiaries and employ various financial methods, such as netting the settlement of transactions of their branch offices and local affiliate companies. However, the regulations of local authorities sometimes become an impediment to using such financial services. Also, the multinationals are often disappointed with the financial and capital markets of their host countries. Since they are not necessarily fully developed, these markets restrict the multinationals' activity of fund raising and management in the local currencies.

In view of the above, we focused on the financial regulations of six countries --- China, South Korea, Thailand, Malaysia, the Philippines, and Indonesia --- in order to clarify how they are affecting Japanese financial institutions and multilateral corporations in their business activities, as well as to suggest proposals that should be made to local authorities to change those rules and regulations. In chapter 1, titled "Financial Regulations and Business Activities of Japanese Corporations in China, South Korea, and ASEAN Countries," the results of the study are described.

Secondly, we focused on the Tokyo financial market. This is because making the Tokyo financial market more user-friendly, particularly for nonresidents, will naturally contribute to making the Japanese yen more attractive and convenient to use as an international currency. This can eventually lead to promoting the internationalization of the Japanese yen. A number of problems have been pointed out about the Tokyo financial market and a wide range of policy proposals for improvement has been made up until now by various kinds of committees or organizations studying "the internationalization of the Japanese yen." Chapter 2, titled "Creating a More Active Tokyo Financial Market," first takes into account what has been done to improve the infrastructure of the Tokyo financial market. It then studies the remaining problems in funding and management from a practical viewpoint, namely "The user-friendliness of the Tokyo Capital Market, mainly for nonresidents."

Thirdly, one of the measures of promoting the internationalization of the Japanese yen is for Japan to directly encourage the Asian economies to use the yen more actively while fully taking their individual situations into account. Chapter 3 titled "Practical Steps toward Promoting the Use of the Japanese Yen for Trade Finance in Vietnam" describes such a promoting project in Vietnam. As part of the project a working group was formed between IIMA and the State Bank of Vietnam (SBV), the central bank. IIMA provided the parties that participated in the project with the necessary support in order to materialize some pilot cases. These cases concern the actual transactions of a financial scheme, in which Japanese banks in Vietnam provide yen funds to Vietnamese commercial banks, which in turn extend yen trade finance to Vietnamese enterprises. At the time this report is made, pilot transactions between the participating Vietnamese banks and their clients of exporters/importers have not yet materialized. However, in the process of coming close to materializing the pilot cases,

we believe that the activities in the project contributed to creating positive conditions and improving the financial environment. This would provide the opportunity for materializing the actual transactions in the future. For instance, the cooperation in connection with the necessary yen funding would by itself be an achievement under the project. Also, for the participating Vietnamese banks to improve their institutional capacity for developing and diversifying the financial products they offer clients, would be an accomplishment. This chapter reviews the activities concerning the project in Vietnam and examines the outcomes.

In conducting the above study, we have received extensive cooperation from the authorities, financial institutions, and corporations of the relevant countries. Although we do not have the space to mention their names individually, we would like to take this opportunity to express our deepest appreciation to them. We hope that the fruit of this study will contribute to the internationalization of the Japanese yen and to the increasing use of the Japanese yen and other Asian currencies.

Listed below are the authors of the report.

Chapter 1: Financial Regulations and Business Activities of Japanese Corporations in China, South Korea and ASEAN Countries

1. Thailand and 3. Indonesia

Jennifer Amyx, Assistant Professor, Political Department, University of Pennsylvania

2. Malaysia, 5. China and 7. Summary

Hideki Nukaya, Lead Economist, Department of Development Economics, IIMA

4. The Philippines and 6. South Korea

Tomohiro Ishiguro, Visiting Senior Research Fellow, IIMA

Chapter 2: Creating a More Active Tokyo Financial Market

Sumino Kamei, Economist, Economic Research Department, IIMA

Chapter 3: Practical Steps toward Promoting the Use of the Japanese Yen for Trade Finance in Vietnam

Haruo Muto, Visiting Senior Research Fellow, IIMA

Yozo Nishimura, Senior Economist, Economic Research Department, IIMA

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Chapter 1: Financial Regulations and Business Expansion of Japanese Corporation in China, South Korea, and ASEAN countries

1. Thailand

(1) Commercial presence of Japanese firms

<1> Evolving presence and business focus of Japanese firms

Thailand ranks second only to China as a destination for Japanese investment.¹ The government has supported and promoted foreign investment in the auto industry, in particular, via tax and other incentives, leading Thailand to become the focal point in Southeast Asia for Japanese auto manufacturing.² Proactive negotiation of free trade agreements has also furthered Thailand's place as the regional automotive hub.³ Thailand is furthermore an attractive platform for entry into Vietnam-- a country rapidly gaining importance in the business strategies of Japanese multinational companies(MNCs), as they seek to exercise a "China plus" investment strategy.⁴

Increasingly, firms that provide support services for manufacturers, such as those specializing in sales and maintenance operations, are also advancing into Thailand. Incentives for non-manufacturers to invest in Thailand are few, however.

<2> Financing needs and banking relationships

Japanese banks expanded into Thailand primarily to provide support for Japanese firms. Although Japanese firms have access to a wide variety of credit instruments in Thailand, in theory, private debt markets are not well-developed.⁵ Therefore, most corporate financing is done via borrowing from commercial banks.

Japanese firms operating in Thailand procure more raw materials and parts domestically (51.2% of total) than they do in any other ASEAN country or in China.⁶ Transactions carried out in baht are therefore frequent (and have risen sharply in relative importance since Thailand's 1997 crisis). Higher local content also means that Japanese corporations in Thailand prefer the local currency for their export settlement to avoid foreign exchange risk. The ratio of Japanese banks' local claims in baht has increased accordingly in recent years.

¹ From 2001-2005, Japanese firms polled annually on their priority markets for overseas expansion consistently ranked Thailand either second or third. 2005 Overseas Direct Investment Survey Results (JBIC), cited in JETRO Bangkok (Nov. 2005), p. 12.

² All five major Japanese automakers have announced plans to expand production significantly in Thailand in coming years.

³ The upcoming Thailand-US FTA is also expected to benefit exports of pickup trucks to the US, the largest pickup truck market in the world.

⁴ The Thai Government promotes the use of Thailand as a platform for entering into business operations in neighboring countries such as Vietnam. For example, a Treasury Center (TC: see section 6) established in Thailand may use baht for receipt, payment, borrowing and lending transactions carried out with group companies or counterparties in neighboring countries and Vietnam. When the TC carries out similar transactions with group companies or counterparts in other countries, however, it must first swap into foreign currencies(Bank of Thailand homepage).

⁵ As of November 2005, only five Japanese firms had issued baht-denominated local bonds to raise funds. Notably, Japanese banks are prohibited by Japanese financial regulations from providing public offering of bonds issued by non-financial corporations abroad-another impediment to greater use of this means of capital procurement.

⁶ 2001 "Ajia Nikei Sozo Katsudo Jittai Chosa" (JETRO), cited on p. 14 of JETRO Bangkok (Nov. 2005) *Tai ni ikiru Nihon Kigyo*.

A recent initiative by Japanese banks operating in Thailand aims to support the growing needs of Japanese MNCs for financing in the local currency. In September 2005, Japan's 3 mega-banks announced a plan in tandem with the Japan Bank for International Cooperation (JBIC) to each extend 1 billion baht (approximately 2.7 billion yen) in loans to Japanese firms operating in Thailand. The proceeds from a 3 billion baht bond issuance by JBIC will finance the loans. The loans are intended to go to Japanese firms with local operations, as well as to joint ventures with Japanese partners.⁷

Steady growth in numbers of Japanese firms investing in Thailand ensures to some extent continued profit opportunities for Japanese banks, and the banks report large increases in the number of newly opened bank accounts. At the same time, increasing numbers of large Japanese MNCs seek to centralize group financing. This has resulted in growing demand from these clients for more sophisticated financial services and cash management service (CMS), in particular. Japanese banks are widely recognized to be less competitive in the offering of such services compared to other foreign banks.⁸ Factors accounting for this situation are many but the number of corporate clients seeking such services as a proportion of the total corporate client base remains relatively low, while costs associated with investment in this area (most notably, investment in more advanced computer systems and in the hiring of those with relevant expertise) remain high. For some banks, therefore, uncertainty surrounding a return on investment inhibits more aggressive activity in this area.

(2) Recent regulatory developments

Thailand has liberalized its investment environment related to foreign capital in recent years, and foreign firms can gain market access via the cross-border supply of capital, as well as through direct and portfolio investment. In 2005, the Government actively promoted the development of the domestic bond market as part of the Asian Bond Market Initiative (ABMI), allowing non-resident entities such as the Asian Development Bank (ADB) and Japan Bank for International Cooperation (JBIC) to issue baht-denominated bonds for the first time.

The regulatory landscape continues to reflect a strong sentiment in favor of continued protection of service industries and the currency, however. Strict measures remain in place to restrict the outward movement of the baht and to curb currency speculation. Moreover, tax benefits applicable to many financial transactions in Singapore are not to be found in Thailand.

⁷ News reports. See also "JBIC Provides Thai Baht Two-Step Loan: First Asian Currency Loan Under ABMI" Press Release (September 15, 2005), Japan Bank for International Cooperation. Available at <http://www/jbic.go.jp/autocontents/english/news/2005/000066/index.htm>.

⁸ In *AsiaMoney* (May 2003 and October 2004) polls, HSBC and Citibank were ranked the top cash management banks for both in country and global cash management.

Table 1-1: Key regulations in Thailand pertaining to financial transactions

Financial institutions	Legal lending limit	25% of Tier 1 Capital Funds
	Legal reserve requirements ⁹	6% of all deposits, foreign borrowings with less than 1-yr maturities, and total borrowings with returns linked to variables. Reserveable assets consist of a minimum (1%) non-remunerated deposits at the Bank of Thailand, vault cash (up to 2.5%) and eligible public securities as residual.
Investment		Non-residents can maintain baht accounts and can freely credit them with proceeds from the sale of foreign currencies, transfers from other nonresident baht accounts or from obligations from residents.
Currency exchange transactions	Exchange rate system	Managed float introduced July 2, 1997
	Currency futures transactions	Financial institutions requested to stop non-deliverable forward transactions against the baht (Exceptions: rollover transactions, transactions to be terminated due to settlement failure).
	Foreign currency conversion	All foreign exchange transactions must be carried out through authorized banks.
Local currency transactions	Regulations on capital movement	Maximum of 500,000 baht for export to Cambodia, Lao PDR, Malaysia, Myanmar, and Vietnam. Limit of 50,000 baht elsewhere.
Foreign currency transactions	Regulations on domestic borrowing in foreign currencies	Nonresidents: funds deposited in foreign currency accounts must originate from abroad. Foreign banks lending domestically must pay withholding tax on funds brought in from abroad.
	Regulations on borrowing from abroad in foreign currencies	No restriction on amounts.
	Regulations on capital movement	Foreign currency must be deposited into a foreign currency account or converted at an authorized bank within 7 days of being remitted to Thailand.

(3) Evolution of business by Japanese financial institutions and the regulatory environment for financial services

<1> Business activity of Japanese financial institutions

As of January 2006, three of the 25 members of the Foreign Bankers Association in Thailand were Japanese banks operating with a full banking license: The Bank of Tokyo-Mitsubishi UFJ, Ltd; Sumitomo Mitsui Banking Corporation, and Mizuho Corporate Bank. These banks—and the foreign banking community as a whole—remain relatively small players in the Thai banking industry.¹⁰

⁹ These requirements must be maintained on average over a fortnightly period, with carry-over provisions using the previous period's average level of deposits/liabilities as the base. The carry-over provision allows banks to fall short of their reserve requirements by up to 5% (of the requirements). They then have to make up their shortfalls in the next period.

¹⁰ DBS and Standard Chartered operate as Thai banks.

Japanese banks are also active in Thailand's offshore banking market, the Bangkok International Banking Facility (BIBF). The BIBF will face elimination under Thailand's Financial Sector Master Plan, as local and foreign banks become forced to operate under a "single presence" concept aimed at streamlining the sector and improving efficiency in regulatory oversight. At present, however, Japanese banks remain active in this market. Two types of BBIF licenses are issued- those attached to foreign bank branches and "stand alone" licenses.

<2> Regulatory environment for financial services

Procedures for establishing business in Thailand's financial services sector are generally burdensome. Wholly owned subsidiaries of foreign financial institutions must obtain a Foreign Business Operations License from the Ministry of Commerce on nearly all service businesses, including securities trading and securities underwriting.

In most financial services, such as credit finance and life insurance companies, foreign portfolio investment is limited to 25% of total issued shares. Foreign directorships are also limited to 25% of the total number of directors, in the absence of approval from the Minister of Finance. Following Thailand's economic crisis, however, the Bank of Thailand invited foreign banks to bid for troubled domestic commercial banks and made an exception at that time to allow foreign banks to acquire up to a 100% stake of troubled commercial banks. Japanese banks did not take advantage of this window of opportunity and, given the 25% ownership constraints noted above, have therefore carried out all activities via a branch structure.

In December 2003, the Thai Cabinet approved a Financial Sector Master Plan (FSMP), intended to increase competition in the nation's financial sector by eliminating many regulatory boundaries. Under this plan, foreign financial institutions were permitted to apply for subsidiary status, with the chance to open additional branches and thereby expand business in the future. The government has not yet specified a timeframe for when it will permit the additional branch openings, however. Thus, foreign banks effectively remain limited to a single branch at present.

The commercial presence of foreign banks is further limited by restrictions on their establishment of off-site ATMs and on their access to local ATM networks. Thai authorities effectively prohibit the establishment by foreign banks of off-site ATMs by defining them as branches. Although foreign banks may join an ATM pool managed by local commercial banks, local banks choose to restrict the range of transactions available to foreign bank clients via such networks. For example, foreign bank clients cannot utilize the ATM to transfer funds between accounts at different banks, while local commercial bank customers are permitted to do so.¹¹

Thai authorities also hold foreign banks to higher prudential regulatory standards than they do local banks. Stricter capital requirements are one example. Capital of foreign bank branches must be comprised of funds brought in from abroad.¹² Additionally, the branches of foreign banks are prohibited from using their parent's capital to meet prudential requirements, even if their home country regulation and supervision has implemented Basle or equivalent standards. Consequently, the lending limits and net foreign exchange open positions of foreign bank branches are limited to on-shore capital, making them less competitive in the domestic market.¹³ Foreign banks lending

¹¹ Coalition of Service Industries (2004).

¹² Branch capital regulations cannot be overcome via guarantees by the bank's head office or another foreign bank.

¹³ Bank of Thailand regulations on net open positions (i.e. net foreign exchange positions) are in line with international standards. Financial Institutions are required to maintain net open positions in each currency of no more than 15 percent

domestically must also pay withholding tax on funds brought in from outside the country, while profit repatriation of foreign banks is restricted to twice annually, following an auditor review.

Thailand uses global accounting standards; since Japanese accounting standards differ from global standards in a number of financial service areas, Japanese financial institutions must adapt at times to different accounting regulations when advancing business in the region.

(4) Current regulatory environment for non-financial firms

<1> Investment regulations

The Alien Business Act governs most investment activity by foreigners in Thailand and limits foreign investment to 49 percent in most domestic companies. Manufacturing is an exception, with 100% foreign ownership permitted here. An alien business license, as well as Board of Investment certification or other government agency approval, is required prior to operating a business.¹⁴ Foreign firms must often navigate through time-consuming procedures involving multiple government agencies.

<2> Regulations on baht-denominated transactions

Thai baht can be brought into the country without restriction. A maximum of 500,000 Thai baht may be exported to Cambodia, Lao PDR, Malaysia, Myanmar, and Vietnam. A limit of 50,000 baht is in place for export of currency elsewhere. The Bank of Thailand requests moreover that financial institutions refrain from engaging in non-deliverable forward transactions against the Thai baht. Permitted exceptions are rollover transactions or transactions that must be terminated due to settlement failure.

Although regulations are relatively strict, non-residents can maintain baht accounts and credit them with proceeds from the sale of foreign currencies, transfers from other non-resident Thai baht accounts or from obligations from residents. Short-term borrowings (maturities of 3 months or less) in baht by non-residents from financial institutions are limited to 50 million baht per financial institution if non-residents do not have any underlying trade or investment in Thailand. When borrowing from non-residents with trade or investment transactions in Thailand, the limit is up to the underlying value of the transaction. Transactions with maturities greater than 3 months are not subject to limitation.

<3> Foreign currency-denominated transactions

The Foreign Exchange Control Act dictates that all foreign exchange transactions must be carried out through authorized banks. Inward remittances are free of controls but foreign currency must be deposited into a foreign currency account or converted at an authorized bank within seven days of being remitted to Thailand. Foreigners staying in Thailand for less than 3 months, embassies, and international organizations are exempt from this requirement, however.

Non-residents are allowed to maintain foreign currency accounts with authorized banks, if funds originate abroad. Short-term exchange transactions with non-residents are limited to the value of the underlying trade and investment. Transactions not involving trade or investment are subject to limits

of total capital at the end of the day, and are required to maintain an aggregate position of no more than 20 percent of total capital at the end of the day (Bank of Thailand, <http://www.bot.or.th/bothomepage/General/PressReleasesAndSpeeches/PressReleases/news2545/Eng/n2145e.htm>).

¹⁴ Changes in business activities or the expansion of a business furthermore require prior permission.

set by the Bank of Thailand. Foreign exchange cover with authorized banks is available for capital transactions. If the value of capital transactions falls below the notional value of the foreign exchange transaction, the currency hedge must be readjusted to reflect the new capital value. Exporting debt and issuing debt to foreign entities is possible.

Netting among residents can be carried out freely, without obtaining prior approval. Bilateral netting between residents and non-residents is permitted with the submission of required documentation to an approved foreign exchange bank.¹⁵ Permission from authorities is required prior to start carrying out multilateral netting between residents and non-residents. Pooling is also possible, although foreign exchange regulations apply. Residents may carry out pooling in baht.

<4> Establishment and operation of a treasury center (TC)

The Thai Government has permitted the establishment of financial center entities called Treasury Centers (TC) since July 2004. Such centers play the role of bank but service only group companies, acting as an agent for settlement, group financing and investment, liquidity and foreign exchange management, and as a pooling center. Settlement in foreign currency in Thailand is prohibited, however.

Some Japanese firms with many affiliates in Thailand are eager to establish TCs but regulations surrounding the establishment and operation of TCs in Thailand remain cumbersome. Most notably, all transactions within Thailand between the TC and group companies must be carried out in baht. Moreover, the net open position for TCs cannot exceed 20% of TC capital or \$5 million-- whichever is greater. Foreign exchange regulations prevent Japanese group firms from integrating treasury management carried out in Thailand—even via TCs -- into regional treasury center schemes.¹⁶

(5) Problematic aspects of regulations and desired reforms

<1> Labor regulations and human resource development

Investment in research and development by Japanese firms to support production in Thailand is constrained by the weak engineering base in Thailand and concomitant scarcity of Thai engineers. Legal restrictions prevent Japanese firms from hiring a sufficient number of foreign engineers to fill the gap. Similarly, Japanese banks in Thailand face constraints in meeting the needs of the growing number of corporate customers as a result of labor regulations. Although Japanese firms reportedly prefer that banks carry out customer support in Japanese, foreign banks are limited in the number of work permits they can obtain from Thai authorities to bring in expatriate staff.

<2> Impediments to establishing treasury centers

As noted previously, regulations surrounding the establishment and operation of treasury centers (TCs) discourage MNCs from using TCs to centralize group treasury functions. Only 2 Japanese firms have established such entities to date.

The administrative burden associated with operation of a TC is high. The TC must be established

¹⁵ The preparation of such documentation does incur administrative costs and time, however.

¹⁶ Japanese MNCs with region-wide activities tend to set up regional treasury headquarters in Singapore for a number of reasons. These include the following: a Financial Treasury Center incentive that eliminates withholding taxes; Singapore's many bilateral tax treaties; the deregulation of derivatives transactions; stability of the Singapore dollar vis-à-vis the US dollar; the nation's strong financial infrastructure; and, ease in dealing with financial authorities (the Monetary Authority of Singapore).

as a separate entity. To carry out financing between the TC and group companies, every firm participating in the scheme (not only the TC) must obtain permission to engage in group-financing from the Ministry of Commerce. Accounting entries of the TC must be reported separately from those of its group companies. And, in addition to the TC's need to keep track of the total net open settlement positions carried out on behalf of group companies, the TC must further monitor this positions on a daily base.

The costs of operation are high relative to benefits. Upon obtaining permission to operate, the TC must pay a registration fee amounting to 0.5% of capital (at least 20,000 baht but not more than 250,000 baht). At the same time, the TC is subject to a 7:1 debt to capital ratio limitation and is prohibited from investing overseas. Moreover, in contrast to TCs established in Singapore, TCs established in Thailand do not receive tax breaks and in fact, must pay a special business tax. As of this writing, the TC can pay only in baht to group companies or counterparts in Thailand. It is not allowed to transfer foreign currencies to group companies except for those registered overseas. Receipt, payment, borrowing, and lending between the TC and group companies or counterparts overseas must be in foreign currency except for those located in Vietnam and neighboring countries.

While the authorities are in the midst of considering changes to or clarifications of the regulations surrounding the establishment and operation of TCs, it is unclear when and to what extent changes will be made.¹⁷

<3> Difficulties in establishing regional operating headquarters (ROH)

Because numerous Japanese MNCs have more group firms in Thailand than anywhere else in the region, Thailand would be a naturally preferred location for setting up a regional headquarters. As already noted, Thailand's geographic location also make it a potential platform for entry into Vietnam, Cambodia, Laos, and the Mekong Delta sub-region. At present, however, incentives are not in place to spur many Japanese MNCs to relocate such headquarters in Thailand, and Singapore therefore remains the base of regional operations for many Japanese firms.

Under the laws establishing the investment category of "regional operating headquarters," companies providing qualifying services to subsidiaries or associate companies or branch offices offshore are granted tax incentives in the form of exemptions or reductions.¹⁸ Yet, these incentives are aimed only at service activities. Some Japanese MNCs wish to create a manufacturing headquarters in Thailand where they can establish a wholly owned company, receive special tax privileges, and be able to more easily obtain work permits for staff. Japanese MNCs seeking to shift their marketing headquarters from Singapore to Thailand also note the insufficient incentives to do so at present. Foremost among their needs is the ability to engage in trading and marketing with 100% shareholding, increase Japanese marketing staff, and receive an exemption from duties paid.

Indeed, Thailand stands out from Singapore for its lack of tax breaks for firms seeking to establish

¹⁷ BOT-M document (2004).

¹⁸ These incentives apply to 1) service fees derived from qualifying services performed in Thailand (taxed at a 10% rather than usual 30% rate); 2) dividends received from offshore (tax exempt if received from offshore subsidiaries or associate companies); 3) dividends paid to companies offshore (exempt from usual 10% withholding tax if paid to firms incorporated outside of Thailand and with no businesses locally); and 4) royalties derived from research and development work performed in Thailand (taxed at a 10% rather than 30% rate). To qualify as a ROH, a company must be incorporated under Thai law, have a minimum of 10 million baht in paid up capital, serve subsidiary or associate companies or branch offices in at least 3 countries outside of Thailand, and derive at least 50 percent of its income from rendering services to its subsidiary or associate companies outside of Thailand.

a regional operating headquarters and many Japanese firms see Thailand's unwillingness to offer similar incentives as a disincentive for moving regional operations to Thailand. Moreover, Thai authorities require that foreign firms move the operations of their entire group headquarters to Thailand; when this is done, however, various foreign investment restrictions are then applicable. Advance approvals required from the Revenue Department, Ministry of Commerce and Board of Investment prior to starting operations as a regional operating headquarters also makes registration of an ROH an unusually lengthy process.

<4> Tax regulations

In addition to the lack of tax incentives related to the operation of regional headquarters and treasury centers, noted above, tax regulations remain burdensome in a number of other areas. Trading companies note, for example, that even when Japanese firms are exempt from customs duties on imports, they end up being taxed if they make use of a trading company. A special business tax¹⁹ has also been the focus of criticism, although the Ministry of Finance has suggested it will sharply reduce the rate of this tax this year.

<5> Uneven playing ground

An uneven playing ground exists for Japanese firms in Thailand along at least two dimensions. First, a gap currently exists between the regulatory terrain that must be negotiated by major MNCs (including some Japanese MNCs) and smaller-sized MNCs. Some major Japanese MNCs have successfully obtained exceptions and favorable tax treatment as a result of direct negotiation with Thai authorities. Such selective concessions are apparently less threatening to the government than across-the-board deregulation. However, only a handful of Japanese firms are of sufficient size to secure such concessions. The vast majority of Japanese firms, including thousands of small and medium-sized enterprises,²⁰ must operate within the confines of the regulatory frameworks described earlier.

The second involves the gap between treatment of US firms and other foreign firms in particular sectors, deriving from a longstanding Treaty of Amity and Economic Relations (AER) between the United States and Thailand. According to the treaty, US individuals and firms are exempt from most of the restrictions on foreign investment imposed by the Alien Business Act, and therefore operate at a comparative advantage vis-à-vis their Japanese counterparts in numerous sectors.²¹ Although financial services currently lie outside the scope of this preferential treatment, negotiation of a US-Thailand FTA inclusive of financial services is currently underway. If successful, the FTA could have the effect of extending preferential treatment to American financial institutions.²² While

¹⁹ Or Specific Business Tax. SBT.

²⁰ According to a survey carried out by the SME Support Committee of the Japan Chamber of Commerce in Thailand, approximately 6,226 Japanese companies operated in Thailand. JETRO Bangkok "Thai ni okeru Nippon Kigyo" (Japanese firms in Thailand) Nov. 2005, p.4.

²¹ In the Uruguay Round trade negotiations, all parties signed agreed that these special privileges provided to US investors in the service sector would be exempted from Most Favored Nation (MFN) requirements for 10 years from 1995. The trade agreement therefore expired last year. Preferential treatment continues to be granted to US firms, however.

²² Many issues related to the regulatory environment for financial services—and the treatment of asset management firms, in particular-- are currently being addressed in US-Thai FTA negotiations. "Increasing Efficiency and Economic Growth Through Trade in Financial Services," Statement of Madeleine L. Champion, Managing Director JPMorgan Chase & Co. on behalf of the Bankers' Association for Finance and Trade before the U.S. House of

provisions of the Thai Financial Sector Master Plan, which call for the introduction of 100% ownership opportunities for foreign financial institutions, would negate the American advantage obtained via the FTA, the timeline for the Financial Sector Master Plan and the details of its provisions lack clarity. Thus, a successfully negotiated US-Thailand FTA that includes financial services could place Japanese financial institutions at a competitive disadvantage with regard to market access until the Financial Master Plan is implemented.

2. Malaysia

(1) Penetration of Japanese Financial Institutions and Businesses

In 1966, Malaysia prohibited the establishment of new branches of foreign banks already present in the country. Since 1974, the only new license extended to a foreign bank was to the Bank of China. This was in exchange for opening a branch of Maybank in China, and in fact, all foreign banks have been prevented from starting business or opening new branches in Malaysia. An article in the Banking and Financial Institutions Act requires all foreign capitalized institutions to be locally incorporated as domestic banks by 1994. Now all foreign banks have been incorporated and there are no branches of foreign banks.

The only Japanese financial institution to have a presence in Malaysia is the Bank of Tokyo-Mitsubishi UFJ, and three institutions including the Bank of Tokyo-Mitsubishi UFJ have off-shore branches in Labuan.

There are 13 foreign banks in Malaysia which comprise more than half of the 23 non-Islamic commercial banks (as of the end of July 2005).

There are 1,322 Japanese corporations in Malaysia, out of which 736 are manufacturing companies (as of May 2004)¹, with a huge number of them in the electric and electronic sector. About 60% of foreign trade in Malaysia is related to electronics.

Because of numerous regulations in such areas as investment, foreign exchange and financial transactions as well as harsh competition with neighboring countries, direct investment into Malaysia has been declining in terms of both value and number. Also, the nature of the assembly-and-process industry means that it is sensitive to labor costs and is heavily affected by the rise of China as the cheap labor provider. The stream of Japanese corporations moving from Malaysia to China has stopped, but there are hardly any new companies moving into Malaysia. This means that the business expansion model based on assembly and process of electric and electronic goods has reached its limitation².

In Malaysia, there is an acute sense of crisis about its economic development, and the country is making efforts to invite mid to small businesses and service industries, to encourage direct investment and to convert its industries to be more knowledge intensive. Such undertakings are leading to deregulation of financial transactions, which will be touched on later in this paper.

Malaysia has also been slow to sign FTAs compared to its neighbors like Singapore and Thailand. Intergovernmental discussions began on economic partnership between Japan and Malaysia in January 2004 and the Japan-Malaysia Economic Partnership Agreement (JMEPA) was signed in December 2005³. This was the first bilateral economic partnership agreement for Malaysia.

In May 2004, Malaysia signed a Trade and Investment Framework Agreement, which is a prerequisite for an FTA, with the United States. FTAs with South Korea, Australia and New Zealand

¹ Source: Jetro's White Paper on Trade and Investment, 2004

² Investment received by Malaysia (approval basis) in the manufacturing sector in the first three quarters of 2005 was up 58.7% compared to the same period of the previous year. As the type of foreign investments, 28.75% was new investment while 71.25 was investment related to expansion and diversification. Of those figures 43.3% and 56.7% respectively were from Japan. The figures were boosted by large-scale investments. (Trade and investment report November 30, 2005)

³ JMEPA is expected not only to expand trade and investment but also to promote cooperation in the areas of bio-industry, manufacturing related services, information and telecommunication technologies and other growing industries.

are also being examined.

(2) Trends in Deregulation

With the coming of the Asian currency crisis, Malaysia adopted a fixed exchange rate of 3.8 ringgit to a US dollar in September 1998 and severely restricted the outflow of ringgit overseas.

On July 21, 2005, Malaysia followed China and moved to a managed float system linked to a currency basket, but the policy of barring the ringgit from being traded offshore continues.

Deregulating financial transactions has continued after moving to a fixed exchange rate system, and extensive deregulations were conducted in 2003⁴ and 2005. The deregulation in April 2005 covered a wide range of areas including borrowing, foreign currency deposits, forward foreign exchange contracts and capital transactions. Major deregulations were as follows:

- Abolition of borrowing regulations for non-resident controlled companies (NRCC)
- Relaxation of regulations on foreign currency denominated borrowing
- Abolition of limitation on foreign currency deposits
- Allowing the opening of foreign currency deposits overseas
- Relaxation of the conditions for forward foreign exchange contracts
- Relaxation of the regulations on overseas investment

Due to these deregulatory measures the remaining key regulations related to financial transactions are as shown in Table 2-1.

⁴ The following deregulation measures were carried out in April 2003.

--increasing the maximum of foreign currency deposits

--extension of the maturity of forward foreign exchange contracts (ringgit buying) from six months to twelve.

--relaxing the fund raising conditions regarding NRCC

--relaxing the fund raising conditions, limits of foreign currency deposits, etc. for Operational Headquarters (OHQ)

Table 2-1 : Key regulations related to financial transactions in Malaysia

Regulations on financial institutions	Regulations on large scale credit	Loan balance to one institution/business group or to an individual must be under 25% of capital. Large-scale loans must be less than 30% of credit outstanding.
	Liquidity regulations	Maintenance of liquidity at a certain ratio of deposits according to maturity.
	Statutory reserve ratio	Compulsory deposit without interest at the central bank at the time of loan execution.
Regulations on foreign exchange transactions	Foreign exchange rate system	Adoption of a managed float system linked to a currency basket from July 21, 2005.
	Forward foreign Exchange contracts	Forward contract period is within 12 months. However, maximum period for forward contract for repayment of principal and interest of loans (in foreign currencies) from overseas is two years. Non-residents are allowed to make forward contract for ringgit denominated asset trading.
	Exchange of foreign currencies	Exchange of ringgit to foreign currencies is not regulated unless there are domestic borrowings. When there are domestic borrowings, transfer is allowed up to 10 million ringgit per year on aggregate of group companies.
Regulations on transactions in the home currency	Regulations on capital transfer	Capital transfer among non-residents needs pre-approval by the central bank regardless of the amount. Limitations on the source of transfer and the use of funds concerning the non-residents' account.
Regulations on transactions in foreign currencies	Regulations on domestic borrowing of foreign currencies	Pre-registration at the central bank is required if the aggregate amount (including two generation loans) exceeds 1 million ringgit. Pre-approval by the central bank is required if it exceeds 50 million ringgit.
	Regulations on overseas borrowing of foreign currencies	Pre-approval by the central bank is required when the loan value is the equivalent of 5 million or more ringgit in foreign currencies from non-residents.
	Regulations on capital transfer	Reporting to the central bank is required for overseas settlement of excess 50 thousand ringgit worth of foreign currencies.

Source: compiled by the Institute for International Monetary Affairs based on available materials

(3) Business Developments of Japanese Financial Institutions and Financial Business Regulations

<1> Business Developments of Japanese Financial Institutions

Business operations of Japanese financial institutions are limited since the only financial institution present in Malaysia is the Bank of Tokyo-Mitsubishi UFJ and it has no branches. Even the Bank of Tokyo-Mitsubishi UFJ specializes in providing services to Japanese institutions and conducts no retail business.

Sumitomo Mitsui Banking Corporation maintains a business partnership with RHB Bank and Mizuto Corporate Bank with Maybank, and they have set up a Japan Desk in the partnered banks to provide services to Japanese businesses.

Japanese banks tend to carry out a follow-the-customers pattern to cope with the business expansion of their Japanese business customers, not just in Malaysia but throughout Asia. This is because serious investment would be necessary to conduct retail business but credit risks associated with transactions with local businesses are too huge. Consequently, Japanese banks tend to specialize

in serving Japanese corporations.

European and American banks, on the other hand, tend to see the economic growth of the host country as a business opportunity and expand retail businesses or chose to pursue a strategy of concentrating on the investment banking businesses. Their strategy of penetrating into foreign markets is fundamentally different from that of Japanese banks.

Japanese businesses in Malaysia operate not only in Kuala Lumpur but are spread around in industrial parks, such as in Johor Bahru, Penang, Malacca, and Ipoh. Since Japanese banks have no presence in such local cities/towns, Japanese businesses sometimes conduct transactions with European and American banks which have branches there⁵. There isn't a strong demand from Japanese businesses for Japanese banks to increase the number of branches.

Restrictions on financial transactions are severe in Malaysia and there are a number of grey areas where decisions are based on the discretion of the authorities. Here again, there is a difference in the attitude of Japanese banks and European and American banks. Japanese banks have a policy of not providing financial services or dealing in financial products until the authorities show a clear indication of their judgment. On the other hand, European and American banks often venture into new areas based on their own judgment. Since a considerable amount of time is required to gain confirmation or approval of an application, there are dangers that European and American banks will have an advantage over Japanese banks in providing new financial services.

<2> Granting of Banking Licenses and Restrictions on Banks

The government announced a plan to strengthen the domestic financial sector, the "Financial Sector Master Plan" (a three stage, ten-year plan), in March 2001 in order to encourage economic growth. According to this plan, encouragement of competition with foreign financial institutions is planned after reorganization and strengthening of domestic banks. There may be admission of new foreign banks and softening of regulations on branches at this stage. However, there are no clear definitions on the admission of new foreign banks in the Master Plan. Bank Negara Malaysia (BNM) has a view that foreign banks have already a major presence, and competition between them and domestic banks is also keen in Malaysia. In 2004, BNM requested foreign banks to expand their back offices or to launch computer operations in Malaysia.

There are regulations on liquidity, large-scale credit and statutory reserve ratio on banks, but since all foreign banks are locally incorporated, these regulations apply, in effect, in the same way as they do to local banks. However, large-scale credit regulation which is calculated on capital is austere for locally incorporated enterprises of foreign banks which generally have less capital.

Since Malaysia has tight control on foreign exchange management and strict regulations on foreign capital, all foreign denominated transactions are conducted in the international offshore financial center in Labuan, and three Japanese banks have branches in the city. Even here, there are restrictions. Permission by BNM is required for remittance of profits raised in branches in Labuan, and branches are restricted from dealing in settlement or trade related businesses, even in foreign currencies.

⁵ Citibank has a total of three branches in Malaysia, in Kuala Lumpur, Johor Bahru and Penang, HSBC a total of 37, in Kuala Lumpur, Johor Bahru, Penang, Malacca and Ipoh, and Standard Chartered a total of 32 branches.

(4) Business Development of Japanese Corporations and Regulations on Business Activities

<1> Business Development of Japanese Corporations

ASEAN Free Trade Area (AFTA) is now in operation. A price competitive edge to countries in this region is gained, and some effects can already be seen; increase of the sales of Malaysia-made television sets in Vietnam and increase of exports to Thailand, using the Common Effective Preferential Tariff (CEPT).

The key question for Japanese corporations now is where they place Malaysia in their region-wide strategic planning. Corporations that operate throughout Asia generally have the following strategy.

- Strengthen the competitive edge by pursuing the benefit of scale by concentrating production
- For corporations that have multiple operational bases in Asia, create a horizontal division of labor structure by concentrating items of production country by country and sharing them mutually. Horizontal division of labor is expected to enjoy the benefit of the FTAs and other measures which should bring down tariffs.
- Coping with the risks inherent in high concentration in China.
- Aim for financial efficiency by establishing a financial control center and the use of CMS and GCMS.

Japanese corporations conduct business with local banks, foreign banks including Japanese institutions and the Labuan branch of Japanese banks. Most Japanese corporations have some business dealings with local banks. They use the local banks with wide branch networks to pay the salaries of their employees, to make payments to their local customers and also for loans because there was a regulation that required the majority of borrowings by NRCCs to be from local banks (abolished in April 2003).

There are some medium or small sized corporations, which can borrow only from Japanese banks, or local banks with guarantee by Japanese banks because of their credibility.

Japanese corporations depend on Japanese banks to assist them in administrative work such as reporting to, filing applications and confirming with authorities besides receiving normal banking services. There are still a number of areas in financial transaction regulations in Malaysia that are ambiguous and some transactions are given approval on a case-by-case basis. Japanese corporations expect the assistance of trustworthy Japanese financial institutions to maneuver through such complications.

<2> Business Regulations

(a) Investment Regulations⁶

Regulations on foreign capital subscription when investing in Malaysia were extensively eased to encourage direct investment from overseas in 2003. For non-manufacturing industries, regulations

⁶ Regulations on overseas investment by residents have been eased and the following are the remaining restrictions.

(a) Residents without domestic loans can convert from ringgit to foreign currency as well as use foreign denominated funds held offshore and onshore to invest overseas without any limit. Overseas investment using foreign currency borrowing is limited to 10 million ringgit per case.

(b) Residents with domestic loans can use foreign currency funds held offshore and onshore to invest freely overseas without any limit. Overseas investment using foreign currency converted from ringgit is limited to 10 million ringgit per corporate group and 100 thousand per individual per calendar year. Corporations investing overseas by using foreign currencies converted from ringgit must have a capital of at least 100 thousand ringgit and must have been in operation for more than a year.

(c) Overseas investment exceeding the equivalent of 50 thousand ringgit must be pre-registered with BNM.

on foreign capital subscription regarding new investment allow 70% of capital to be foreign as long as 30% or more of capital is Bumiputra. As for manufacturing industries, 100% of capital can be foreign for initial investment as well as additional investment for expansion and diversification. OHQ and corporations with a multimedia super corridor status are also allowed 100% foreign capital.

As seen above, regulations on foreign capital subscription have been eased on the surface, but restrictions still remain in the operation of non-manufacturing industries. For example, for Japanese trading companies, it is still necessary to have 70% or more Bumiputra capital to conduct their business smoothly. In order to meet this need, they usually own locally incorporated companies. It seems also the case that they must have at least 51% Bumiputra capital to win government bid projects.

(b) Regulations on Foreign Exchange Transactions

Although some restrictions were eased on April 1, 2005, there are still stringent regulations on foreign exchange transactions.

Maturity of forward foreign exchange contracts for trade settlement of both exports and imports can only be up to 12 months. Contracts with longer maturity need to receive permission individually from BNM⁷. In reality, applications are hardly approved, and even if they were, it would be extremely difficult to trade because a long-term foreign exchange forward market does not exist⁸. Although it is theoretically possible to sign a forward foreign exchange contract before actual demand, contract must be within the actual trading value of the past year and evidence of transactions must be presented.

However, BNM believes that it is now possible for residents to hedge the foreign exchange risk of all capital and trade transactions based on real demand, and the actual demand rule continues after regulations have been eased⁹.

(c) Regulations on transactions denominated in Ringgit

Transactions in ringgit are restricted only in Malaysia. Ringgit-denominated borrowing from non-residents, ringgit loans to non-residents and settlement in ringgit overseas are prohibited¹⁰.

⁷ Residents are allowed to conduct forward exchange contracts to hedge foreign exchange risks in relations to the following transactions.

- (a) foreign currency exposure due to approved foreign investment
- (b) payment related to approved foreign investment
- (c) capital and interest repayment of borrowings in foreign currency (offshore and onshore) with a payment date arriving within 24 months or less
- (d) anticipated receivable and payment from trade in goods and services based on the value of actual transactions of the past 12 months.

⁸ Most forward exchange contracts have a maturity of two to three months.

⁹ Transfer of ringgit into foreign currencies to be paid into foreign currency accounts held at domestic banks, Labuan offshore banks and overseas banks is allowed with the following conditions.

- (a) no limitation for residents without domestic borrowing
- (b) transfer of up to 10 million ringgit per corporate group per annum for resident corporations with domestic borrowing.
- (c) transfer of up to 100 thousand ringgit per annum for residents with domestic borrowing

¹⁰ Following are the regulations on ringgit denominated accounts held by non-residents. Regulations were made stricter even as overall regulations on financial transactions were eased in 2003.

- (a) Permission from BNM is required for transfer of funds between ringgit denominated accounts held by non-residents regardless of the amount.

Netting or pooling of both ringgit and foreign currencies need approval by BNM.

(d) Regulations on Transactions denominated in Foreign Currencies

As for the foreign currency deposits held by residents, the overnight balance brought forward was limited by a ceiling based on the monthly average of receipts from export. This regulation was abolished on April 1, 2005.

This allowed residents to open foreign currency accounts in domestic banks, Labuan offshore banks and overseas banks. There is no upper limit to the balance of those accounts. However, for foreign currency deposits in domestic banks, there is still guidance, mainly through banks, to continue regulating the balances according to performance. Foreign currency denominated receipt for exports can only be deposited in foreign currency deposits in domestic banks. A monthly statement to the BNM is required on foreign currency deposits held at Labuan offshore banks and overseas banks by resident corporations.

The following conditions apply to foreign currency borrowings by residents from non-residents, domestic and merchant banks.

- Resident corporations can borrow up to 50 million ringgit worth in sum per corporate group.
- Residents can borrow up to 10 million ringgit worth in sum.
- Pre-registration with BNM is required for borrowings over one million ringgit worth in the above both cases.
- Residents can use up to 10 million ringgit worth to finance foreign investment.

(5) Problems regarding Business Regulations and Future Prospects

<1> Dialogue between the government of Malaysia and JACTIM

A dialogue session is conducted once a year between the private sector and ministries as a way for the Malaysian government to hear the opinions of the private sector. The Japanese Chamber of Trade and Industry, Malaysia (JACTIM) assembles the opinions of Japanese companies and presents them to relevant ministries beforehand. At the annual dialogue session, the ministries will make their comments on those opinions.

The list of opinions presented by the JACTIM before the dialogue with the Malaysian Treasury in 2005 is listed in Table 2-2. The JACTIM proposed to abolish restrictions on foreign capital and clarify guidelines in the dialogue with the Ministry of International Trade and Industry¹¹.

(b) Origins of funds transferred into ringgit denominated accounts held by non-residents are limited to the following:
--Proceeds for goods denominated in ringgit, for securities denominated in ringgit and registered in Malaysia and for the sales of assets in Malaysia.
--Salaries, fees, interest and dividend.
--Proceeds from sales of foreign currencies.

(c) Funds from ringgit denominated accounts of non-residents can only be used for the following purposes:
--Purchase of assets in Malaysia denominated in ringgit
--Payment of costs in Malaysia
--Payment for goods and services purchased in Malaysia
--Opening of a ringgit account

If the ringgit denominated asset had been owned for less than one year, the proceeds from its sales must be kept in a non-resident account. If it had been owned for one year or more, the proceeds can be exchanged into foreign currencies.

¹¹ Request to clarify procedures and conditions on increasing foreign capital ratio when manufacturing companies, which had started operations before June 2003, make further investment for business expansion. Request to allow

Table 2-2 : Proposals for budget dialogue with the MOF, 2006

Manufacturing sector	1. Promotion of technical transfer (1) fiscal measures to promote new products and introduction of new technologies (2) securing technology-oriented personnel (3) fiscal measures to strengthen local supporting industry
	2. Improvement of competition environment for automobile and iron and steel sectors (1) organizing the competition criteria for Japanese car manufacturers (2) lowering tariff barriers in the iron and steel sector
	3. Creating a smoother environment for business activities (1) faster and smoother dealings by customs (2) coping with environmental regulations (3) counter measures to cope with increasing theft
Banking sector	1. Further easing of regulations on financial hedging methods 2. Abolition of over-night regulation on the total amount in banks' foreign currency accounts 3. Easing of restrictions on internet banking services 4. Improvement of process of registration / approval for new financial derivative products 5. Earlier enforcement of Financial Master Plan 6. Expansion of those eligible for ringgit denominated loans by offshore banks 7. Support for the current fixed exchange rate system
Insurance sector	1. Easing of regulations on resident workers 2. Easing of regulations on opening branches 3. Liberalization of the reinsurance market
Securities sector	Flexibility in the registration system of final beneficiaries

Source: JACTIM publication No. 93, July 2005

In the budget proposal of 2006, a preferential tax system was created to decrease the operating costs of corporations and improve and organize business environments, which allowed the transfer of losses to group companies, the expansion of multimedia super corridor entities and the adoption of a tax system to promote the use of alternative energy. The loss transfer system allows losses generated in one of the group companies to transfer up to 50% of that loss to another member of the group and for that company to cancel that out with profits in tax calculation. The system will be applicable from fiscal 2006¹².

<2> Restrictions easing is desired in relations to future Business Development

(a) Problems related to financial business regulations

The major issue concerning financial business regulations is that all foreign banks, including Japanese ones, have been prohibited from starting their businesses in Malaysia. In view of the number of Japanese corporations in Malaysia, the presence of just one Japanese bank, the Bank of Tokyo-Mitsubishi UFJ, is not adequate, and the improvement of this situation is of the utmost necessity. Expectations for other banks to begin business are especially high with Japanese

100% foreign capital for services related to wide range of manufacturing business and to clarify standards for approval (JACTIM publication No. 93, July 2005).

¹² Companies transferring and receiving losses must meet the following criteria.

(a) paid in capital of both companies must exceed 2.5 million ringgit.

(b) loss and profit that are cancelled out must be generated in the same fiscal year.

(c) two companies must have a capital tie of over 70% and the condition must have existed from the previous year

companies that have no business dealings with the Bank of Tokyo-Mitsubishi UFJ in Japan. The law of competition will apply if there are more Japanese banks and customers can expect to receive better services.

As is mapped out in the Financial Sector Master Plan, there are possibilities that more foreign banks will be allowed to begin business in Malaysia. Transparency should be strictly applied when decisions are made on the standards for the choice of banks.

Malaysia has the policy of aiming to become the hub of Islamic financing¹³. Three banks from Qatar, Saudi Arabia and Kuwait were approved licenses for Islamic banks in 2005. Japanese banks can establish an Islamic bank and they can provide 100% of capital when it first begins operation. However, under the present condition where Islamic investors must first be cultivated to establish Islamic banks and where there are no business models, it would be extremely difficult for Japanese banks to establish Islamic banks. Japanese corporations seem to be using Islamic banks from the point of cost-effectiveness when they can raise funds more cheaply through them. Several foreign banks, including Citibank, provide Islamic financial services.

The biggest problem regarding financial business operation is the regulations on large-scale loans. Locally incorporated banks usually have smaller capital. Since large-scale loans are calculated based on the capital, it is difficult for such banks to extend significant financing, such as infrastructure funds, in Malaysia.

Malaysia still continues to apply various restrictions on financial transactions, and some rules are unclear with the application of regulations dependent on the case-by case judgment of the authorities. As mentioned before, there are concerns that there are and will be differences between the Japanese on one hand and Europeans and the Americans on the other in the kind of new financial services they provide because of their varied attitudes in coping with this situation. Japanese banks would be likely to provide financial services more freely, quickly and flexibly if they did not have to consult and confirm with the authorities so often. Hence, Japanese banks earnestly require not only the easing of regulations on transactions but also clarification and transparency of regulations on transactions.

(b) Problems related to financial transaction regulations

Since all transactions denominated in ringgit must be conducted in Malaysia, foreign settlements are all denominated in foreign currencies. This means that companies located in Malaysia have to bear the foreign exchange risk burden in all foreign transactions. Companies were not much troubled by the fact that ringgit could not be used for foreign settlement or by the foreign exchange rate fluctuation risks in the past, partly because a fixed exchange rate system against US dollar was applied. (Companies which deal in both exports and imports consolidate settlements into one currency, such as US dollar or yen, to avoid foreign exchange rate fluctuation risk.)

However, the foreign exchange rate system moved to a managed flexible system linked to a basket on July 21, 2005. For the time being, the value of ringgit against US dollar has been moving only

¹³ Malaysia works in concert with Singapore with regard to Islamic financing and is considering moving the fund operations to Singapore. That is the reason why Singapore attended the meeting of the Organization of the Islamic Conference. Islamic financing includes insurance business. BNM issued four licenses which allow the recipients to begin Takaful operation (Islamic insurance) on January 30, 2006. A Japanese company, Millea Asia, participates in the joint venture company, which was given one of those licenses. Takaful is an insurance business based on Islamic teaching (sharia law) and a foreign capital subscription rate of 49% is applied to Takaful operators.

marginally, even after changing the foreign exchange rate system of ringgit and hence, no major problem has occurred from the switch.

In view of the expected changes in the Chinese foreign exchange rate system and the revaluation of renminbi, a further review of the foreign exchange rate system and foreign exchange value of ringgit could become necessary. Then, Japanese corporations are likely to have to devise ways to cover the foreign exchange rate fluctuation risk of ringgit.

Though regulations on forward foreign exchange contracts have been eased, there are still some severe restrictions. Furthermore, the long-term foreign exchange forward market is underdeveloped.

The Japanese manufacturers in Malaysia which mainly deal in assembling and processing import material and parts from overseas, denominated in foreign currencies, and export the finished product, again denominated in foreign currencies. When these companies conduct multiple business dealings with parts manufacturers or processing companies in Malaysia, the counterparts have to bear the foreign exchange fluctuation risks since settlement in foreign currencies is prohibited in Malaysia. Demands to allow settlement in foreign currencies domestically are likely to strengthen in the future¹⁴.

Looking at the fund raising side, there are no restrictions for borrowing in ringgit now since restrictions on borrowings by NRCCs were abolished in April 2005. However, in Malaysia's financial market, mid to long term funds are affected by the operational needs of the providers (mainly pension funds and insurance companies) and it is difficult to raise mid to long-term funds steadily. Also, interest rates are set quite high.

Concerning foreign currency borrowing, it is still restricted to a total of 50 million ringgit worth per corporate group and borrowings exceeding 1 million ringgit worth require pre-registration with BNM. The same regulation is applied to two generation loans often used by medium and small scale industries.

There are various ways of borrowing (short and long term, fixed interest rate, flexible interest rate, etc) in the offshore loans extended by Labuan branches of banks providing means to raise funds with low interest. However, foreign exchange fluctuation risk exists in borrowings denominated in foreign currencies so that foreign exchange risk hedging methods such as matching up with profit denominated in foreign currencies becomes necessary.

Finally, let us touch on the issues related to financial headquarters. Since Malaysia does not allow foreign settlement in ringgit nor domestic settlement in foreign currencies, the country is placed outside the financial network, even for large corporations that have a financial headquarters in Singapore. It is a great disadvantage for Japanese corporations that operate widely in Asia that Malaysia, where there is a high concentration of industries, cannot be in the network.

As for establishing a financial headquarters overseeing subsidiaries in Malaysia, a special approval by BNM is required. Although this is the rule, in reality, approval is given on a case-by-case basis to large corporations, and most Japanese companies do not see this regulation as a significant problem.

¹⁴ According to a survey conducted by the JACTIM in 2004, Japanese companies acquire less than 20% of parts and materials from domestic companies. This is especially evident in home appliance manufacturers, which acquire necessary components from group companies.

3. Indonesia

(1) Commercial presence of Japanese firms

<1> Evolving business presence and business focus of Japanese firms

Japan is the top export destination for Indonesian products, the single largest foreign investor in Indonesia, and the top donor of development assistance to Indonesia. A variety of problems in the Indonesian investment environment contribute to relatively sluggish levels of investment by Japanese firms today in Indonesia compared to current investment activity elsewhere in ASEAN. These problems include insufficient infrastructure development, labor issues (including a steep hike in wages that exceeds productivity improvement), corruption and other “unseen” costs, and weakened industrial competitiveness.¹ Nevertheless, expectations remain strong for increased investment in the future in the automobile and motorcycle sectors and in new electric power projects. Moreover, a huge latent consumer demand tied to Indonesia’s large population, continued high levels of Japanese ODA support for Indonesia, and the Indonesian government’s own pledges for infrastructure development² provide optimism about future investment opportunities. Japanese investment today is spread throughout Indonesia, but focused in particular on the greater Jakarta area, East Java, West Java, and Sulawesi.

<2> Financing needs and bank relationships

For Japanese multinational companies (MNCs) carrying out retail operations in Indonesia, a weak settlement system poses particular business challenges because of the country’s large land area. Real Time Gross Settlement (RTGS) is “real time” in name only: remittances must be sent by 11am in order to settle on the same day. For this reason, most MNCs rely on a single local bank to collect funds at various branches, thereby centralizing settlement operations.³

Indonesia is also behind its major neighbors in capital market development, and most corporate financing is done via borrowing from commercial banks.⁴ A legal lending limit (LLL) imposed by Bank Indonesia on foreign banks constrains Japanese banks in their ability to meet large-scale financing needs of Japanese MNCs, although such limits are generally in line with those found elsewhere in the region. Large-scale financing needs are typically met via a company’s regional headquarters located in Singapore. Online banking is also less advanced in Indonesia than many other countries in the region.

¹ “Indonesia in the Era of East Asian Economic Integration: Toward Reinventing Indonesia’s Industrial Competitiveness” Keynote Speech by Osamu Watanabe, Chairman and CEO of JETRO at the Symposium on Reinventing Indonesia’s Industrial Competitiveness in Jakarta, Indonesia on March 1, 2005

² The Indonesian government announced a plan in January 2005 at the “Infrastructure Summit 2005” in Jakarta to tackle infrastructure development.

³ Even in the absence of these regulatory impediments, incentives for MNCs to use Japanese banks for cash pooling are weak, given the weakness of cash management service systems offered by Japanese banks. Factors accounting for the weakness of Japanese banks in this area are many. Most notably, the number of corporate clients seeking such services as a proportion of the total corporate client base remains relatively low, while costs associated with investment in this area (investment in more advanced computer systems and in the hiring of those with relevant expertise, in particular) remain high. For some banks, therefore, uncertainty surrounding a return on investment remains.

⁴ While Indonesia has the world’s largest population of Muslims, Islamic finance also has yet to take off. Islamic banking assets total about \$1.7 billion, or just over 1 percent of total bank assets (CIMB figures; CIMB is the investment bank of Bumiputra-Commerce Holdings of Malaysia. Cited in “Asian Islamic Finance is a Market for Non-believers” Reuters (Feb.22, 2006)).

(2) Recent regulatory developments

<1> Strengthening of banking oversight

Indonesian authorities recently introduced a number of new measures to strengthen supervisory oversight of the banking system. In 2004, Bank Indonesia announced a blueprint (the “Indonesian Banking Architecture”) for the direction of the banking sector for the next 10-15 years. Authorities are paving the way for more risk-based supervision by incorporating market risk into the calculation of capital asset ratios for banks with larger trading portfolios, introducing new asset quality valuation rules that contain more stringent classification and provision requirements for performing and non-performing assets, and higher statutory reserve requirements for banks with larger deposit bases. Other measures include:

(a) Introduction of new rating system for asset quality and debtors

On January 20, 2005, Bank Indonesia issued a new regulation regarding the procedure for rating borrowers. The Regulation, which reflects a ‘one debtor, one project’ concept, requires commercial banks to apply uniform procedures of quality classification towards multiple accounts of earning assets used to finance one debtor and of earning assets used to finance the same project.⁵ Uniform quality classifications also apply to earning assets extended by more than one bank. If a difference arises in how banks have assessed the quality of one borrower's earning assets, or a difference arises in how multiple banks have assessed the quality of earning assets granted to finance the same project, each earning asset must be classified at the lowest earning assets quality rating. Reassessments must be undertaken every three months and audited financial statements for each period are reviewed regularly by Bank Indonesia to ensure compliance.⁶ Although heightened prudential regulation appears on the surface to be a positive development, a lack of transparency surrounds the way in which Indonesian authorities calculate the new ratings, creating some concerns for Japanese banks.

(b) Introduction of a deposit insurance system and associated regulations

In an effort to regain public trust after the 1998 Indonesian banking crisis, the Indonesian government provided a blanket guarantee over all bank obligations to depositors. This action helped restore public trust in the banking industry, but at the same time placed a burden on state finances and generated moral hazard for bankers and depositors. In September 2005, the government revised regulations to replace the blanket guarantee with a deposit insurance system. Each bank in Indonesia is now required to participate in the deposit guarantee system, paying participation fees and premiums to the Deposit Insurance Agency (DIA) so as to insure people’s deposits to a maximum of 100 million rupiah.⁷ Each bank must also submit documents including a letter from the bank’s Board of Directors and other officers stating personal liability. This rule arises out of a history of many Indonesian banks being owned by individuals and incidences of improper conduct by some.

⁵ Certain exceptions apply—generally for loans made for less than or equal to 500 million rupiah or funding to specified regions. Loans must be classified into one of five categories: current, special mention, substandard, doubtful, or loss.

⁶ There is also a general sense that Bank Indonesia inspections of banks with regard to asset classification have recently become stricter.

⁷ To cover the gap between the dissolution of the Indonesian Bank Restructuring Agency (IBRA) and the enforcement of the new law, the government set up a Government Guarantee Implementing Unit within the Department of Finance. This unit provides deposit guarantees for ailing banks in situations of crisis.

However, the appropriateness of application of such a rule to foreign banks, where boards of directors play a very different role, is questionable.

(c) New Tier 1 Capital Regulations

In late 2005, Bank Indonesia announced obligations for banks to adjust their minimum Tier 1 Capital.⁸ All commercial banks in Indonesia that provide payment services (excluding branches of foreign banks) are obliged to comply with Tier 1 capital requirements equaling at least IDR80 billion (\$7.9 million) by December 31 2007 or December 31 2008. Commercial banks that already have Tier 1 capital of IDR80 billion must have IDR100 billion of Tier 1 capital by December 31 2010, or, at the latest, December 31 2011. After December 31 2010 all banks must have 100 billion rupiah of Tier 1 capital.

<2> Creditor's voting rights in bankruptcy

In 2005, the Indonesian government also made revisions to Indonesian bankruptcy regulations that affect creditors extending credit in currencies other than rupiah (International Financial Law Journal, June 2005). Formerly, when a creditor had a claim in currencies other than rupiah, the claim was converted into rupiah for the purposes of calculating voting rights. Under the new regulation, only the size of creditor claims in rupiah will be taken into account when determining the number of entitled votes per creditor.

(3) Evolution of business by Japanese financial institutions and the regulatory environment for financial services

<1> Regulatory environment for financial services

(a) Legal Lending Limits (LLL)

Legal Lending Limits (LLL) for non-related parties are divided into two types: those applicable to an individual debtor and those applicable to a group of debtors. For an individual debtor, lending is limited to no more than 20 percent of bank capital. For a group of debtors, lending is limited to no more than 25 percent of bank capital. Lending to related parties is limited to no more than 10 percent of bank capital. While such lending limits are not particularly low compared to other countries in the region, the types of investment made by Japanese firms in Indonesia tend to be those requiring greater capital expenditures than those done elsewhere. In particular, spending by Japanese firms in Indonesia (especially by Japanese trading companies) tends to focus on infrastructure and resource development, and therefore involves massive amounts of capital investment relative to other types of general manufacturing projects. For this reason, the LLL is particularly constraining on Japanese firms in Indonesia.

(b) Capital requirements for business establishment

Indonesian banking regulations stand out for the large amounts of capital required of banks to establish domestic lending activities. Because of the high capital requirements, Japanese banks—as well as other foreign banks—have only established branches in main cities, even though greater

⁸ This capital consists of paid-up capital and disclosed reserves.

branch expansion is legally permitted.⁹

(c) Foreign Borrowing

Banks are required to limit the daily balance of short-term borrowings to no more than 30 percent of bank capital. Banks intending to proceed with market entry to raise long term foreign borrowings are required to obtain prior approval from Bank Indonesia.

(d) Minimum Capital Requirements

Since 2001, banks have been required to maintain a minimum 8 percent capital to asset ratio, calculated by comparison of capital with risk weighted assets.

(e) Prohibitions and Restrictions on Rupiah Transactions

Banks are prohibited from conducting certain transactions with foreign parties such as rupiah transfers to an account held by foreign parties in a domestic bank. This prohibition does not apply, however, if the transaction is part of an economic activity in Indonesia or between accounts held by the same foreign parties.

(f) Net Open Position (NOP) and Netting

Bank Indonesia requires banks to maintain a net open position no greater than 30% of capital.¹⁰ No particular regulations pertaining to netting.

Table 3-1: Key regulations in Indonesia pertaining to financial transactions

Regulations affecting financial institutions	Legal lending limit ¹¹	1. To related parties: 10% of capital ¹² 2. To bank's unaffiliated parties: 20% of bank capital for individual debtors; 25% of bank capital for group debtors. ¹³ 3. To state-owned companies, projects which affect the prosperity of a great many people and projects establishing infrastructure: 30% of capital.
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⁹ Eleven foreign banks and 19 joint banks operated in Indonesia as of 2005. Together, the foreign banks and joint banks held 12.34% of total bank assets in Indonesia, as of 2005. Their branches comprised less than 2% of the total number of branches, however.

¹⁰ Under Bank of Indonesia guidelines, "net open position" means the sum of the absolute value of the net differences between asset and liability balances for each foreign currency and the net differences between claims and liabilities, in the form of both commitments and contingencies in administrative accounts, for each currency, which are all stated in rupiah. Banks unable to maintain minimum capital requirements are limited to a net open position equivalent to 20% of capital.

¹¹ "Capital" is defined as tier 1 and tier 2 capital for a bank having its head office in Indonesia; or, net head office funds, for a branch office of a foreign bank. (Bank Indonesia Regulation Number: 7/3/PBI/2005).

¹² Tighter restrictions regarding Legal Lending Limit to bank's related/affiliated parties were introduced in January 2005 through the increase of coverage in what is defined as a bank's related/affiliated party (Bank Indonesia).

¹³ From January 2005, placements in other banks are no longer calculated in the Legal Lending Limit provided that a bank's financial statements are consolidated with that of the target bank (Bank Indonesia).

	Legal reserve requirements ¹⁴	5-8% of deposit funds in rupiah (5% plus additional reserves determined on the basis of levels of deposit funds and on the Loan to Deposit Ratio) ¹⁵ ; 3% of deposits in foreign currency.
Investment		Nonresidents can maintain rupiah and foreign currency accounts at licensed banks with no restrictions.
Currency exchange transactions	Exchange rate system	Free-float since August 1999
	Currency futures transactions	Banks may conduct derivative transactions in foreign currencies against the rupiah with nonresidents up to a maximum nominal amount of USD1 million (or its equivalent). Restrictions do not apply when carried out for investment purposes although supporting documentation is required. Restricted derivative transactions involve forward sale, swap sales, and options. Onshore entities are allowed to access the derivatives market without documentation.
	Foreign currency conversion	No restrictions on amount of foreign currencies that can be brought into or taken out of the country (conversion not required).
Local currency transactions	Regulations on capital movement	Transfer of rupiah to nonresident accounts in banks outside Indonesia is prohibited for investment activity. For amounts up to or exceeding 100 million rupiah, proof of underlying economic activity is required. Local banks are prohibited from purchasing securities issued in rupiah by nonresidents.
Foreign currency transactions	Regulations on domestic borrowing in foreign currencies	No restrictions.
	Regulations on borrowing from abroad in foreign currencies	Foreign borrowings must be reported to the Ministry of Finance and Bank Indonesia.

¹⁴ As of 29 Nov. 2005; statutory reserve requirement percentages may be adjusted from time to time, taking into account the condition of the economy and the policy direction of Bank Indonesia. Amendments were made twice in 2005 alone.

¹⁵ The Loan to Deposit Ratio (LDR), is the ratio of credit extended to third parties in rupiah and foreign currencies (not including credit to other banks) against deposit funds, encompassing demand deposits, savings deposits, and time deposits in rupiah and foreign currencies, not including Inter-bank deposits. Bank Indonesia Regulation Number: 7/29/PBI/2005. See this same regulation and Regulation Number: 7/49/PBI/2005 for details on precise statutory reserve requirements according to various levels of deposit funds and LDRs.

	Regulations on capital movement	Local banks are prohibited to lend in rupiah or foreign currencies or extend overdraft facilities to certain nonresident accounts.
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<2> Business activity of Japanese financial institutions

Japanese banks have operated branches and sub-branches in Indonesia for decades. Today three major Japanese banks operate as foreign banks: Bank of Tokyo-Mitsubishi UFJ, PT Bank Mizuho Indonesia, and PT Bank Mitsui Indonesia. Bank of Tokyo-Mitsubishi UFJ provides full range banking services including Deposit, Loan, Remittance, Export, Import and Foreign Exchange transactions, and is a settlement bank for many Japanese companies in Indonesia. PT Bank Mizuho Indonesia and PT Bank Sumitomo Mitsui Indonesia are engaged in deposit taking, lending and other commercial banking services. The form of business organization adopted by each of these three banks differs significantly, however. PT Bank Mitsui, for example, operates as a subsidiary with 99% ownership by Mitsui Sumitomo Bank and 1% ownership held by Indonesian domestic investors. In contrast, Bank of Tokyo-Mitsubishi UFJ operates in the form of foreign bank branches, having benefited from the earlier timing of its entry into the market and the application of a grandfather clause on amounts of capital required for establishment of new branches. In addition to the aforementioned three banks, Bank Resona Perdani also operates (and has operated for over 45 years) as a joint venture bank, providing banking services to local Indonesian companies as well as to joint venture Japanese-Indonesian companies.

(4) Current regulatory environment for non-financial firms

<1>Investment regulations

Indonesia's regulations governing foreign investment have loosened in recent years. However, the country is notable for its lack of special investment promotion policies, particularly when considered in comparison to some of its ASEAN neighbors. There is little evidence of proactive measures to attract investment into the country.

<2> Regulations on rupiah-denominated transactions

Indonesia has a flexible exchange rate system but strict regulations work against speculation on the rupiah in foreign exchange markets. Those regulations aim to ensure that rupiah is supplied to meet real demand rather than being funneled into speculative investment.

Because domestic entities are not permitted to move the rupiah freely outside of Indonesia, they must carry out foreign exchange conversion into US dollars and then transfer funds to a regional treasury center (typically located in Singapore).¹⁶ Because of the regulatory environment, capital can be procured more cheaply locally and Japanese firms are typically able to borrow locally at the same terms and conditions as from their Tokyo headquarters.

<3> Foreign currency denominated transactions

Although dollar-denominated settlement carried out within Indonesia must be reported to

¹⁶ Certain major Japanese MNCs maintain regional headquarters in Thailand but do not carry out lending among group companies due to withholding tax issues.

authorities, it may be carried out with relative ease and reporting requirements are light (the submission of a single report). No particular impediments to maintaining dollar accounts or carrying out dollar-denominated investment exist. Settlement of accounts (accounting of books for reporting to local authorities) must be done in rupiah, however, and the dollar-rupiah exchange rate has been very unstable. Foreign exchange contracts are available as a means of hedging against risk, but because of the extremely high interest rate on the rupiah, such mechanisms for managing foreign exchange risk are very costly. Accordingly, few firms actually hedge foreign exchange risk, the market for such contracts is thin, and foreign exchange contracts are not an effective means of hedging.¹⁷ Therefore, countering the interest rate risk associated with rupiah-denominated settlement accounting is difficult and a problematic aspect of carrying out business in Indonesia.

Due to political instability in Indonesia, most MNCs prefer to move surplus foreign-currency denominated income out of the country and to Singapore rather than keep the funds within Indonesia. The transfer price tax is one of the Government's means of responding to this tendency to export surplus capital, and there is some concern that the government will more strictly apply the transfer price tax system in the future.

(5) Problematic aspects of regulations and desired reforms

<1> Absence of industrial strategy

Against the backdrop of a rising China, most of Indonesia's ASEAN neighbors are employing strategies to raise the prominence of their economies and particular industries in the region. Indonesia has lagged behind here, but in December 2004, the Indonesian Government, Indonesian Chamber of Commerce and Industry (KADIN), JETRO Jakarta and the Jakarta Japan Club met to draw up a comprehensive strategy for improving the country's investment environment and strengthening industrial competitiveness. Following up on this event, Japan's Finance Ministry worked with the Indonesian Government to formulate in May 2005 a "Strategic Investment Action Plan". This plan covers tax, customs, labor, competitiveness and SME issues, and infrastructure development. Japanese ODA is a source of support for some projects listed under the infrastructure development part of this plan. A series of important laws related to taxation, investment, trade, labor, and customs legislation remain in the drafting stage, however, with little prospect of enactment in the near term. At the same time, macroeconomic and political stability remain of concern.

<2> High costs associated with bank lending

The requirement to provide uniform classifications of debtors can be costly to Japanese banks, if banks have assessed debtors to be of greater strength than assessments by other banks, since this means raising amounts of reserves set aside.¹⁸ The key question is what standards are being used to judge these assessments. Although the central bank's guidelines are currently used, these guidelines lack transparency and clarity. Japanese banks also face an extra cost through a regulation imposed by Japan's Financial Services Agency that requires banks making loans in Indonesia (and in Argentina) to set aside 10% of the loan amount in loan loss reserves in Japan. This rule is imposed due to perceived

¹⁷ Repurchase agreement transactions are also legally questionable, with concerns reported about reliability of the Indonesian judicial courts and absence of a rule of precedence. Some Japanese MNCs also do not engage in derivatives transactions because of orders from their headquarters.

¹⁸ Notably, Japanese financial regulators introduced similar regulations in Japan when efforts were being made to address the large amounts of non-performing loans in the domestic banking system.

country risk attached to Indonesia.¹⁹ Lending also involves unusual risks in Indonesia because of regulations surrounding the use of collateral. Often real estate is used as collateral but collection of real estate collateral can be virtually impossible in some cases, due to legal priority given to workers inhabiting buildings. Recent introduction of many of the aforementioned regulations arguably reflects concerns about supervisory capacity.²⁰ Support for deregulation in Indonesia thus likely to be most effective via capacity-building efforts.

<3> Defects in the investment environment affecting MNCs

Unseen costs of business for Japanese firms and financial institutions are high. A lack of legal certainty and transparency means that only a small percentage of business disputes are resolved through the courts, and incentives to pay bribes instead to resolve issues are high. Problems, for example, often arise related to imports and exports. Corrupt practices, such as the solicitation of bribes, are common and Japanese firms, along with other foreign firms, seem to be frequent targets. Complex and conflicting regulations also mean that firms spend more time dealing with government regulations and less on their core business activities.

Similarly, numerous problems surround the tax system, with many firms facing difficulties in their dealings with tax authorities. Actions of central and local governments (and courts) are not coordinated and problems are rampant with ensuring consistent rules across different levels of government: regulatory implementation often differs depending on the government agency in charge, with one agency's interpretation or mode of operations conflicting with another. Improprieties in the system are common. While problems may be dealt with in the courts, 50% of any tax in question must be paid in advance, therefore meaning that the regulatory framework favors the authorities over investors.

Indonesia's restrictive labor laws and high labor costs also pose challenges to MNCs. Labor regulations are biased in favor of workers and labor protests are frequent. The cost of firing a worker is unusually high, for example, and corruption is unpredictable and widespread. The physical infrastructure in Indonesia is moreover low. Sales are at times lost due to power outages and transport problems.²¹

Many of the aforementioned problems are also observed elsewhere in the region. The magnitude of problems in Indonesia, however, appears to be higher. The current government led by President Yudhoyono has made significant progress in tackling bribery and corruption, but deep-seated structural impediments to investment remain.

¹⁹ Banks noted the irony of the regulation, given that Indonesia is a top recipient of overseas development assistance from the Government of Japan and ODA from the Japanese government remains strong.

²⁰ Commercial banks' non-performing loan ratios have been increasing.

²¹ Therefore, relying on communications networks for the electronic movement of cash is risky.

4. The Philippines

(1) Penetration of Japanese Financial Institutions and Businesses

The Philippines have pursued an industrial policy of encouraging export-oriented companies by inviting foreign capital. Consequently, Japanese companies investing in the country are mainly export and processing-oriented. Exports from the Philippines to Japan are the second largest after those to the United States, and Japan is the largest exporter to the Philippines. Exports to Japan in 2004 were mostly electronic components and semiconductor products (more than 80% of exports) and machine and transport equipment (9.2%). Imports from Japan included electronic goods (more than 43%), machine and transport equipment including automobile parts (25%). There is a clear picture of importing components and material related to electronic goods, machine and transport equipment, and exporting processed goods.

ASEAN Free Trade Area (AFTA) began to function in 2003 and lowered intra-regional tariffs, which increased the amount of intra-regional procurement.

516 Japanese companies were members of the Japan Chamber of Commerce in the Philippines (within greater Manila) in 2005 and 107 companies were members of the Japan Chamber of Commerce in Cebu. 1098 companies are registered at the Philippines investment offices (BOI, PEZA, CDC, SBMA)¹.

The recent trend shows that more Japanese companies in the services sector are beginning operations in the Philippines. European and American corporations are investing in the services sector in order to take advantage of cheap labor costs and time difference to run call-centers and outsourcing back office functions. On the other hand, Japanese companies are investing to make use of designing capabilities and high computer skills for computer-aided drawing (CAD) and software development.

Four Japanese banks are operating in the Philippines through branches, capital investment into local banks or representative offices. Two life insurance companies, three non-life insurance companies (five locally incorporated companies), two securities companies and three leasing companies are in the Philippines either through joint ventures with local corporations or as locally incorporated companies with 100% capital subscription².

(2) Easing of Regulations

Deregulation was carried out in the Philippines prior to the 1997 Asian crisis, in parallel with the financial system reform conducted by the Akino (86-92) and Ramos (92-98) administrations.

The Foreign Investment Act, which had been a subject of long debate, was passed in 1991 and foreign capital subscription was permitted up to 100% except for industries listed in the negative list of the Act.

The new central bank, the Bangko Sentral ng Pilipinas (BSP)³, which succeeded the Central Bank of the Philippines, simplified and consolidated foreign exchange control regulations and issued “BSP

¹ Philippine Board of Investment “Japan Desk” (December 2005)

² “List of Japanese Companies Overseas” by Tokyo Keizai Shinposha, 2005

³ BSP was established in July 1993, succeeding the old central bank, once the parliament passed the new central bank law in June 1993.

Circular 1389 of April 1993”, which has been repeatedly revised and supplemented since.

In the same year, President Ramos issued the “Philippines’ Plan 2000” and called for financial liberalization, investment promotion, deregulation and privatization. Following this plan, the Foreign Bank Liberalization Act was enacted in 1994 and ten foreign banks (including two Japanese) were permitted to open their branches for the first time in half a century, as part of the policy to promote competition in the financial sector. The Act also allows banks to establish multiple branches (up to six), to create new venture capital banks and to buy existing banks. The government also announced the reform of supervisory system and regulatory means (regulations on large-scale loans and capital adequacy ratio, loan loss provision) for the stability and soundness of the financial sector. In 1995, the Philippines were designated IMF’s Article VIII country and foreign exchange transactions were liberalized.

(3) Environmental Framework for Investment from Overseas

Investment in the Philippines from domestic and overseas sources comes under the jurisdiction of the Department of Trade and Industry (DTI), and is also regulated by two basic laws, Omnibus Investment Code of 1987 and Foreign Investment Act of 1991.

The Omnibus Investment Code regulates investments within the country and investments from overseas. It stipulates establishment of the Board of Investment (BOI) as the enforcement agency, regulates the Investment Priority Plan (IPP), which prioritizes areas besides the financial sector, guarantees of investors’ rights, special incentives to attract corporations and the establishment of regional headquarters and associated incentives for multinational industries. The BOI draws up the IPP every year and with the consent of the President, announces the “Memorandum Order.”

The important characteristic of the Foreign Investment Act is that it regulates foreign investment to industries in the Philippines and restricts types of jobs open to foreigners in the “Foreign Investment Negative List”, and clearly states that unless an industry is mentioned in the list, foreign capital can invest up to 100%. The “Negative List” is reviewed every two years.

As enforcement agencies, there are the following four institutions in charge of attracting investment under the DTI.

The Philippine Board of Investments (BOI)

The Philippines Economic Zone Authority (PEZA)

Clark Development Corp. (CDC)

Subic Bay Metropolitan Authority (SBMA)

Among these, the PEZA now has become the largest agency in charge of attracting investment. CDC and SBMA are the previous sites of American military bases, and after withdrawal of Americans, the bases were designated as special economic zones.

(4) Business Developments of Japanese Financial Institutions and Regulations

<1> Current situation of regulations on financial transactions

The Philippines carried out financial reforms from the second half of the 1980s to the first half of 1990s, and the amount of foreign debt at the time of the 1997 currency crisis was smaller than that of Thailand or Indonesia. Also, its main official debts were medium to long term, so the damage inflicted on financial institutions was not as significant. Even under that situation, many small to

medium sized banks, including one commercial bank, was forced to close⁴.

Building on the lessons learned from such closures, the banking law was reformed in April 2000 to become the “General Banking Law 2000” which strengthened banking regulations including capital adequacy ratio. This law categorizes banks into commercial, thrift and rural banks. As of the end of March 2005, there are 42 commercial banks, including Japanese banks. They are further classified into universal banks (UBs), which can establish branches around the country and are allowed to conduct securities business, and commercial banks (CBs), whose activities are limited to ordinary commercial banking services. (table 4-1)⁵.

Table 4-1: Categorization of Commercial Banks in the Philippines

	Private banks	State banks	Locally incorporated institutions of foreign banks	Branches of foreign banks	Total
UCs	12	3	--	3	18
CBs	9	--	4	11	24
Total	21	3	4	14	42

Source: Updates on the BSP Regulated/Supervised Financial Institutions (June 2005)

The BSP has been encouraging mergers of banks in order to consolidate the banking sector and, has been freezing the opening of new branches since September 1999. It only allowed the establishment of branches as micro-financing centers under strict filtering in places where even rural banks were not present. Except for these cases, branch approvals were, in effect, on the backburner.

At the end of 2005, the BSP announced a new guideline with the purpose of strengthening and expanding micro-financing services, and made it possible for both banks dealing in micro-financing business and normal banks to open branches not only in remote areas but around the country, including city centers, if they meet the necessary criteria as long as the branches are established with the purpose of extending micro-financing⁶.

As for peso loans to customers, there is prime base lending with the one-month prime rate as the base interest rate. Interest rates are determined individually by banks in accordance with the funding cost and reported to the BSP on a daily basis. There are other types of lendings such as adding spread to the interest rate of the Treasury Bill. Many loans use the interest rate calculated from foreign exchange swaps as a base rate. There is no official discount rate but the BSP employs the overnight borrowing/reverse-repo interest rates, overnight lending/ repo interest rates as key policy interest rates⁷. Although the long-term financial market is underdeveloped, major European and American banks offer interest rate swaps up to about ten years, using T-Notes (2,3,5,10 years) as a guideline rate.

The BSP decided to implement the international accounting standards which were approved by the

⁴ In the five years between 1996 and 2000, one commercial bank, ten thrift banks and over 100 rural banks closed their operation. (home page of the Philippine Deposit Insurance Corporation)

⁵ Besides the 42 commercial banks, there are 83 thrift banks and 757 rural banks, so there are 882 banks in total under the supervision of the BSP.

⁶ Press Release on the BSP Home Page dated 27 December 2005. “New BSP Branching Guidelines a Boost for Micro-finance.”

⁷ Interest for overnight borrowing has been 7.50%, for overnight loan 9.75%, since October 20, 2005.

Philippine Accounting Standards Council in 2004 in order to promote fairness and transparency. It obligated financial institutions to adopt these standards from January 2005. These measures enabled transactions in foreign currencies including the dollar and the yen both from the operational and accounting point of view.

Major regulations on financial transactions are indicated in table 4-2.

Table 4-2: Major Regulations on Financial Transaction in the Philippines

Regulations concerning banking operations	Legal lending limit	Loans to one corporation/corporate group, one individual must be 25% or less of bank capital
	Reserve requirement	10% of statutory reserve + 11% of liquid reserve
	Regulations on assets and liabilities in foreign currencies	100% of net liabilities in foreign currency denomination must be operated in foreign currencies. 30% of foreign currency liabilities must be operated in foreign currency liquid asset. 70% or more of the foreign currency assets which correspond to foreign currency liabilities must be in the same currency.
	Regulations on foreign currency positions	Long position of foreign currencies must be within lesser of 5% of owned capital or equivalent of 10 million dollars
Regulations concerning foreign exchange	Actual demand principle	Evidence of actual demand must be presented to banks for any foreign exchange transaction of more than the equivalent of US \$5000.
	Forward foreign exchange	Approval by the BSP is necessary for foreign exchange forward transactions with a maturity of more than one year
Regulations concerning foreign currency transactions	Foreign currency borrowing	Registration with the BSP is required for mid to long-term borrowing including a schedule for principal and interest payment. Approval by or registration with the BSP is required for short-term borrowing. All changes in repayment schedule need the approval of the BSP.
Regulations on transactions in the home currency	Opening of non-resident deposit accounts	Both individuals and corporations can open such accounts but in the case of corporations, they must operate within the Philippines.

Source: compiled by IIMA using available materials

Reserve ratio for deposits (statutory reserve + liquid reserve⁸), which is one of the regulations on banking operations, is a significant financial adjustment method along with open market operation of the BSP (repo transaction of short-term government securities). The BSP is sustaining a policy of a high level of reserve ratio for deposits in order to cope with high inflation (inflation rate for 2005 was 7.6%), The reserve against deposits bears BSP's key policy interest rate which is currently 7.5%. Since this BSP's policy rate is often higher than market interest rates, banks can benefit from the margin and the policy is not a burden on banks.

There are other regulations, as follows, because of the policies pursued by the government. Foreign banks are subjected to the same regulations.

- Regulations on agriculture/agricultural land reform: 15% of peso funds for loans must be

⁸ Both statutory and liquid reserves are required for various deposits (including CDs) and lending between head office and branches. Statutory reserves also encompass bonds issued by banks.

directed to borrowings related to agriculture, and 10% to those related to agricultural land reform. It is possible to substitute these criteria with holding government guaranteed bonds for agriculture and agricultural land development.

- Regulations on loans to small-and-medium sized enterprises(SMEs): Banks must use 2% of their total assets to extend loans to medium size enterprises and 6% to small enterprises. Such loans can be substituted by non interest bearing funds release to the BSP.

Since the non interest bearing funds released to the BSP in relation to regulations concerning SMEs does not specify the currency, Japanese banks are coping with the regulation by releasing mainly the yen which bears low interest rate and which is in surplus.

(4) Business Developments of Japanese Financial Institutions

Business conducted by Japanese banks concentrates primarily on lending to Japanese corporations and does not include retail operations, just as Japanese banks normally do in other Asian countries.

For exporting companies, whose business pattern is mainly importing parts and materials, processing and exporting, 90% of transactions are dollar denominated. Transactions in yen denomination are limited to transactions involving Japanese SMEs. Even for trading companies, more than half of transactions are US dollar denominated. For example, 90% of all transactions of a trading company are in either the US dollar or the yen, and the peso is used in only 10% of business.

Foreign currency holdings and settlement by residents are allowed in the Philippines. There is no so-called authorized foreign exchange bank policy, so non-banks can deal in foreign currency transactions as well. As the US dollar circulates widely along with the peso in the Manila metropolitan area, there are a numerous foreign exchange brokers operating on the street corners.

Checks are the most general means of settlement. Checking accounts can only be opened in peso and dollar checking accounts are not available. US dollar settlement in the Philippines is conducted through the Philippine Domestic Dollar Transfer System (PDDS) operated by the Manila branch of Citibank.

It is possible to settle yen transactions in the Philippines but there is no yen settlement system equivalent to the dollar settlement system operated by private banks.

Concerning the insurance sector, foreign capital is allowed to own only up to 51% of insurance companies. However, insurance companies that already have more than 51% foreign capital ownership are allowed to keep the status quo as vested interest⁹.

Only state run insurance companies are allowed to insure government supported projects. In the executive order of 1994, this rule was applied to public works and private sector Build-Operate-Transfer projects (BOT projects), and is seen as a significant impediment to Philippino and foreign private insurance companies¹⁰.

Two life insurance companies and three non-life insurance companies have established locally incorporated joint ventures. Non-life insurance companies' deal in insurances related to cars and fire. Since the majority of their customers are local companies, local capital accounts for 50% or over and Japanese capital 50% or less. With regard to reinsurance, it must first be offered to insurance companies located domestically (five local, three foreign, and three reinsurance companies), and

⁹ Insurance business is not included in the Foreign Investment Negative List, which means that 100% foreign capital ownership should be possible. However, this is restricted by the Insurance Commission Circular Letter published by the Treasury. (USTR "2005 National Trade Estimate Report on Foreign Trade Barriers – Philippines")

¹⁰ USTR "2005 National Trade Estimate Report on Foreign Trade Barriers – Philippines"

only when they reject the offer, can it be presented to reinsurance companies overseas.

(5) Business Developments of Japanese Enterprises

<1> Japanese PEZA Corporations

Registration to establish a company in the Philippines is directed to the Securities Exchange Commission (SEC). In the case of businesses that are eligible for investment priority treatment, registration must be made at the PEZA or BOI. Japanese corporations in this category have established locally incorporated companies based on the detailed regulations in the “Philippine Special Economic Zone Act of 1995” enacted to encourage foreign capital to invest in export-oriented and processing companies. The Philippine Economic Zone Authority (PEZA) is the enforcement authority of the “Philippine Special Economic Zone Act of 1995.”

Japanese PEZA-registered corporations are allowed to establish up to 100% owned subsidiary. They manufacture in the special economic zones designated by the PEZA (ECOZONES = industrial parks, exporting goods processing areas, free trade areas and tourism and entertainment centers) and export 100% (70% with the approval of the PEZA) of their products overseas. Incentives for PEZA corporations vary from industry to industry but they extend to a wide range including exemption from corporate tax (from four to eight years maximum), and from import tariffs on capital goods, machinery, parts, materials, etc., deduction of training fee for employees, simplification of import and export procedures and the use of encouragement methods specified by a presidential decree.

Many of the Japanese corporations registered as PEZA companies began their operation in the Philippines in 1995 when the Special Economic Zone Act was enacted. They benefited a great deal from special treatments, expanded their businesses, and are at the phase of repaying for investment on infrastructure expansion and paying dividends.

Most major Japanese corporations have already established business in the Philippines, but a growing number of Japanese SMEs are now beginning to set up their business bases in the Philippines. There is a huge benefit from PEZA arrangements for Japanese SMEs --- the tax incentives, easiness with which they can process establishment, simplification of export and import procedures --- which contribute a great deal to those companies that are short of personnel.

As mentioned above, the currency used for settlement by these export-oriented companies is mainly the US dollar. They partly use the yen for business with Japanese companies and the peso for transactions with local companies and for salary payment.

<2> Problems facing Japanese Companies

The following are the key problems facing Japanese companies in expanding their businesses.

(a) Problems concerning land ownership

Since land lease is highly expensive in the Philippines, ownership is the preferred method. However, land ownership by non-residents are not allowed. For corporations, if capital subscription ratio is 40% or less, the company will be categorized as local, so it is the custom for corporations to establish a land ownership company by finding a local partner that would invest 60% or more of the capital. There are a number of cases where foreign companies fail to find an appropriate local partner and find themselves in trouble with them. Some companies look for a silent partner, such as a lawyers' office or accounting office, but strictly speaking, such means are said to

infringe the anti-dummy law.

(b) Restrictions on foreign currency purchase

For a locally incorporated company with no foreign currency income and who wants to transfer profit or dividend through a bank, it had to have registered the funds that would be turned into peso with the BSP at the time of capital payment. If the company had not registered beforehand, it will be subjected to severe regulations and cumbersome procedures based on the principle of actual demand in the Philippine Foreign Exchange Law when it tries to purchase foreign currencies. Paid-in capital is often held in foreign currencies due to the fear of peso devaluation, and registration to the BSP is not necessarily carried out. This is not a problem for export-oriented companies that can transfer profit and dividend in foreign currency in hand, but for others it is a significant problem. Some such companies exchange currencies among themselves without going through banks. This is a means that is permitted by the authorities, so it is legal and is sometimes mediated by banks.

(c) Prohibition of overdraft

Overdraft is prohibited in the Philippines, and it is necessary to issue bills for loans and borrowings, which bear a stamp duty of 0.5%. This makes it virtually impossible for joint ventures to pool cash together.

(d) Problems related to labor law

Labor unions can be organized with the support of the majority of workers, but they are regarded less as organizations for workers and more as groups based on specific beliefs. The problem with the labor law is that after the six months trial period, when workers become proper employees, it becomes extremely difficult to fire them even when there is a good reason to do so.

(e) Japan-Philippines Taxation Convention

Japan-Philippines Taxation Convention (1980) was signed before the establishment of the PEZA (1995) or CDC/SBMA, and it is clearly stated that the special tax rate under the Convention is applied to the BOI registered companies. Currently, in order to benefit from the special tax rate, the PEZA, CDC, SBMA registered companies are also registering at the BOI. However, the Philippine Treasury seems to believe that dual registration is against the articles of the Convention and does not agree to the application of the special tax rate. The BOI legal office continues to study this issue. Hopefully, a decision will be reached to update the Japan-Philippines Taxation Convention by including such enforcement agencies as the PEZA and others in the Convention.

(6) Problems related to business regulations and prospects for the future

Various problems still exist in the business environment, such as cumbersome procedures concerning foreign currency purchase under the foreign exchange regulations and regulations on land ownership under the foreign capital law, but in practice, there are no critical hurdles for Japanese corporations, many of which deal mainly in export businesses. However, other basic problems are pointed out: insufficient infrastructure, such as lack of adequate transportation means and unstable electricity supply caused by blackouts, concerns for safety in daily life and lack of growth of mid to small size enterprises despite the government's promotion policies.

The Japan Chamber of Commerce and Industry of the Philippines (JCCIPI) presents a list of requests related to operational difficulties faced by Japanese companies to the President of the Philippines each year¹¹. The JCCIPI conducted a study in the autumn of 2005 by comparing the business environment in the Philippines to those in Thailand. It concluded that the insufficient foreign capital introduction into the Philippines was the reason why the economic situations of the two countries reversed in the 1970s. Based on this study, the JCCIPI compiled a proposal with the following key five areas and presented it to President Arroyo.

<1> The quality of labor in both countries is the same, but the minimum wage in the capital area in the Philippines is high compared to other Asian cities¹². Abrupt announcement of irregular holidays by the government disrupts the production and shipment schedule of manufacturing companies.

<2> Regarding the investment incentive system, there are multiple offices in the Philippines compared to one window in Thailand, and this is quite confusing for new investors. There are no restrictions on land or foreign capital in cases approved by the Board of Investment in Thailand. This system is superior to that of the Philippines.

<3> Corporate tax rate in the Philippines is 32%, and is one of the highest among the ASEAN countries¹³. It takes one year to receive the refund on VAT in Thailand but in the Philippines refunds have not been received for VAT paid in 1990.

<4> Infrastructure, such as electricity, water and sewage, communication, roads and ports are all inferior to those in Thailand. The unsolved issues over the unopened terminal 3 of the international airport¹⁴, development of the Subic-Manila-Batan gas route and building of industrial waste disposals are all problems that should be dealt with urgently.

<5> Though the regulations on foreign exchange are less stringent than in Thailand, the rules are difficult to understand due to repeated reforms. They should be reorganized.

Besides the five issues indicated in the study, the problems that the JCCIP has been pointing out every year in the request list are as follows.

- Delay in payment by the government for ODA constructions.
- Although accounting procedures in foreign currency denominations are now allowed, notice on detailed rules has not been published and the system is still difficult to apply.
- As mentioned above, the Philippine Treasury is unwilling to apply the special tax ratio agreed under the Japan-Philippine Taxation Convention to the PEZA, CDC, and SBMA registered

¹¹ The One Stop Action Center (OSAC: serves as the window to various bureaucracies) in the BOI of the DTI deals with the list of demands presented by the JCCIPI.

¹² Comparison with Shenzhen, Shanghai, Jakarta, Hanoi and Kuala Lumpur besides Bangkok is made in the list of requests.

¹³ Corporate tax is planned to rise between November 2005 and December 2008 from 32% to 35%, then be lowered from January 2009 to 30%.

¹⁴ The work on the expansion of the international airport was finished under President Estrada. But President Arroyo has not paid for the construction saying that there are some problems in the contract with the German company which carried it out. The new terminal has not been opened.

companies.

- Problems related to black markets in automobiles and chemical products.
- Deregulation on foreign capital concerning the mining industry (copper, gold, nickel, chrome, etc)

Despite these difficulties, the Philippines is still an attractive destination for investment because English is the official language, labor costs are still low, foreign capital inducing corporations can enjoy a wide range of incentives, there are an abundant number of university educated IT specialists, the country's geographical location, etc. It can look forward to additional investments by Japanese manufacturing companies and cultivate new areas such as natural resources development and infrastructure projects. There are also good prospects for the services industries. Companies dealing in software development, designing, engineering, Business Processing Outsourcing (BPO), computer graphics and animation are increasingly investing in the Philippines. There are some companies that see the Philippines as a contender to be in a strategic position, along with Thailand and Vietnam, to become the production hub in Asia in order to avoid concentrating entirely in China.

5. China

(1) Penetration Trend of Japanese Financial Institutions and Corporations

Five major Japanese banks and five trust banks have a total of 11 branches and 18 representative offices in China (as of 2005). They are highly focused on business in China and are planning to open more offices¹. Their major goal is to assist Japanese companies to penetrate the Chinese market, but with the approach of the deadline committed to the WTO to open financial businesses at the end of 2006², they also aim to do business with European and American companies, to expand their dealings with Chinese businesses and, in the future, to enter the huge retail market³.

However, as will be mentioned later in this section, there are still stringent restrictions on opening branches, capital subscription and financial transactions among others, and foreign banks are still hampered from developing their business activities. Consequently, foreign banks still play a relatively small role in China and their share in the total assets of banks in China is around 2%. This is highly unbalanced compared to the amount of export share of foreign corporations, which amounts to nearly 60%⁴.

Japanese corporations began penetrating into China in earnest from 2000 after it became clear that China was joining the WTO. At an early stage, the companies that invested in China were mostly export-oriented, wanting to reap the benefit from the cheap and abundant labor and use China as the assembly base for export. Later, manufacturing companies aiming to produce and sell in the Chinese domestic market began investing in China or further increased their investment. This trend owes to the fact that production in China became more costly due to the increase in wages, purchasing power, especially of the residents living along the coast as in Shanghai increased, and opening of the domestic markets to foreign corporations and deregulation since joining the WTO.

The electric home appliances sector was the first to begin investing in China. After 2000, auto manufacturers and their parts manufacturers, then the material industry that provides various materials to electric and auto manufacturers moved in. Then with the significant easing of the foreign capital regulation for distribution and services industries in 2004, an increasing number of trading companies, retailers and services industries, like warehousing, began operations in China. On the other hand, over-investment and over-production have become the problem for the manufacturing industry and there is now the tendency to be more selective in granting permission to establish a production base. More research and development offices are also being established in China, and according to the Ministry of Commerce, about 750 companies have launched R&D centers. They belong to such industries as electronics, electrical machinery, transport machinery, drugs and chemical products, and are located mainly in the big cities, such as Beijing, Shanghai and

¹ According to the Banking Supervisory Authority, 173 banks from 40 countries/regions have opened a total of 238 offices in 23 cities as of the end of October 2005. 138 of the offices have a permit to deal in renminbi, 15 in net-banking, 41 in derivatives and five in trust management operations as qualified foreign institutional investor (QFII). (Ministry of Trade and Industry report December 12, 2005)

² China joined the WTO in December 2001 and has been easing regulations on foreign bank operations and regional restrictions step-by-step. It promised to fully open banking activities to foreign institutions in five years, which will be at the end of 2006.

³ European and American banks are increasing their investment into banks with Chinese capital. This tendency will be discussed further later in the paper.

⁴ According to the Banking Supervisory Authority, foreign banks have a share of about 20% in foreign currency denominated lending. This is especially true in Shanghai where investment by foreign banks is highly noticeable. There the share of foreign banks is 12.4% of assets and 54.8% of foreign currency denominated lending.

Shenzhen. Japanese companies, such as Honda and Panasonic, have established R&D centers.

Looking at Japan's trading counterparts (as of 2004), China is the second export destination after the United States, and is the largest importer to Japan. Total trading value including trade with Hong Kong, China is the largest trading partner ahead of the US. Also, in the number of incorporated companies overseas, China had the largest share at the end of 2003 exceeding North America. However, in the aggregate number of investments, it is behind the ASEAN countries which had a head start.

Now that a FTA has been signed between China and ASEAN⁵, Japanese corporations have to consider what kind of business strategy they should pursue having built up investments both in ASEAN and China.

(2) Movements towards Deregulation

China is adopting a complicated policy of pursuing both deregulation and more regulation at the same time. Some deregulation measures have been taken in line with commitments related to WTO membership. On the other hand, regulation on the inward flow of foreign capital has been applied to ease upward pressure on renminbi. At the same time forward exchange and swap markets are being created hastily with the change in the foreign exchange rate system for renminbi.

The major changes in regulations in recent years are as Table 5-1.

Among the major deregulation measures, investment regulations have been eased in the services sector in accordance with the commitment made at the time of WTO membership. In the financial area, more markets are being opened to foreign banks and regional operations on renminbi are being gradually opened to foreign banks⁶.

In August 2005, regulations on purchase and holdings of foreign currencies were eased⁷. Maximum holdings of foreign currency income through current transactions for domestically incorporated companies were raised from 30% (if the ratio of foreign currency expenditure to foreign currency income in the current transactions of the previous year was less than 80%) or 50% (if more than 80%) to 50% or 80%. If such a company did not have any foreign currency income the previous fiscal year and wants to open a new foreign currency account with current items, the initial maximum holdings were raised from 100 thousand dollar equivalent to 200 thousand dollar equivalent⁸.

⁵ "Framework Agreement on ASEAN/China Comprehensive Economic Cooperation" became effective on January 1, 2005.

⁶ As of end of 2005, there are 25 cities/regions where foreign banks are allowed renminbi operations; Shanghai, Shenzhen, Dalian, Tianjing, Guangzhou, Zhuhai, Qingdao, Nanjing, Wuhan, Jinan, Fuzhou, Chengdu, Chongqing, Beijing, Kunming, Xiamen, Shenyang, Xi'an, Shantou, Ningbo, Harbin, Changchun, Lanzhou, YinChuan and Nanning.

However, by the end of 2006, they will be able to do so everywhere in China. The Banking Supervisory Authority is applying easier criteria for foreign banks to operate in renminbi in western areas (inland), such as Chongqing, compared to cities along the coast. In the inland areas, it is possible to apply for permission to conduct business in renminbi if a bank has been in surplus in the loss and profit total of all its branches operating in China (in principle, it is calculated solely on the relevant branch).

⁷ One of the aims of deregulation seems to be to suppress the increase of foreign currency reserve and the pressure to reevaluate renminbi.

⁸ The length of period during which foreign currencies exceeding the maximum amount to be held in foreign currency accounts for current items should be exchanged into renminbi was extended from ten to 90 days. In the case of export and import companies and manufacturing oriented companies, the State Administration of Foreign Exchange can judge that the company can hold up to 100% of its foreign currency profit. In the case of Japanese companies, there are many which fit into this category.

Table 5-1: Recent Changes in the Regulations on Transactions in China

<Foreign Exchange Areas>	
2004 July	Enforcement of the “Notification on the inspection on the conversion of foreign currencies into renminbi in capital transactions by foreign funded corporations and improvement of registration management of foreign currencies”. Strengthening of control on foreign currencies.
2005 April	Enforcement of the “Notification on foreign currency collateral for designated foreign exchange banks”. Strengthening of control on foreign currencies.
July	Switch to the currency basket system for renminbi. (21 st)
August	<ul style="list-style-type: none"> • Enforcement by the State Foreign Currency Administration of deregulation on acquiring and possessing foreign currency by individuals and corporations. (2nd) • The People’s Bank of China lifted the ban on swap trading into foreign currencies (excluding interest rate swaps). (9th) • Banks are authorized to conduct forward exchange in renminbi in the inter-bank market.
September	<ul style="list-style-type: none"> • Six foreign banks (including two Japanese) are authorized to deal in renminbi forward exchange for corporate customers. • Easing of the daily exchange rate limit in foreign exchange spot trading for customers. (from within 0.2% of base rate to within 1%) (23rd)
2006 January	<ul style="list-style-type: none"> • Inter-bank trading is added in the spot market. (4th) • The People’s Bank of China changed the way it determined the basic rate from using the closing rate of the previous day to employing the weighted average calculated by collecting information on the quoting rates from specified banks immediately before transactions begin each day. (4th) • Announcement on the adoption of a market-maker system.
<Financial Transaction Areas>	
2004 May	Application of a ban on the conversion of borrowed foreign currencies into renminbi by applying collective framework restrictions (for short-term funds with maturity of one year or less. Case-by-case approval required by mid to long term funds) on overseas fund raising by foreign banks in the “Ordinance on Foreign Debt Control of Foreign Banks” .
June	Official announcement of a regulation to limit the short-term foreign debt of foreign funded banks and Chinese funded banks to five times their operating capital or less.
August	Partial lifting of the ban on insurance companies to invest foreign currency deposits overseas.
October	Abolition of the upper limit of the interest rate on renminbi lending (minimum is 0.9 times of the base rate).
November	Lifting of the ban on multilateral companies to invest foreign currency deposits overseas.
2005 March	Increasing the maximum balance of current foreign currency deposit accounts for corporations.
April	Strengthening of regulations on and obligating registration of foreign currency denominated borrowings from overseas and provision of guarantees.
August	Re-increase of the maximum balance of current foreign currency deposit accounts for corporations.
<Others>	
2003 March	Enactment of a “Preliminary law on the establishment of Chinese-foreign joint-stock trading companies”. Conditions for establishing a trading company by foreign enterprises were eased. Regional regulations were abolished. It is now possible for foreign enterprises to subscribe more than half of the capital.
2004 March	Enforcement of “Regulations on the establishment of a corporation with investment propensity (holding company) with investment from foreign companies”. Holding companies established as a regional headquarters of multinational corporations are provided a wider range of business compared to normal holding companies.
July	Enforcement of the revised “Law on foreign trade”. Obtaining the rights to trade changed from approval basis to registration system.

Source: compiled by IIMA using various materials.

On the other hand, regulations were strengthened regarding foreign currency control. Regulations on foreign capital inflow were adopted to ease the upward pressure on renminbi⁹. As concrete measures, exchanging of foreign currency borrowings from foreign bank branches into renminbi, and renminbi borrowings from Chinese funded banks with the guarantee of foreign bank branches were both banned in June 2004. Then in April 2005, regulations on foreign currency borrowings from overseas and provision of guarantees were strengthened. Registration became a requirement.

In July 2005, a currency basket system was adopted for renminbi. Deregulation of foreign exchange transactions, such as increases of foreign exchange risk hedge methods, is being carried out and a foreign exchange market is being nurtured and organized rapidly. On August 9, 2005, operational regulations on forward exchange transactions were eased and the ban on currency swap transactions in renminbi was lifted (excluding interest rate swaps¹⁰). Then on September 19, the State Foreign Currency Administration authorized six foreign banks, including The Bank of Tokyo-Mitsubishi and Sumitomo Mitsui Banking Corporation, to trade in forward exchange of renminbi for corporate customers. This allowed Japanese corporations to trade in forward exchange¹¹. Renminbi forward exchanges and swap transactions are allowed in limited areas of capital transactions such as current transactions, repayment of foreign currency borrowings, settlement of direct foreign investment and foreign currency denominated capital income for foreign owned corporations.

China is also adopting various measures to organize its foreign exchange market; increasing the number of participants in the foreign exchange spot transactions (insurance, securities and trust companies in addition to banks), developing a foreign exchange brokerage system, easing the limits on margin for foreign exchange transactions, introducing inter-bank trading in the foreign exchange spot market¹², changing the method by which the basic rate is determined, and the introduction of a market maker system.

(3) Operational Developments of Japanese Financial Institutions and Regulations on Financial Activities

<1> Operational Developments of Japanese Financial Institutions

Japanese banks are expanding their network in China vigorously to support the increasing investments of Japanese corporations in China. Since there are restrictions on the renminbi operations that they can conduct, foreign bank branches, including those of Japanese banks, make the majority of loans in dollar denomination.

The first problem encountered by foreign banks in developing their business in China is the restriction placed on developing their network. As the regulatory basis of establishment, operation and supervision of foreign banks, the People's Bank of China officially announced the "Regulations

⁹ Measures to promote the outflow of domestic capital, such as lifting of the ban on investing foreign currency deposits overseas, were adopted.

¹⁰ The People's Bank of China announced on February 9, 2006 that it will lift the ban on interest rate swaps.

¹¹ Until then, the banks that were allowed renminbi forward exchange for customers were seven Chinese funded banks with the four major state commercial banks as key players. Renminbi forward exchanges are allowed in current transactions, with the maturity in less than a year. Most Japanese corporations do not make use of such transactions. As for the inter-bank forward exchange, foreign banks had a permission at the end of August 2005.

¹² In inter-bank trading, a trading center does not serve as an intermediary. The transaction is conducted directly between banks and the rate is determined by the credibility of banks.

on the Administration of Foreign-Funded Financial Institutions” and the “Detailed Rules for the Implementation of the Regulations on the Administration of Foreign-Funded Financial Institutions”, which laid down the rules for concrete procedures in February 2002. Concerning the opening of foreign bank branches, the “Detailed Rules for the Implementation of the Regulations on the Administration of Foreign-Funded Financial Institutions” stipulated that banks could not apply for another branch for one year after the opening of a branch was ratified and that they could not apply again for one year in the same city after an application to open a branch was denied. These two rules were abolished on September 1, 2004. Currently, there are no regulations on the opening of foreign bank branches but authorization is still required. In authorizing the opening of branches, the government always has an overall balance in mind. This means that applications for branches in the Western inland areas, where the government is promoting development, will be approved quickly. On the other hand, if banks try to open branches in the coastal area but do not apply for branches in the Western inland area, then authorization for coastal branches will be slow to come. Japanese banks try to open branches where Japanese corporations have moved in. Since this is not in line with the policy direction of the Chinese authorities, authorizations are not given easily. It usually takes a considerable amount of time to open a branch; about six months for a preliminary approval to be issued and a year for a branch to be actually opened. Even if an application is submitted for a number of branches, the Chinese authorities follow the practice of waiting for one branch to open before considering the next one. This means foreign banks can open only one branch per year at the most.

The Commercial Banking Law is applied to the Chinese-funded banks as the regulatory basis of establishment, operation and supervision. This means that the regulatory basis vis-à-vis foreign and domestic banks are different, which violates the WTO rule of “no discrimination between domestic and foreign entities” and “national treatment.” The financial sector will have to be opened in accordance with the WTO commitments by the end of 2006, and consequently, these regulations may be revised.

Paid-in capital is determined by the type of operational activities a branch is going to carry out. The minimum is about the equivalent of 100 million renminbi in foreign currencies, but at this level, the branch’s activities are limited to foreign currency business extended to foreign funded companies and individual foreign customers. In order to conduct a full banking operation, the branch needs to pay in the equivalent of 200 million renminbi in foreign currencies and another 300 million in renminbi (Table 5-2).^{13 14}

¹³ Paid-in capital is also regulated by the “Detailed Rules for the Implementation of the Regulations on the Administration of Foreign-Funded Financial Institutions” and the required paid-in capital amount was lowered on September 1, 2004. (from the equivalent of 600 million renminbi for full banking, of which 300 million had to be in renminbi, to 500 million renminbi of which 200 million has to be in renminbi).

¹⁴ According to the Banking Authorities, 22 foreign funded companies are investing in 17 Chinese funded banks as of the end of October 2005. Investment by foreign funded entities amounts to more than 16.5 billion renminbi which is about 15% of the total capital of Chinese funded banks.

Table 5-2: Regulations on Paid-in Capital

Paid-in Capital		Foreign Currency Operations		Renminbi Operations		
Foreign currency denominated (equivalent of 1 mil RMB)	Renminbi (1 mil. RMB)	Foreign funded corporation Foreign individual	Chinese funded corporation Chinese individual	Foreign funded corporation Foreign individual	Chinese funded corporation	Chinese individual
100		○				
200		○	○			
100	100	○		○		
200	100	○	○	○		
200	100	○	○	○	○	
200	300	○	○	○	○	○

While Japanese banks concentrate on supporting Japanese corporations and have not joined the retail market, European and American banks are aggressively investing in Chinese-funded banks (Table 5-3)¹⁵. European and American banks are investing in Chinese funded banks with future retail business development in mind. A strategy to strengthen the retail business would be to buy a major share of a blue chip local bank when the financial sector is liberalized in the future, use that bank as the cornerstone of business expansion in China and invest in large banks at the same time to acquire a nation-wide network.

Table 5-3: Capital Investment by European and American Banks in Chinese-funded Banks

State owned commercial banks	Bank of China	Royal Bank of Scotland/Merrill Lynch (10%) UBS (1.61%)
	China Construction Bank	Bank of America (9%)
	Industrial and Commercial Bank of China	Goldman Sachs (6.8%), Allianz (2.6%), American Express (0.5%)
Major banks	Bank of Communications	HSBC (19.9%)
	Shanghai Pudong Development Bank	Citibank (4.6%)
	Bohai Bank	Standard Chartered (19.9%)
Local banks	Bank of Shanghai	HSBC (8%)
	Beijing City Commercial Bank	ING (19.9%)
	Nanjing City Commercial Bank	BNP (19.2%)
	Xi'an City Commercial Bank	Nova Scotia (5%)
	Jinan City Commercial Bank	Commonwealth (11%)
	Tianjin City Commercial Bank	ANZ (19.9%)
	Huaxia Bank	Deutsche Bank/ Sal Oppenheim (14%)
	Ping An Bank	HSBC (27%)

Note: The list includes only the main investments. There are other capital investments by investment companies.

Source: Compiled by IIMA using various available material

¹⁵ The upper limit of investment by foreign funded entities into Chinese funded banks is 25% of the capital (up to 20% per bank). This does not mean that foreign funded entities can invest only up to 25%. If the invested capital exceeds 25%, the bank is categorized as a foreign funded bank.

<2> Current Regulations on Financial Activities

Major regulations concerning financial transactions are as Table 5-4. Although some deregulation measures are being carried out, there still are innumerable regulations, making flexible operation extremely difficult.¹⁶ The following section is a view of those regulations from banks' point of view followed by those that are problematic to corporations.

Table 5-4: Major Regulations on Financial Transactions in China

Regulations on Financial Institutions	Paid-in Capital	A system where the required paid-in capital differs according to their operations.
	Renminbi business	Authorization based on application for individual city. Full deregulation expected at the end of 2006.
	Foreign currency fund Raising	Borrowing limit (for short term and mid to long term) is determined on a yearly basis for foreign currency fund raising.
	Regulations on liquidity	<ul style="list-style-type: none"> Foreign currency liquidity regulation: foreign currency liquid assets divided by foreign currency liquid liabilities must be more than 25%. Renminbi liquidity regulation: renminbi liquidity assets divided by renminbi liquidity liabilities must be more than 25%.
	Regulations on interest rates	Legal interest rates announced by the People's Bank of China are applied for renminbi deposits, renminbi loans and foreign currency deposits of less than 1 million dollars.
	Regulations on opening branches	Regulations, in effect, limit the opening of branches to one per year.
	Regulations on capital investment	Ceiling for foreign capital subscription ratio in Chinese-funded banks is 20%. Total capital subscription ratio of foreign funds is limited to the maximum of 25%.
Regulations on Investment	Inward direct investment	Direct investment must be authorized by the Ministry of Commerce and the State Administration of Foreign Exchange. Pre-authorization by the State Administration of Foreign Exchange is required if the capital account is to exceed 200 thousand dollars.
	Overseas investment	Investment cannot be made with foreign currencies converted from renminbi.
Regulations on Foreign exchange Transactions	Foreign exchange rate system	Renminbi moved to a currency basket system on July 21, 2005.
	Forward exchange Currency swaps	<ul style="list-style-type: none"> Trading for customers is limited to authorized banks. Banks with a minimum of six months of experience in forward exchange operation can apply for currency swap operation.
	Foreign currency Exchanges	Foreign-funded corporations cannot convert renminbi freely into foreign currencies in China. They need the authorization of the State Administration of Foreign Exchange.
Regulations on trading in home currency	Regulations on Borrowing	Borrowings based on guarantee by overseas institutions need to be registered as accidental debt with the Administration of Foreign Exchange. Maximum amount that can be registered is "total investment - registered capital - registered foreign debt".

¹⁶ In the course of deregulation, there are cases where deregulation is applied only to Chinese-funded banks as a test case. This creates a real difference between foreign and Chinese-funded banks in their operational activities and it could lead to advantages for those with a head start. Such a form of deregulation is problematic.

Regulations on trading in foreign currencies	Regulations on foreign currency deposits	<ul style="list-style-type: none"> • Foreign currency accounts are categorized according to their purpose (for example capital account, foreign currency account for current items) and each account must be authorized by the State Administration of Foreign Exchange individually. • Capital accounts and foreign currency accounts for current items are limited to one each at the bank, in the location of account holder. However, it is now possible to open multiple foreign currency accounts for current items, but they need the individual authorization of the local Administration of Foreign Exchange. • Ceiling is set for the balance of foreign currency account for current items.
	Regulations on domestic borrowing of foreign Currencies	Foreign debt registration must be made with the Administration for Foreign Exchange for borrowings in foreign currencies.
	Regulations on overseas borrowing of foreign Currencies	<ul style="list-style-type: none"> • Pre-authorization is necessary for local corporations and local financial institutions. The State Development Planning Commission provides authorization for borrowings with a maturity of over a year, and State Administration of Foreign Exchange for those with one year and less. • For foreign-funded corporations borrowing is unrestricted as long as it is within the difference between the investment total and capital. Pre-registration on foreign currency denominated debt is required. • A total borrowing control system is applied for foreign banks. They have to apply for approval to the State Development Planning Commission and the Administration of Foreign Exchange by calculating the expected total borrowing each year. The banks are allowed borrowing within the authorized amount.

Source: compiled by IIMA based on various materials.

A capital adequacy ratio of 8% or more is necessary to conduct renminbi business. The ratio is calculated on a branch by branch basis, and if a branch increases its renminbi assets, it needs to increase its capital. Looking at the way in which Japanese banks are opening multiple branches in China, they may not be able to develop their business operations flexibly in the future if the regulation on capital adequacy is applied on a branch by branch basis. On the other hand, capital adequacy regulation for Chinese-funded banks is calculated comprehensively on the basis of the capital of the head office. This is an apparent discrimination between foreign and Chinese-funded banks.

As for fund raising in renminbi, since there is a limit to raising funds through renminbi deposits for foreign banks, they raise renminbi funds mostly in the inter-bank market. There are regulations on liquidity, but for the time being, there are no other rules concerning fund raising in renminbi.¹⁷

In relation to foreign currency fund raising, there are restrictions on foreign borrowing besides regulations on liquidity. Foreign borrowing is divided into short-term and mid to long term. Total

¹⁷ A new regulation to limit renminbi fund raising to within 40% of renminbi liabilities is being planned. Since this would be a grave problem for foreign banks, they are asking for reconsideration. There is some information that the People's Bank of China has already withdrawn the proposal.

expected borrowing must be calculated each year, application for approval is sent to the State Development Planning Commission and the Administration of Foreign Exchange and a borrowing limit is determined. Application comprises borrowings for domestic branches for mid to long term borrowings, and each branch applies individually for short term borrowings. A borrowing limit is set individually for each branch for both mid to long term and short term borrowings and there is no accommodating amongst the branches. The short term borrowing limit is especially stringent and when a branch reaches the limit it has to apply for an increase in the limit. The borrowing limit is determined based on various factors such as results from the previous year, but there are policy considerations such as to allocate more to branches in the development promotion areas. Foreign currencies borrowed from foreign banks cannot be converted into renminbi.¹⁸

Domestic foreign currency deposit is limited to within 70% of total foreign currency asset. This is an increase from the previous limit of 40%. The affect of the restriction is now very limited.¹⁹

Interest rates for lending and deposits are also regulated. The interest rate ceiling for renminbi loans was abolished in October 2004²⁰, but the floor is still set at 0.9 times of basic interest rate²¹. There are no restrictions on interest rates on foreign currency lending nor on large-scale foreign currency deposits, but for foreign currency deposits of 3 million dollars or less, a ceiling of basic interest rate is applied. Basic interest rate is determined by the People's Bank of China.

There are many types of reports that banks are requested by the authorities to submit. Now there are cases where electronic reporting is required. However, there are various problems related to reporting which place a huge burden on banks; the cost of system development falls on banks, there are a number of reports which must be duplicated, the format of reports differs according to the supervising ministry, and sometimes banks are directed to develop multiple systems at the same time because of a lack of coordination among ministries²².

As for securities companies, the ceiling for foreign capital subscription is 33% and they are not allowed to open branches, which means that the environment is not adequate for Japanese securities companies to operate in China²³. The area of business conducted by securities companies in China is limited to investment banking (fee business). There are some recent cases where they provide assistance when a company that deals solely in processing and trade retreats from China.

China is deregulating the insurance business in accordance with its commitment to the WTO, and regional restrictions were repealed in December 2004. Authorization was given to sell non-life

¹⁸ This used to be permitted but was banned with the "Control of Foreign Loan for Foreign Banks" of May 2004. This regulation has traditionally been applied to Chinese-funded banks.

¹⁹ The Banking Supervisory Authority has announced that this ratio will be adjusted at some appropriate time in 2006.

²⁰ Ceiling of 2.3 times the basic rate still applies for city and rural credit associations.

²¹ Operating tax of 5% is applied not against interest margin but against interest income for renminbi loans. This tax is a burden on earnings from loans for foreign banks that gain only small interest margins because of the small amount of renminbi deposits.

²² For example, according to a regulation on money laundering, banks must report to the People's Bank of China, the Banking Supervisory Authority, Administration of Foreign Exchange and a supervisory organization specializing in money laundering in Beijing. The type of transaction that must be reported is specified as those "remitting large amounts repeatedly in short period of time", but the definition of "short period of time", "large amounts", and "repeatedly" are not described. The interpretation of this rule differs from authority to authority and region to region, and banks are forced to make judgments of their own. As a result, problems arise at inspections and sometimes banks incur fines.

²³ Nomura Securities, Daiwa Securities SMBC, Nikko Asset Management are authorized as QFII and invest in Chinese stocks, but the transaction is conducted from their Japanese headquarters.

insurance to Chinese-funded companies and individuals as well as foreign companies. However, there are still judgments made at the discretion of the authorities. For example, in practice only one branch is approved at once for foreign insurance companies.

The notion of life insurance had not developed under the socialist system, and the market is still in a developing stage where life insurance companies are competing for customers by raising the prospective yield. The ceiling for foreign capital subscription is 50%.

In the non-life insurance field, it is possible to incorporate a local company with 100% foreign capital, but they are not allowed to sell car indemnity insurance, which is the most profitable area for non-life insurance companies. So the non-life insurance companies which began business in China ahead of life insurance companies by building networks in large cities to support Japanese companies are now maneuvering to move into the life insurance area.

There are strict regulations on the imposition of insurance fees, and companies can offer deposits but are not in a position to offer asset management.

(4) Operational Developments of Japanese Companies and Regulations on Business Activities

<1> Operational Developments of Japanese Companies

Local operations of Japanese businesses can be described as being on an even keel, after going through the stage of shifting their production base to China, then building their manufacturing facilities. Distribution and services markets were opened extensively to foreign capital at the end of 2004, and sales to the huge retail market have gained momentum.

Many Japanese companies are building multiple factories, establishing sales companies and developing multiple operational bases in China. These companies tend to establish an umbrella-type company, a holding company, in China. However, the functions of such umbrella-type companies are limited. They can conduct blanket purchase of raw materials, function as the control center for domestic sales and collect sales credits. But funds, foreign exchange nor settlement operations (details in following section) can be consolidated into such companies. It is also difficult to gain the benefits of an umbrella organization because the preferential tax system is different in different regions.

The renminbi moved from a de facto fixed exchange rate to a currency basket system in July 2005, and there is keen concern among Japanese companies in the future exchange rate trend of the currency. Though the rise of renminbi will lead to an increase in cost for companies building their production base, it is not realistic to consider shifting their base to another country for that reason now that high concentration in China is already very much a reality. This means that the key issue in the future for Japanese companies will be how to hedge foreign exchange risks.²⁴

Since moving to the currency basket system, the Chinese authorities have introduced various deregulation measures successively and made efforts to develop and organize the markets. Some of those measures are liberalization of currency swap transactions²⁵, authorizing foreign banks to deal in inter-bank forward exchange transactions in renminbi, authorizing forward exchange trading for customers, increasing the categories of participants in the inter-bank foreign exchange spot

²⁴ Rise of renminbi will first affect trade settlement because US dollar and other foreign currencies are used for foreign settlements since the use of renminbi is not permitted.

²⁵ The Banking Supervisory Authority issues a license to banks for derivative operations. However the detailed rules on operation are planned to be determined by the Administration of Foreign Exchange. Since these rules have not been written, banks are unable to conduct derivative operations even though they have the license to do so.

transactions²⁶, expanding the limits on margins for foreign exchange spot transactions for customers, introduction of inter-bank trading in the spot market, changing the basic rate, introduction of the market-maker system. But it takes time for a foreign exchange market with an adequate cushion for foreign exchange risk hedging to mature, and it could cause a significant problem for companies if the timing of the rise of renminbi rate and the development of markets are misaligned. Since subsidiaries are not allowed to consolidate their foreign exchange into their umbrella-type company, they have to hedge the foreign exchange risks individually, thereby incurring a huge hedging cost.

<2> Regulations on Business Activities

There are a number of regulations that impede business activities for Japanese corporation in China. Following are the key features of those that are seen as obstacles to all types of companies²⁷.

(a) Bank accounts

Different bank accounts must be opened for different types of transaction in renminbi and in foreign currencies.

There are basic account, general account, temporary account and special account as renminbi accounts. The basic and general accounts are those used for general transactions. Only one basic account can be opened per company and cash payment cannot be conducted through a general account.

As foreign currency accounts there are accounts for capital, current items, foreign dept, domestic foreign currency lending and expenses. All foreign currency accounts need the pre-authorization of the Administration of Foreign Exchange. Foreign-funded companies open their foreign currency accounts within the jurisdiction of the Administration of Foreign Exchange in charge of the region where the company has established itself. A separate authorization is necessary if a company wants to open an account outside that region. The controlling authority for that authorization was switched from the regional to the central in 2005. This is likely to lead to rejections of opening accounts outside the region of operation. Many of the Japanese corporations that established themselves in rural areas opened foreign currency accounts with a Japanese bank in Shanghai. If such arrangements are not going to be permitted, Japanese corporations operating in regions where there are no Japanese banks will be forced to open accounts with Chinese-funded banks.

The rule is that companies can open only one foreign currency capital account and one for current items, but multiple accounts for current items are approved on a case by case basis.

Foreign currency accounts for current items are used for credit and payment of current transactions such as trade transactions, but as mentioned before, there is a ceiling to the balance.

The procedure for switching a foreign currency account from one bank to another has not been announced. This is a problem for companies wanting to move their account to a bank that provides better services after having opened an account at another bank. The lack of rules is also fuelling

²⁶ Non-banks and business industries are now allowed to conduct spot transactions. The condition for participation in the market for industrial businesses is a trading amount of 2 billion dollars or more per year, and a registered capital of 500 million renminbi or more for non-banks (1 billion renminbi or more for insurance companies).

²⁷ There is also a very strict regulation on actual demand in foreign exchange transactions, and conversion of the capital into renminbi is not allowed unless there is actual demand. There are many cases where business opportunities arise for a trading company after it pays in its capital, in which case actual demand has not materialized at the time of paying in the capital, making it impossible to convert into renminbi.

competition over winning foreign currency accounts among banks.

(b) Overseas remittance

The difficulty of foreign remittance for non-trade is another of the problems in China. There is no restriction against such transactions but the procedure is so cumbersome and the judgment of the Administration of Foreign Exchange, which is responsible for authorization, is so formalized that in reality, there are many cases where remittance overseas is impossible²⁸. This situation is a problem in such cases as paying fees to the head office, payment of advance expenses and royalties. So corporations are coping with the situation by making payments in cash for small amounts, and for larger amounts by adjusting the price of goods in trade transactions that require movement of goods. Such operations require much work after the transaction so companies would like to avoid them as much as possible.

(c) Bank loans

There are detailed regulations on loans.

The following are the rules for borrowing foreign currencies:

- Borrowings based on a guarantee by overseas institutions need to be registered as “accidental debt” with the Administration of Foreign Exchange. The maximum amount that can be registered is “total investment minus registered capital minus registered foreign debt”.
- Borrowings from the parent company (two generation loans) need “foreign debt registration” with the Administration of Foreign Exchange. The ceiling for registration is “total investment minus registered capital minus registered accidental debt”²⁹.
- Borrowings from overseas cannot be used for repayment of loans in renminbi.
- Foreign currency borrowings from banks located in China cannot be converted into renminbi.
- There are many cases where authorization is not given to convert borrowed renminbi into foreign currencies to be used for repayment of foreign currency borrowings³⁰.

With regard to borrowings in renminbi, an accidental debt registration with the Administration of Foreign Exchange is necessary in case of borrowings based on guarantees by overseas institutions and borrowings from the parent company (two generation loans). The ceiling for registration is as stated in previous section. Renminbi borrowings from Chinese-funded banks based on guarantees by foreign bank branches are not allowed.

The problem that became a huge issue recently is local loans based on guarantees by the parent company. Accidental debt registration became necessary in April 2005, going back to March. This rule was applied to regulate the inflow of investment capital from overseas. However, because there was considerable repercussion from corporations and the amount of direct investment into China decreased, the rule was repealed on December 1, 2005. Foreign debt registration is necessary in case a guarantee is called upon.

The reform of this regulation provoked various repercussions. At the time the regulation was applied in April 2005, banks and corporations were forced to respond quickly since the rule applied

²⁸ Authorization is judged based solely on papers, such as giving permission if there is a customs verification.

²⁹ Borrowings from banks located in China are not categorized as foreign debt.

³⁰ It is possible to convert the renminbi acquired through sales into foreign currencies and repay foreign currency borrowings but foreign currency holdings must be used first.

going back to March. They took measures such as switching from a guarantee from their parent company to continuing the loan with a letter of comfort. In the case of Chinese-funded banks, there are reports of a tendency to refrain from extending loans based on the guarantee of parent companies. In regions where Japanese banks are not present, this is making loans most difficult for mid to small corporations.

(d) Group financing

With the increase of group companies, conducting effective business operation by consolidating the finances of companies in the group is becoming an important issue. Netting and pooling are not allowed in China³¹, and consignment loans through banks are used to adjust funds among group companies. This is not cost effective since there are fees and taxes associated with consignment loans³². In the case of umbrella-type corporations, various methods are used to cope with the situation, such as providing de facto financing by the umbrella-type corporation adjusting the sales site with the affiliated factory.

The best way to consolidate funds among group companies is to establish a financing company, but it is extremely difficult under the current conditions. The notion of financing companies does not exist in China and they are categorized as financial institutions. This means that establishing such an organization requires the authorization of the Banking Supervisory Authority³³.

Consolidating foreign exchange is even more difficult than consolidating funds. The only area of operation that is permitted is agent operation in foreign exchange dealings (delegation of exchange contracts). There are few cases of an umbrella-type corporation carrying out this operation³⁴. Consequently, group companies are bearing their foreign exchange risks individually, which incurs a substantial hedging cost.

(e) Response by the authorities/ business practices

Besides such issues related to regulations, there are problems related to the way in which the Chinese authorities deal with a situation and the differences from international business practices.

With regard to issues concerning authorities, companies face difficulties because the authorities in charge of authorization are so diverse, judgments differ among different authorities or even within the same authority, and rules themselves are either different in different regions or the interpretation varies³⁵. There are a number of cases where it is murky whether a certain transaction is permitted by regulation. Furthermore, when a regulation is changed, information on the change is often not well distributed, so that there is no way for companies to know the change until they confirm with the relevant authority.

³¹ Since neither netting nor payment in advance is permitted, China cannot be structured into a global, central settlement system.

³² Regulations for interest rates on consignment loans differ according to the region. There is no interest rate regulation in Shanghai, but in Beijing, the same rule applies as to ordinary loans, which is a floor of 0.9 times that of basic interest rate.

³³ In order to establish a financing company, a capital of 100 million renminbi must be paid in to establish a regional headquarters. There are Japanese corporations which have established such headquarters. Then an authorization by the Banking Supervisory Authority is required. The only company that has a financing company in China is Siemens.

³⁴ Re-invoice and foreign exchange contracts between an umbrella-type corporation and its affiliate are not permitted. Invoices denominated in the renminbi are, in effect, not possible for trade transactions.

³⁵ There was a case where investment in kind was rejected by the Administration of Foreign Exchange even though the Administration is not in charge of authorizing investment in kind.

With regard to differences with international business practices, not fulfilling the obligation for payment on due date is normal in China. This creates difficulties in fund management since there is strong demand from the recipient for payment. Such cases are pointed out explicitly. Differences with international business practices should be corrected through organizing proper laws as the number of domestic transactions increase in the future³⁶.

(5) Problems related to Regulations on Business Activities and Prospects for the Future

China has made some progress in deregulation in accordance with the commitments made to the WTO, but there are still a huge number of regulations, far more than in any other country in Asia.

The Chinese method with regulations is to set a very high hurdle initially, see how it works, then to lower it gradually. For that reason, it is unlikely that liberalization of financial activities at the end of 2006 will produce a drastic change in environment. Various activities could be deregulated on paper but would be restricted at the authorization stage.

In some cases other methods are applied where regulations are eased in some regions as test cases or certain activities are allowed only to state owned banks. Consequently, it is vital to collect information on the policy attitudes of the relevant authorities and changes in regulations.

The key problem for Japanese companies is the consolidation of funds, foreign exchange and settlement among group companies. Running its finances in an efficient way will be the biggest challenge for companies, with the increase in the number of group companies in China, the huge number of regulations on borrowing and foreign exchange, the cumbersome procedures and the possibility of fluctuation in renminbi foreign exchange rate in the future. It would be hugely beneficial for companies if establishment of financing companies among group companies, pooling among group companies and consolidation of foreign exchange transactions among group companies were authorized. Establishment of financing companies may not be totally impossible seen from the example of Siemens.

Japanese banks, too, are actively expanding their business operations in China. They tend to follow the business operations of Japanese companies, and banks are likely to expand their operations as Japanese companies increase their domestic sales in China. Japanese banks have a different strategy from European and American banks, such as regarding capital investment to Chinese-funded banks. However, all aspects of financial operations, whether it is a certain business activity or opening of a branch, are subject to authorization and Japanese banks must ensure that they are not treated discriminately.

³⁶ When a bill is dishonored, it is simply returned but cost related to bill exchange is incurred.

6. South Korea

(1) Penetration Trend of Japanese Financial Institutions and Corporations

South Korea created an export led economy with the IT industry as the key player. Among the major products, the export dependency of key export products such as semiconductors and liquid crystals has risen over the years and was 45% in 2005. Japan is the third largest trading partner along with the EU for South Korea after the United States and China.

Of the electric/electronics corporations, Samsung Electronics and LG Electronics have developed into global companies, as have Hyundai Motors among transportation machinery companies. However, for materials, parts and capital goods, they tend to depend on imports from Japan and other countries, and the country's trade balance with Japan is structurally in the red. The South Korean government has launched the Northeast Asia Business Hub Scheme (reference at the end of this chapter). As part of this scheme, which aims to strengthen the competitiveness of domestic industries and correct trade imbalances, it is seeking more corporate investment in the sectors producing parts and materials from Japan. This led to the "South Korea-Japan Bilateral Investment Treaty", which became effective in January 2003.

The South Korean government is highly aware of the rise of China. With the Northeast Asian Business Hub Scheme as national policy, it is aiming to create a hub for the flow of goods and to finance as well as to establish a National Innovative System (NIS), unique to South Korea. By doing so, the country aspires to be the concentration point for innovative industries, and both the public and private sectors are working hard to attract foreign capital. At the same time, the government is pursuing FTA negotiations with multiple countries in order to expand trade and investment and to mutually ease related regulations¹.

As part of attracting investment, the government has designated foreign investment areas throughout the area south of Seoul, and there are 26 designated industrial parks. Japanese corporations are concentrated in Gyeonggi-do, and Chungcheongnam-do and Maehwado, which are close to Seoul. About 470 companies, which amount to more than 70% of locally incorporated Japanese companies, are funded by Japanese manufacturing companies. The remaining 30%, or about 170 companies, are funded by the services industry. The size of most of locally incorporated Japanese companies is mid to small size with a capital of 30 billion won or less.

Japan ranks third in direct investment to South Korea after the United States and the EU, and a large part of the investments are "greenfield" type, such as liquid crystal, semiconductors, and materials and parts related to the auto industry. Japanese investments are mostly in the manufacturing sector. But in sharp contrast to this, European and American companies concentrate on the services industry, such as pursuing large scale M&A type of investment (Citibank, GE Capital, Standard Chartered, etc) in the financial sector, along with food, accommodation and distribution sectors.

Of the Japanese financial institutions, there are seven banks (five have branches and two representative offices), three securities companies (branches), two non-life insurance companies (branches) and one life insurance company (representative office) in South Korea.

¹ South Korea has already signed FTAs with Chile, Singapore and EFTA, and is in negotiation with Japan, ASEAN, Canada and India. It has begun a joint study with Mexico and Mercosul. Inter-governmental preliminary discussion is going on with the United States.

In contrast to this, Citibank and the Standard Chartered Bank, one American and one European, have bought KorAm Bank and Korea First Bank respectively. They now have a full range of networks throughout South Korea as Citibank Korea, Inc and SC First Bank, and are offering a wide range of commercial bank services using abundant won capital. HSBC is said to be planning the acquisition of a local bank as well. Of the seven major Korean banks, including the two mentioned above, six have a foreign capital of more than 60%, and the majority of the Woori Bank's capital is South Korean.

(2) Trends in Deregulation

After the Asian currency crisis of 1997-98, South Korea recognized the importance of direct investment from overseas and moved swiftly with reform.

The government announced a plan to liberalize all foreign exchange transactions in June 1998 with the aim to encourage the inflow of foreign capital and enabling smooth foreign economic activity. It also made clear that foreign exchange liberalization will be conducted in two stages. In September of the same year, the "Foreign Exchange Management Act" was abolished and a new "Foreign exchange Transaction Act" was enacted.

The first stage of liberalization (April 1999) deregulated most of the restrictions on current account payment related to overseas operations, furthered liberalization on capital transactions applying a negative system of "free in principle with exceptions", switched the foreign exchange operation authorization to a registration system and established the framework for emergency measures.

The second stage of liberalization (January 2001) further eased regulations on areas that were untouched by the first stage, mainly foreign exchange transactions by individuals (expenses for foreign travel, gift-natured remittances, expenses for moving abroad, etc) and capital transactions (regulations on foreign deposits, purchase of foreign securities, purchase of overseas real estate, etc).

In April 2002, "Areas of Mid-term Development for the Foreign Exchange Market" was announced as a third step to ease the foreign exchange restrictions that were left from the first two stages of liberalization. It aims to deregulate to the same level as developed countries by 2011. The deregulation measures in the third stage are as follows.

- First period (2002-2005): Easing of the regulations concerning the means used in individual or corporate activities and further liberalization of capital transactions while maintaining the current structure.
- Second period (2006-2008): Drastic reduction in the remaining restrictions including abolition of the authorization system for capital transactions.
- Third period (2009-2011): To achieve the level of the regulation of advanced countries by finishing the liberalization measures of the foreign exchange system with the exception of safeguards.

The Ministry of Finance and Economy (MOFE) plans to place the completion of the foreign exchange liberalization plan by 2011 as part of realizing the Northeast Asia Financial Hub. In relation to the Financial Hub scheme, the MOFE has recently announced, that consolidating the foundation of the hub is in its final stage in 2006, that it plans to submit the Financial Investment Services & Capital Market Act, which includes financial reform, foreign exchange liberalization, and

reform of the financial supervisory framework to the Parliament, that it is making an implementation program for the development of major financial services, such as issuance of bonds, corporate restructuring financing, derivative trading, asset management and investment banking in order to modernize and internationalize the domestic financial markets, and also, that it plans to establish a graduate course on finance at the Korea Advanced Institute of Science and Technology (KAIST) to nurture financial specialists.

In relation to direct investment from abroad, "Foreign Investment Promotion Law" was enacted in September 1998. This law constitutes a part of the Foreign Exchange Transaction Act and was placed as a special law in the Act. The law specifically aims to attract and support foreign capital. "Foreign Investment Promotion Law" adopts, and unless otherwise stipulated (a Negative System), a principle of free foreign investment, and provides guarantee for remittance of investment principal and returns, equal treatment as citizens, tax exemption, loan and sales of assets held by national or local governments. It also provides incentives by having the central government provide investment support, simplification of various procedures for investment and establishment of Investment Promotion Centers that have one-stop functions such as dealing with complaints.

There are 1058 areas of business that are listed as possible investment areas for foreigners. The government applies the Negative System, which means that it only notifies the areas that are restricted for foreign investors. The areas of business that are not listed in the Negative System are all available for foreign investment. The categories and the numbers of areas of business are as follows.

Completely open to foreign investment: 1,030 areas of business

Partially open to foreign investment: 26 areas of business (foreign investment is allowed only when the investor meets the authorization criteria)

Currently not open to foreign investment: 2 areas of business (radio and television broadcasting)

Outside the areas of business offered to foreign investment, there are 63 sectors, such as public administration, foreign affairs, defense, that are excluded from foreign investment. Domestic banks are one of the partially opened areas of business. Investment in city and local banks is permitted, but foreign investment is not allowed in the Industrial Bank of Korea and the Export-Import Bank of Korea.

As part the Northeast Asian Business Hub scheme, the Roh Moo-hyun administration named Incheon, Pusan-Jinhae, Gwangyang Bay Area as Free Economic Zones in 2003. Incentives include exemption from corporate and income tax and deduction in land lease payments as well as providing facilities for the living environment, such as schools for foreigners and hospitals. Under the system of designating industrial location sites for foreign investment, there are foreign corporation designated industrial parks (6 parks), foreign investment areas (8 parks) free trade areas (8 parks) and the Cheju International Free City (Cheju) besides the three Free Economic Zones.

(3) Operational Development of Japanese Financial Institutions and Regulations on Business Activities

Of the seven Japanese banks in South Korea, four city banks and one regional bank have branches, and one trust bank and one regional bank have representative offices. One city bank has branches in both Seoul and Pusan, while the other city banks have branches only in Seoul and the regional bank in Pusan (as of December 2005).

In terms of total assets of commercial banks in South Korea, the percentage share of foreign banks, including Japanese banks, was 12% as of June 2004. Commercial banks are categorized into Nationwide Commercial Banks, Local Banks and Foreign Bank Branches. (Table 6-1)

Table 6-1: Commercial Banks in South Korea (June 2004)

Banks	No. of Banks	Total Assets (W billion)	Percentage of Share
National Commercial Banks	8	661,882	80.3
Local Banks	6	61,886	7.3
Foreign Bank Branches	39	100,196	12.2
Total	53	823,964	100.0

Source: Bank of Korea Homepage

Foreign banks have been concentrating on wholesale banking, but some have begun to go into private banking, targeting the wealthy people. As mentioned previously, Citibank and Standard Chartered Bank have bought local banks in 2005, and have become National Commercial Banks. Besides the commercial banks listed above, there are five specialized banks in South Korea. They depend on ordinary deposits as well as bond issuance and government borrowing as source of funds. They also deal in some areas of commercial banking activities and sometimes compete with commercial banks.

The major regulations on business activities of financial institutions in South Korea are as table 6-2.

Table 6-2: Major Regulations on Financial Transactions in South Korea

Regulations on Banking Activities	Regulation on large-scale loans	Ceiling of 20%/25% of bank capital per company/group
	Regulation on foreign exchange position	Foreign exchange net position must be 20% or less of bank capital.
	Reserve ratio against deposits	5% for deposits payable on demand, 2% for savings deposits, 1% for foreign currency deposits.
	Regulation on liquidity	80% or more of short-term foreign currency debt must be managed in short-term assets of three months or less.
	Loans to mid to small size industries	25% or more of increase in loans must be extended to mid to small size industries.
Regulations on Foreign Currency Trading	Overseas borrowing by residents	Foreign currency borrowings of the equivalent of 30 million dollars or more must be reported to the MOFE through a foreign exchange bank. However, pre-authorization by the MOFE* is required for fiscally unsound corporations.

*MOFE : the Ministry of Finance & Economy

Source: compiled by IIMA from various available materials

Reviewing the funds market, there is no official discount rate in South Korea. However, the central bank uses the interest rates for clean overnight call loans as the target rate². The Korea

² The central bank law was revised in April 1998, and under the new law, the Bank of Korea must set and announce the target rate using the annual inflation rate projection for the following three years as part of a basic policy aimed at price stabilization. In order to meet this objective, the Bank of Korea announces the overnight call rate every month as the policy interest rate to guide market interest rates. The target interest rate as of March 2006 is 4.00%, the same as the previous month. (Bank of Korea Homepage, etc)

Federation of Banks (KFB) has been announcing the Korea Inter-Bank Offered Rate³ (KORIBOR) every day since July 2004, but since South Korea hardly has a mature fund market other than the overnight one, KORIBOR remains a symbolic target rate. For lending to customers, the available interest rates are the one based on prime rate (7.5-9.5% for major nationwide commercial banks) and the one based on various interest rates such as those for negotiable certificate of deposits. The latter is now being used more regularly.

For foreign banks that do not have the means to amass savings through customer deposits, the domestic call market is the main source of raising the won fund. Various financial institutions participate in the call market such as banks (first financial layer), securities companies, money market dealers, comprehensive financial companies (second financial layer), but most financial transactions are conducted within the first financial layer, among the banks and financial companies of the same category. This means that for foreign banks, won funds are sometimes not readily available⁴.

The Seoul-Japan Club (SJC), which has 315 Japanese corporations as members, submitted the eighth "SJC Proposal for Improvement in Business Environmental Reform" (Proposal) in October 2005⁵ to the Ministry of Commerce, Industry and Energy. There are seven appeals regarding the financial sector in the proposal, and one of them concerns won fund raising.

<1> Opening of the Won currency market to non-residents

Access to the won currency market by non-residents is still very restricted. There is a limit to the use of Non-Deliverable Forward (NDF)⁶ for hedging won by non-residents in view of the increasing demand for hedging. For this and to increase the inward investment into South Korea, the proposal asks for an early opening of the won currency market to non-residents.

<2> Reforming the operational procedure for regulation of loans to a single borrower/group (regulation of large-scale loans)

The proposal asks for improvements in the way in which net worth of a branch office is used to determine the maximum amount of loan to a single borrower. It also asks to revise the cumbersome procedure for certifying loan amount which is a requirement for lending to a single borrower or single group. (regulations on large scale loans)

<3> Revision of the subscription system to credit guarantee funds

Subscription to the credit guarantee funds is regulated by the credit guarantee fund law and banks are obligated to pay contribution fee each month. The fee is calculated as "monthly average of loan

³ Fourteen reference banks submit the interest rates for ten maturity dates (one week to 12 months) to the KFB. The KFB discards the three highest and three lowest rates, calculates the average of the remaining eight and announces it at 11 am every day.

⁴ The situation can be said to be much better than that before the Asian currency crisis. The more serious problems than the tendency of the market to be divided based on the category of financial institutions could be that the inter-bank fund market has not matured adequately and that pricing of loan interest rates in the market has not become a general practice.

⁵ Since 1998, the SJC has been compiling the obstacles to business promotion and suggesting reform measures in a wide range of business sectors, including the financial sector, to the Ministry of Commerce, Industry and Energy. In recent years, a meeting with the Minister also takes place along with the submission of the proposal.

⁶ NDF trading is permitted for residents and non-residents, but foreign exchange transactions (spot and futures) in won trading which involve delivery of won funds can only be conducted among financial institutions with offices in South Korea.

balance denominated in won x 0.3% x 1/12” (0.2% for credit guarantee funds and 0.1% for technology credit guarantee funds). The proposal argues that since foreign banks hardly gain benefit from the funds, the fee should be paid by the local banks only. The contribution fee rates, after several stages of adjustment, will be 0.25% for credit guarantee trusts and 0.15% for technical guarantee trusts as from July 2006.

<4> Abolition of bank lending obligation to small-to-medium sized enterprises (SMEs)

Concerning the lending obligation, the proposal argues that it is against the market principle to force banks to lend certain portion of loan funds to SMEs. It suggests that the government should take other measures to support SMEs, such as to extend special loans or provide special guarantees initiated by the government.

<5> Request to review the educational tax levy imposed on specific industries (financial institutions and insurance companies)

The proposal states that the improvement of the educational environment should be paid by general tax revenue and questions whether it is appropriate to impose educational tax on specific industries, such as banks and insurance companies, in order to sustain fiscal resources, and whether that follows the principle of fair taxation. If such taxation cannot be avoided, the amount of burden should not be calculated on the basis of sales but of profit. (earnings minus expenses).

<6> Voluntary enrolment in the deposit insurance system

Concerning banks' obligatory enrolment in the deposit insurance system, the proposal states that many foreign banks, which are not conducting retail banking, do not benefit from the system. It argues that collecting the special deposit premium in order to replenish the funds that were used to save domestic banks is equivalent to an income transfer from foreign banks to domestic banks, and requests a change to allow voluntary enrolment into a deposit insurance system and stop premium collection from foreign banks.

<7> Granting of corporate insurance agent status to foreign companies with branches in South Korea

The proposal requests that foreign insurance companies be allowed to assign corporate insurance agent status to foreign companies (non-insurance companies) conducting business as branches, which is currently not permitted.

There are individual problems as mentioned in the proposal, but the key aspect for Japanese banks is competition that is expected to multiply in the future. As already mentioned, European and American banks have purchased local banks, which means that they can provide a wide range of local financial services. Some Japanese companies which target the local market may prefer to deal with European and American banks that have high credibility, a wide network of branches and provide retail services such as credit cards. As the range of activities of Japanese companies expands, there is a good chance that they might switch to European and American banks. In order to compete, Japanese banks must have the same competitive foothold as the local and European and American banks.

The insurance market of South Korea has a total premium of 51 billion US dollars (58.4 trillion won), which is second in Asia after Japan. The South Korean government has gradually opened up the insurance market through allowing business tie-ups between foreign-funded and Korean insurance companies and allowing partial subscription to Korean insurance companies. A new insurance law was passed in the Parliament in 2003 and the floor for necessary capital for foreign on-line insurance companies was lowered, the authorization system of new insurance products was changed to a reporting system and regulations on asset management was eased⁷. There are two Japanese non-life insurance companies and one life insurance company in South Korea. The two non-life insurance companies opened representative offices in the late 70s, invested capital in local insurance companies and created operational ties. In 2002, they acquired a license on mainly fire, marine and reparation insurances, and began offering services to Japanese manufactures and others in the form of reinsurance and primary insurance.

(4) Operational Developments of Japanese Companies and Regulations on Business Activities

Many of the Japanese companies in South Korea are in the electronics/electric parts, machinery, transport machinery, chemical and textile industries. Instead of targeting the Korean domestic market, they aim to penetrate the international market by supplying parts and products to Korea's global companies such as Samsung, LG and Hyundai. At the same time, there is a strong demand from these major Korean companies, as well as from the government, for the Japanese companies to invest in South Korea. Generally speaking, Japanese companies began operations in Asia because of cost-efficiency such as cheap labor. But the labor cost in South Korea is as high as developed countries and Japanese companies can no longer enjoy cost benefit in that regard. For Japanese companies opening factories comes into the same category as opening them in Japanese local towns.

As a form of investment, many Japanese companies prefer a 100% owned subsidiary. This is because regardless of the share in capital, whether Korean capital provides only a minor share, it tends to be aggressively involved in the management of the company. Some companies targeting the local market, or those that invested before 100% capital subscription was sanctioned, made inroad to Korean market as joint ventures with Korean companies. There are some Japanese companies that formed a joint venture with local capital and run a successful operation by having total control on the technical side while allowing their Korean partner to manage the company. In this way, problems such as labor related ones are handled by the Korean partner which avoids difficulties for the Japanese investor.

Labor issues are the most serious for foreign companies. After the Asian currency crisis, the firing of excessive labor was written into law and regulations on manpower-leasing, which had been restrictive, were eased. However, the management still has to deal with labor unions that are generally radical and over-demanding in labor negotiations.

Life time employment is the rule on the surface in South Korea. However, in large corporations, in-house competition for salary and posts is severe and there are many who are forced into voluntary resignation through job transfers. In reality, life time employment is not the norm and hence, there are few who enjoy full fringe benefits. On the other hand, in the case of Japanese companies (especially 100% owned subsidiaries or branches), where in-house competition is not so severe and job-transfer is very limited, local employees tend to enjoy the full fringe benefits which are the same

⁷ USTR; "2005 National Trade Estimate Report on Foreign Trade Barriers – Korea"

as those for employees of major local companies. This is one of the reasons for the rise in fixed expenses of Japanese companies in Korea.

The recent rise of China is affecting Japanese companies in South Korea. In the 70s, processing and trading industry was very active in the southern free trade areas, such as Pusan and Masan, but now operations in Korea cannot compete with those in China because of the rise in labor cost. On the other hand, with the growth of the Korean domestic market, some Japanese manufacturers have shifted 80% of their sales from export to sales in the domestic market in the last few years.

For Japanese companies operating in South Korea, there are no basic regulation problems that seriously inhibit smooth operation. This is partly because business regulations were eased under the Foreign Exchange Transaction Act and Foreign Investment Promotion Law but also because extensive deregulation was carried out after the Asian currency crisis. However, there are views that there is room for improvement in the foreign exchange market, in respect of won trading and won fund raising.

(5) Problems related to Business Promotion and Prospects for the Future

The 2005 proposal by the SJC mentioned above is the eighth that the SJC has submitted, and besides the requests concerning the financial sector, it also included requests for improvement in other business environment. The requests included areas such as labor and labor/management relationships (13 items), taxation (3), intellectual property (4), other requests (10) and improvement in the living environment (12). There were a total of 49 issues in the six areas, including finance sector. Majority of the issues have been continuously presented by SJC for several years

In the labor related field, the continuing issues were improvement of labor/management agreement and of employment practices, abolition of the purchase system of unused paid holidays, abolition of guidance on part-time workers (obligation on the part of the company to hire part-time workers as full employees after a certain period) and strict application of the law concerning illegal labor conduct by unions. The new issues in labor related field included early enforcement of the Japan-South Korea Social Security Agreement and easing of the conditions for firing full-time employees.

In the taxation field, all issues were continuing ones such as allowing the interest cost on corporate borrowings for lending to employees to be included in expenses.

In the field of intellectual property rights, stricter application of penalties for infringement of intellectual property rights and a more rapid procedure for intellectual property appeal were pointed out.

At the meeting between the Ministry of Commerce, Industry and Energy and the SJC, the SJC stated that the negotiations for the Japan-South Korea FTA, which will bring the benefit of market expansion for the Korean industrial sector, should be reopened urgently. (discontinued since November 2004)

Of the 49 items included in the JSC proposal, the majority, 33, are continuing issues. This is especially true in the labor related area, where 11 out of 12 are continuing, and in the financial area, where all seven have been carried on from previous years. This is likely to indicate that issues that can be improved easily have been already achieved and the remaining ones are those that take time to consider and adjust various interests. On the other hand, the intellectual property field (5 out of 7) and living environment field (5 out of 12) have many new issues. Intellectual property right is an

area where more problems will be brought up in the future. Of the imitation goods that are prohibited from import by the Japanese customs because of an infringement of intellectual property rights, the number of goods from Korea are said to be the largest.

For Japanese companies, the areas that continue to and/or will have difficulties in the future are limited to labor, finance and intellectual property rights. Although the life environment area has a number of issues to be improved, they relate mostly to personal lives and are placed lower in the rank of issues for corporations.

The US Commercial Service Korea (Korean office of the US Commercial Service which is an affiliated organ of the US Department of Commerce) appreciates the various reforms that were made in the financial sector and in regard to foreign investment after the currency crisis. However, it lists immature management of corporations, lack of clarity on various rules, economic control by the zaibatsu groups, an inflexible labor system, lack of control on intellectual property rights and difficulties in solving disputes as obstacles to foreign direct investment.⁸

With regard to the lack of clarity on various rules, the actual problems that the US Commercial Service Korea points out are that definitions of various rules are not clear, that it is necessary for the private sector to ask the public sector informally for the interpretation of a rule by the person in charge, that interpretations tend to differ according to the person in charge and that the person in charge tends to be transferred in a short time. Other problems that are pointed out are that there are guidelines that are not made public and executive guidance that is not written.

With regards to disputes, there are not many cases where foreign companies are involved in large disputes, such as over investment or business activities, besides intellectual property rights. Various problems are pointed out: the language problem in court (adequate interpretation is not offered), the requirement to hire Korean lawyers, being forbidden to leave the country until the ruling is made in some cases, the long hours and high costs incurred, that disputes usually mean the end of business relationship with the customer. For all these reasons, taking legal action is the last resort for foreign companies and is, in effect, not a means to solve a problem.

Looking at the prospects for business expansion by Japanese companies, it is likely that the services sector, in addition to the manufacturing sector, will increase investment in South Korea. As regards development in the areas of distribution and financing related to the Northeast Asia Business Hub scheme, companies in the distribution sector, such as trading companies, and financial institutions may well expand their operations. The Korean government is likely to develop and organize railways, ports and energy transportation system and adopt an innovative distribution system, where Japanese companies will have business opportunities. If further liberalization, development and expansion are carried out in the foreign exchange and capital markets, and if development of asset management and operation activities are encouraged, business opportunities for Japanese banks and securities companies will be increased.

⁸ US Commercial Service Korea: "Investment Climate Statement"

Annex: South Korea's Northeast Asia Business Hub Scheme⁹

The scheme to establish South Korea as the Northeast Asia business hub had been debated for a number of years among academics, and was finally announced by the former president, Kim Dae-Jung as a New Year message in January 2002. As part of this scheme, the government enacted a law related to the designation of economic free zones in November 2002. This business hub scheme was taken over and developed into a grand vision of the Northeast Asian Business (or Economic) Hub by the current president, Roh Moo-hyun, as one of the priority policy areas.

The scheme consists of both hardware and software aspects. The hardware aspects include the development and organizing of infrastructure such as railway, energy resource development, IT/science and technology and the financial system. The software aspect puts emphasis on regional cooperation such as FTAs, coordination in financial/currency environment and inter-regional exchanges. It has four key objectives, assuming that South Korea will play a leading role.

<1> promotion of a distribution hub in Northeast Asia

<2> promotion of a financial hub in Northeast Asia

<3> A plan to create a National Innovative System for R&D, based on technical developments achieved by Koreans, and to create innovative technology industry clusters.

<4> Strategic planning for attracting foreign direct investment (FDI)

The plan for creating a Northeast Asian financial hub is to use the pension funds and foreign currency reserves¹⁰ to develop the asset management business, then to use this as a core to develop a niche financial hub for Northeast Asia and attract foreign financial institutions. In concrete terms, the plan is to create a financial hub in three stages by 2020.

As the first step, the government plans to achieve the following seven goals by 2007.

<1> Establishment of a Korean Investment Bureau (provisional name) that will manage public funds, such as pension funds and foreign currency reserves.

<2> Creation of an asset management market by entrusting the management of public funds to private companies.

<3> Further liberalization and expansion of domestic long-term bond, stock and foreign exchange markets.

<4> Nurturing of specialized financial services markets (corporate restructuring, project financing for infrastructure renovation, etc)

<5> Establishment of a financial global network

<6> Improvement and strengthening of financial supervisory system

<7> Improvement of business environment related to financing and living environment.

As the second stage, it aims to develop South Korea as the financial center of asset management as a niche financial hub by 2012 as well as attracting 50 of the top global asset management companies, expanding other financial business activities, such as investment banking, and nurturing the local financial institutions into major players in Northeast Asia.

By the end of the financial stage in 2020, it plans to develop an Asian financial center, so that the world's major banks will establish their regional headquarters there.

⁹ Lee Chang-jae, "Korea as a Northeast Asia Business Hub: Vision and Tasks", <http://keia.com>

¹⁰ Balance of the National Pension Fund is W165,860 billion (US \$165.5 billion) and the balance of foreign currency reserves is US\$206.1 billion (as of May 2005)

The Northeast Business Hub scheme is a plan essential for the economic development and growth of South Korea and is named as a key policy area for the current government. However, there are also criticisms such as the following¹¹.

- The current government has named other priority plans (“attaining per capita income of 20 thousand US dollars”, “regionally balanced industrial development”, etc.) and the Northeast Asian Business Hub does not necessary seem to be the most prioritized issue. It should be more clearly placed as the national priority plan.
- Regional cooperation within the Korean Peninsula, with China and Japan added to the initial plan of 2002, would complicate the scheme in the implementation stage, because the international political and regional peace aspects have to be considered.

The following aspects are also pointed out.

- The financial hub scheme assumes financial market opening based on further liberalization, but there is no consideration of negative aspects such as the possibility of incurring market instability.
- Many of the policies aim solely at attracting foreign capital. For example, the free economic area framework provides a number of incentives, such as special tax treatment, for foreign corporations but it might not necessarily contribute to the development of the domestic economy. Infringing on the vested rights of laborers has a considerable possibility of instigating social tensions.
- The geopolitical position of South Korea is very complex and the country is not in a position to obtain regional cooperation easily.

All reports agree that the Northeast Asian Business Hub has significant importance for the future of South Korea.

¹¹ Lee Chang-jae, “Korea as a Northeast Asian Business Hub”.

7. Summary

(1) Operational Developments and Problems of Japanese Financial Institutions

<1> Japanese Banks

(a) Strategic differences between Japanese banks and some of the European and American banks

The business operations of Japanese banks in Asia are entirely focused on transactions with Japanese corporations penetrating those countries, and there are hardly any business dealings with European and American or local corporations. Japanese banks are not conducting any retail business. Consequently, Japanese corporations spread their dealings among Japanese and local banks, and some even deal with European and American banks for cash management services. Whereas European and American banks conduct business much more extensively, dealing with European, American and local companies, and offering retail transactions, private banking to the affluent customers and credit cards, etc.

(b) Possibility of differences in competitive advantages due to FTAs

Although there still are disparities in the competing conditions for business operation between local and foreign banks in China, there are hardly any differences in other Asian countries except for conditions placed on the development of branch networks¹. Currently there is no difference in conditions governing competition between Japanese and American banks. But the United States tends to pick the financial services area as an important field in FTA negotiations, while Japan has not been doing so. Financial services were included in the US-Singapore FTA (USSFTA) which was signed after the Japan-Singapore FTA (JSEPA), and as a result there are concrete differences in opportunities between the Japanese and American banks that operate in Singapore, in such areas as operational locations and access to the local ATM network. An FTA was signed recently between Singapore and India which also included financial services, and as a result, some of Singapore banks are going to be afforded special rights, such as regarding 100% owned subsidiary companies and creating office networks. These facts indicate that if the United States and Asian countries were to include financial services in the future FTAs and other agreements, then there is no denying that there would be differences in conditions governing competition between Japanese and American banks. Such discrepancies are likely to create obstacles as Japanese banks try to expand their operational activities in Asia beyond their business relationship with Japanese corporations.

(c) The possibility that restrictions over opening branches and newly entering a market would create problems in the future

Besides the regulations on business activities, the common problem in Asian countries is the restriction placed on developing operational networks. Malaysia is an extreme case which has virtually stopped allowing new entry of foreign banks into the country. All these countries aim to strengthen the competitiveness of local banks and fear that if they allow foreign banks with their superior competitiveness to develop their operations freely in the country, there would be a huge

¹ There are even differences among Japanese banks depending on the timing of when they began their business in the country. Depending on whether a bank penetrated before or after certain regulations were enforced, different rules could apply concerning paid-in capital, etc.

negative effect on the local banks. The restrictions on creating branch networks hugely limit the business activities of Japanese banks in China and Indonesia because these countries are geographically large and Japanese corporations are operating around the whole country in both cases. But in other countries, restrictions are not creating any significant effect, mostly because Japanese banks are not into the retail market. In the future, however, there would be a need for Japanese banks to extend retail services if Japanese companies were to begin seriously to try expanding their domestic sales in a huge retail market like China or if the retail business itself should offer considerable profits. In that case the capacity to develop branch networks and to participate in the local ATM network would become serious issues.

(d) Restrictions on fund raising from local sources and regulations on large-scale loans

Since Japanese banks do not run retail operations, they hardly collect deposits from individuals in local currencies. This limits their capacity to raise funds in local currencies to accepting deposits from Japanese corporations and using the inter-bank market. However, the money markets in Asian countries are generally underdeveloped and raising funds from the inter-bank market is not satisfactory from the perspective of both amount and cost (interest rate level). This is especially true of long-term funds.

When there is a demand from a Japanese corporation for large scale investment finance, it is sometimes difficult for a Japanese bank to provide the loan because of the limitations on fund raising as well as due to the regulations on large-scale lending. These regulations use the capital of the locally incorporated bank or the paid-in capital of a branch to calculate the amount of large-scale loans that can be extended and such a ceiling inhibits foreign banks with relatively small capital in the country.

(e) Increase of administrative cost for foreign exchange management and other activities, and the shortage of Japanese employees

There are strict foreign exchange regulations in these countries, partly as an effect of the Asian currency crisis. This leads to a considerable increase in the administrative burden on the banks in managing their foreign exchange activities.

There are also many Japanese companies that depend on Japanese banks to cope with fiscal management and administrative procedures as there tend to be many regulations in Asian countries and it is quite often unclear how the authorities interpret the rules. This tendency is stronger with medium to small size companies. Although Japanese banks are expected to provide services in Japanese, they suffer from a chronic shortage of Japanese manpower in countries where there are tight regulations on the allowed number of employees from the home country of the institution. This is an especially serious problem in Thailand where the number of Japanese corporations is growing rapidly.

<2> Japanese Securities Companies and Insurance Companies

(a) Scope of activities for Japanese securities companies

The main form of finance in Asian countries is indirect financing. The securities markets are small and the scope for foreign securities to operate is very limited. There are countries like China which maintain a strict rule on capital subscription for foreign securities companies. This means that local

financing by Japanese corporations is conducted mainly through banks. There is also only a small demand for Asian stock or bond investment, except for Chinese securities, by Japanese investors.

Consequently, the activities of Japanese securities companies in Asia are limited to collecting information by creating contacts with the local governments and to bringing the European and American borrowers and Asian investors together. Most companies create offices in Hong Kong and/or Singapore for investment banking purposes and operate businesses in other countries from those offices.

(b) Japanese insurance companies target the local markets and operate mainly as joint ventures

Non-life insurance companies have led the overseas operations among Japanese insurance companies. They begin with a focus on Japanese corporations dealing in fire, marine and indemnity insurance, but because of limitations in earnings, move on to the local market, starting transactions with local companies and penetrating the auto insurance market. The exception is China where the authorities do not allow foreign funded companies to penetrate the auto insurance market. Because of this general trend, the share of Japanese customers for non-life insurance companies is on the decline. To move into the local markets, Japanese companies often form joint ventures to have a better name recognition and to take advantage of the local network. Finding a partner with high credentials is the key to success in such cases.

Because the minimum capital requirement is low in Thailand, Indonesia and the Philippines, there are too many insurance companies and some are going bankrupt. Strengthening of the regulations must be carried out.

In Malaysia, there are more consolidations of insurance companies but except for Islamic insurance companies, new entrants are not authorized.

For life insurance companies, the volume of corporate insurance (group insurance) is small and earnings depend on individual insurance, which means the local market is the target. This gives the companies the incentive to form joint ventures, just as in the case of non-life insurance companies. The growth of life insurance business is greatly limited by the difference in the social welfare system and culture, and except for China which is growing into a huge market, there is not much scope for business expansion in Asia for Japanese life insurance companies.

(2) Operational Developments and Problems of Japanese Corporations

In analyzing the operational developments of Japanese corporations in Asia, the most appropriate way is to divide the countries into four groups: China, Thailand and Malaysia, Indonesia and the Philippines, and South Korea.

<1> China: consolidation of foreign exchange, funds and settlement among group companies

The largest investment destination for Japanese corporations is China and they hope to penetrate into the huge domestic market in the future. However, the number of regulations and the complication of those regulations far exceed those in other Asian countries. Various regulations apply to banks and corporations with regard to foreign exchange and fund transactions, and China cannot be included in the global network for foreign exchange and fund management transactions that cross borders.

There are also a number of Japanese companies which have multiple factories and sales companies in China, and consolidating their foreign exchange, funds and settlement is critical to running the companies finances efficiently. This is currently not possible in China. It is understandable that China needs to maintain some regulations on transactions because their foreign exchange and funds markets are still at a developing stage, but the environment that would allow the consolidation of operations, at least for group companies, should be prepared. That would lead to more availability of funds, which in turn could lead to more investment and domestic sales.

The other important issue in China is the future direction of renminbi foreign exchange rate. Although the foreign exchange market is being developed rapidly following the easing of some regulations on foreign exchange transactions with the switch to the currency basket system, it will take considerable time for derivative markets, such as forward exchange contracts which can be utilized for foreign exchange risk hedging, to develop. The key question is when the fluctuations of renminbi foreign exchange rate will occur and to what extent and whether, in such a situation, foreign exchange risk hedging methods could be employed.

<2> Thailand and Malaysia: domestic foreign currency settlement and participation in global networks

Thailand and Malaysia are the countries in Asia where there are very high concentrations of Japanese industries. This is especially true of Thailand where Japanese investment is increasing rapidly and the current flow could spread to South Asia and along the Mecon River in the future.

Regulations are being eased gradually in both countries, but the biggest obstacle is the restriction on domestic foreign currency settlement. Most of the Japanese companies in both countries are in the processing/trade sector, importing or locally acquiring parts and materials and exporting the products. Also, they acquire much of the parts and materials from Japanese companies that are operating locally. Since domestic foreign currency settlement is not allowed, these companies must settle their domestic transactions in the local currency which incurs foreign exchange risks.

Also, the current regulations do not allow netting or pooling across borders. So when companies that have a financing consolidating office in places like Singapore want to manage their financing operations on a global scale, they cannot include these two countries in the network. The fact that the two countries where there are such high concentrations of Japanese companies cannot be included in the global network implies that a global management of finances is meaningless in Asia.

Malaysia, like China, also has problems concerning the foreign exchange rate fluctuation of ringgit and the extent to which foreign exchange risk hedging means are available.

<3> Indonesia and the Philippines: improvement on the investment environment

Regulations are relatively relaxed in Indonesia and the Philippines, and it is possible to conduct domestic foreign currency settlements. Local currencies constantly face the risk of devaluation and transactions are preferred to be in US dollars. These two countries are where Japanese companies penetrated before Thailand and Malaysia, but because of the lack of infrastructure and political instability, Indonesia and the Philippines are now some distance behind them in attracting business.

However, they both have the advantage of the size of their domestic markets and cheap labor, so there are some possibilities for investment expansion in the future. They should concentrate, not on regulations on transactions, but on infrastructure development and improvement of the general

investment environment.

<4> Common problems : Underdevelopment of the financial markets

The problems that are pointed out by Japanese companies regarding their financial operations in South Korea are the underdevelopment of won foreign exchange market and the high cost of won denominated loans. In all the countries mentioned here including South Korea, short-term financial markets are underdeveloped and what can be referred to as benchmark three months or six months short-term interest rates are not available in most of those countries. The bond markets have developed considerably due to the promotion of the Asian bond market initiative and other means, and the same type of development must be pursued in the short-term financial markets in the future. Larger and deeper financial markets enormously benefit the users. On the other hand, the immaturity of the foreign exchange markets indicates that the authorities of these countries continue to be extremely sensitive about the foreign exchange market movements. When there are more serious discussions among the regional countries to achieve foreign exchange stability among the regional currencies, it would be possible to abolish foreign currency controls in a broad sense, such as the non-internationalization of a currency, step by step.

<5> Common problems : Application of regulations, taxation and labor issues

Although to different degrees, companies in these Asian countries point out the same problems on the control and application of regulations by the authorities, taxation and labor issues.

Administrative procedures are often extremely cumbersome due to regulations. Some regulations are not clear and the interpretation by the authorities often lacks transparency. Even if those regulations must exist, the transparency must be improved. Unambiguous regulations, and highly transparent management and application of those rules must be in place, and duplicate and exaggerated reporting must be eliminated.

On the issue of taxation, there are many cases where a murky approach to tax collection by the tax authorities becomes an issue. Japanese corporation have only a few cases of labor problems for the time being, but it is undeniable that this is an area with potential difficulties. Taxation and labor constitute important parts of the investment environment and cannot be neglected.

(3) Dealing with the financial regulations of these countries

In view of these problems, there is no doubt that efforts should be made to influence the authorities of these countries, such as by making relevant and precise proposals on the future reform of financial regulations. These proposals must meet the two criteria, that they would help promote business activities for Japanese financial companies and corporations and that they would contribute to the healthy development of the real economy and financial and capital markets of individual countries. Abstract comments are easy to make but what should be the key perspectives as concrete efforts are made?

First, upon comparing the situation across the region, some advice should be given to countries that have exceptionally strict financial regulations. Needless to say, the level of economic progress and the maturity of financial markets differ in each country, and such differences should be taken into consideration when offering advice. For example, before the Asian currency crisis, it was a general custom across the board to limit the activities of foreign banks and assure that the local

financial institutions had a competitive advantage by placing regulations on the paid-in capital, placing ceilings on the lending per company and on the number of employees from the home country. However, after the currency crisis, there is now an acceptance of the importance of achieving and maintaining currency value, financial markets and financial system stability, and the governments now understand that it is unwise to take measures to protect local financial institutions at the expense of such stability. It is invaluable to compare the regulations of these countries across the board in view of such developments.

Second, it is important to distinguish the market participants that share the interests of Japanese financial institutions and corporations because many reforms do not get anywhere due to the complicated conflicts of interest among the market participants, even if the proposal is beneficial to the interest of that country. Before the Asian currency crisis, the position of the market participants was relatively simple; foreign banks vs. local banks. Foreign banks moved into the markets through establishing branches. So the foreign banks would push for deregulation and financial market liberalization, while the local banks would oppose such measures. But after the currency crisis, European and American banks began to purchase or invest in local banks making this structure of conflicts of interest more complex. Some foreign banks that bought local banks now tend to place priority on the interest of local banks before those of foreign banks. Also, between the Japanese banks on one hand and European and American banks on the other, there are differences in the type of business activities they focus on as well as in their management style, and such differences are reflected in the concrete demands they make on the local authorities. For example, regulations on large-scale loans and the number of employees from home countries are serious issues for Japanese banks, but are not high on the priority list of European and American banks. The Japanese banks need to be keenly aware of such differences. It is also important to make full use of the information and support of local business groups, such as the chamber of commerce, in addition to bank federations and foreign bank associations, in approaching the authorities.

The third point is the full use of the experience and know-how that Japan has accumulated in the area of financial market development over the years. Many countries, including China, have high expectations for the utilization of such knowledge and experience. There is a commonality between the current Asia and Japan in the past in the way high economic achievements are led by the urge to catch up with the West. Making proposals based on its experience on deregulation of foreign exchange management and capital, and on domestic financial system reform is just the first step for Japan. Japan has the people with the empirical knowledge, and conveying that experience and know-how in person to their counterparts in Asia and studying the financial regulations together with the local authorities are the kind of activities that will be increasingly valuable in the future. Unlike simply making proposals, such support will strengthen the sense of responsibility in those who are in charge in those countries and will lead to building up the capacity of local authorities and market participants.

The presence of Japanese financial institutions and securities companies faded considerably after the eruption of the Asian currency crisis, but there are signs of reversal of that trend in the recent years. There are still some cases where regulations in Japan are restricting overseas operations. An example is Securities Transaction Law Article 65. There are a number of countries that allow universal banking but the stricter regulation still prohibits Japanese institutions from such activities.

These differences in the regulations of the home countries seriously effects the way in which financial institutions can develop their overseas operations. Such restrictive regulations should be amended. Regarding FTAs, the government should be aware that negotiations could lead to differences in the way Japanese financial institutions could compete with their American counterparts because of the way in which the US negotiates to obtain advantages for their financial institutions. The Japanese government should adjust their negotiating strategy to avoid creating such differences. If any difference should occur, Japanese financial institutions should provide the information to the authorities conducting the FTA negotiations as well as promote operational strategies to cope with the situation based on the requirements of Japanese corporations developing their business activities in Asia.

Japanese financial institutions, securities, insurance and non-life insurance companies and industrial enterprises should discuss the problems that inhibit their business activities with the Ministry of Finance, the Financial Services Agency, the Bank of Japan and the attachés of local Japanese embassies. They should also promote forums where they can coordinate their efforts to encourage the creation of better financial infrastructure and regulations in Asian countries.

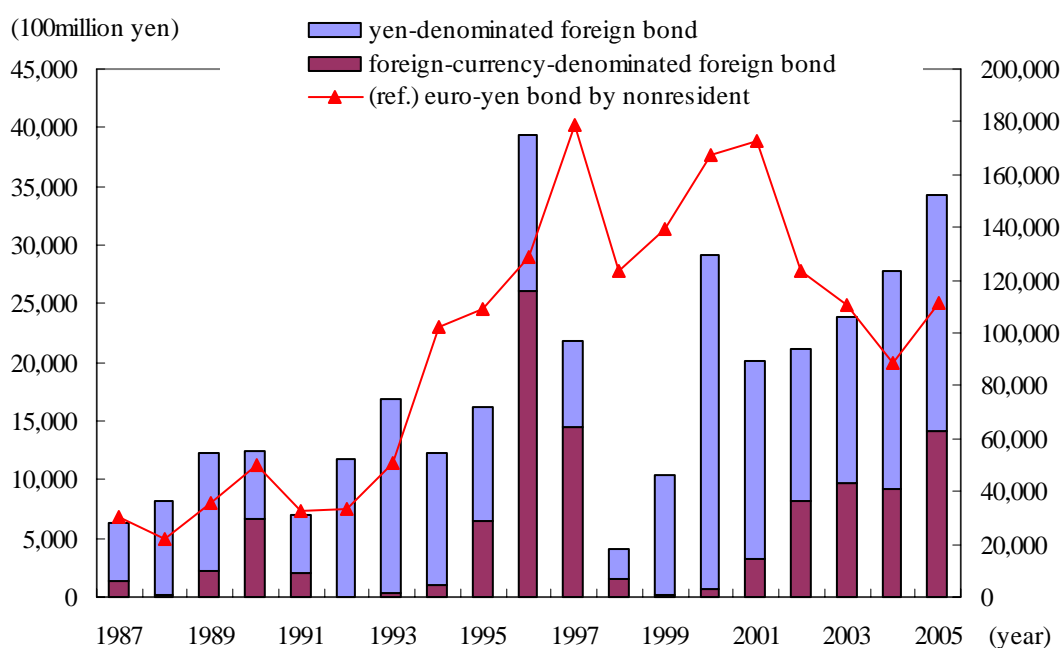
Chapter 2: Creating a more Active Tokyo Financial Market

This chapter will review the infrastructure issues of the current Tokyo bond market from the perspective of the nonresident issuers and nonresident investors.

1. Environment for the Nonresident Issuers

There are two possible categories of nonresident issuers: sovereign (governments or government agencies) and foreign corporations. The following discussion is mainly on corporate issuers but also refer to sovereign issuers. What issuers require to a market is the environment where they can raise the fund flexibly. There used to be numbers of inadequacy pointed out in the Tokyo Samurai Bond market, when compared to the euro markets, mainly to the London market. But its reputation has been rising in recent years as a market where large scale funds can be raised for M&A and capital increase.

Figure 1: Bond issuance and offerings in Japan by nonresidents



Compiled from data of Ministry of Finance Japan

To issue a bond in Tokyo bond market, there are two methods, Securities Registration Statement (SRS) and the Hakkou-Touroku (Shelf).

Table 1: comparison of the two methods of issuance

	SRS	Shelf
outline	The issuer must submit a securities registration statement (SRS) to the prime minister on offering or selling securities. However, it is not necessary to file a statement “if a disclosure has already been made about the securities”, “if the intended buyers are qualified institutional investors (professional private placement)” and “if the total issue amount or issue price is less than 100 million yen”. When a statement is filed, it instantly becomes available to the public, and the issuer who is offering or selling the bonds can immediately begin soliciting investors. However, actual sales cannot be made until the statement become effective.	Issuance companies that meet certain criteria can place securities on sale by filing supplement documents, which states only the terms of issue, without filing the offerings or secondary offerings of the said securities if they had filed a shelf registration statement on the planned offerings and secondary offerings of securities within a certain period of time with the Minister of Finance primarily.
Required documents	SRS and attachments (documents that are deemed necessary and appropriate in the cabinet ordinance for public interest or investor protection such as legal opinion and contract) A copy of the contract with signatures after the issuance conditions are determined. When an issuer whose securities are listed in a securities exchange submits a SRS, the issuer must send a copy of the statement to the exchange. When an issuer of over-the-counter stocks submits a SRS, the issuer must supply a copy to the National Association of Securities Dealers.	Shelf registration statement with attachments, Supplement and attachments.
Conditions	Samurai bonds are divided into sovereign bonds and corporate bonds. Both needs to meet the disclosure requirements of the Securities and Exchange Law. International organizations in which Japan is represented are exempt from filing this document. Disclosure format: Issuers of sovereign bonds must prepare the securities registration statement in accordance with “the Cabinet ordinance regarding the disclosure of the details of the issuer of foreign bonds, etc.” (foreign bond ordinance) Issuers of corporate bonds must prepare the securities registration statement in accordance with “the Cabinet ordinance regarding the disclosure of the details of the corporation” in the same way as domestic corporations. Language use for disclosure: Japanese	The issuer must meet the following two criteria: <1> continuous discloser The issuer must have submitted a financial report continuously at least for a year. <2> public information In addition to <1>, the issuer must meet at least one of the following four criteria. • Market value at the time of primary filing is 25 billion yen or more. • Market value beyond 10 billion yen or more and stock trading value beyond 10 billion yen. • The issuer has two or more credit rating equivalent to or better than A-by designated credit rating institutions. • The issuer is a company that can issue general mortgage bonds.
Credit ratings/listing	Optional. However, if the issuer has no credit ratings, it should be noted that “credit rating not obtained” in the notification statement.	
Applied law	Japanese laws	
procedures	The issuer submits a SRS. If an amendment is submitted to increase or decrease the issuance amount depending on the margin of change in the issuance amount, it would take two to four days until the amendment become effective.	The issuer set up a shelf for a scheduled amount and period (maximum period is 2 years). File the Supplement at each time of new issuance.(Supplement: documents that provide the information on conditions that were previously unknown. Major items of information are issue amount, term, issuance/redemption date, issue amount and rate.)
Time before launch	Statement will become effective after "15 days have passed" after the day it was submitted. Public holidays are included in the 15 days but the holidays at the beginning and the end of a year could be treated differently. (This is laid down as the period to inform investors from the view of investor protection. With the introduction of the EDINET, information is posted within 30 minutes to two hours after it is submitted.)	Registration become effective after “seven days have passed” since filing.
Market risk	If offering cannot be made on the day the conditions are determined, market risk of one to two days will arise until the day of offering.	In theory, it is possible to conclude all procedures on the day the primary filing becomes effective by submitting the Supplement.
Recent reforms		“Widening the qualification conditions of the users of Hakkou-Touroku” was enacted in January 2003. This allowed the non-listed, non-registered foreign corporations which previously were not allowed to employ the system to do so in the same way as the domestic non-listed, non-registered companies.

compiled by IIMA based on interviews with market participants

(1) Issuance by SRS

<1> Outline of the issuance procedures

On issuing a Samurai bond, the issuer must prepare and file a SRS to the Kanto Local Financial Bureau. The issuer must also disclose required information in accordance with the Securities and Exchange Law, but international organizations in which Japan is represented are exempt from this rule.

The documents for disclosure must be in compliance with “The Cabinet ordinance regarding the disclosure of the details of the issuer of foreign bonds, etc.” (foreign bond ordinance) for sovereign issuers and “The Cabinet ordinance regarding the disclosure of the information on the issuing corporation, etc” (ordinance on disclosure) for foreign corporate issuers just as for Japanese corporations. When the SRS is prepared, the statement and attachments (documents that are deemed necessary and appropriate in the cabinet ordinance for public interest or investor protection such as legal opinion and contract) must be filed. Fifteen days after the filing of the documents, the registered statement would be effective. When an issuer whose stocks are listed in the Stock Exchange files a SRS, the issuer should send a copy of the statement to the Stock Exchange. When an issuer of over-the-counter stocks files a statement, the issuer should send a copy to the National Association of Securities Dealers.

<2> points

Although issuance by filing a SRS was not structured to provide flexibility in fund raising, there are numbers of regulations that inhibit flexibility and efficiency.

First, items that are listed in the statement regarding the offering or secondary offering (securities information) that can be omitted according to the Securities and Exchange Law are limited to a few items such as issue amount and interest rate (others are underwriter, managing company, registration organization, place of principal and interest payment and down payment for application and so on) by the Cabinet ordinance. It is difficult to change the offering date after the statement is submitted and no changes in term or securities information (such as attachment of a special clause) are accepted.

Second, if an amendment is filed, it would take time until it will become effective. Sometimes it is difficult to expect how long it takes to be effective. If there is a change in the issue amount, it would take two to four days until the notification become effective and how long it takes depend on the margin of change. The issue amount may change depending on the movement of market environment. Since the effective date of the statement varies according to the margin of change, it would affect the offering date and could be an obstacle for a flexible issuance. In case “information on the issuer” is amended, the days required for amendment to become effective varies (in most cases it takes four days but it could take more days according to the item amended) and this becomes a significant obstacle when the offering is made internationally in various markets.

In addition, it is also pointed out that preparing SRS documents requires more paperwork and costs than that of Shelf.

(2) Issuance by Hakkou-Touroku (Shelf)

In Europe and the United States, shelf registration is used widely as a most time-efficient method of bond issuance. This method is handy when the market environment is volatile. Japan followed

this example and created the “Hakkou-Touroku” (Shelf) in 1988.

The advantages of issuance by Shelf compared to filing the SRS is that the method allows issuance at any time just by submitting Supplement provided that Shelf is set up for a scheduled amount and period. It also has the advantage of being able to shorten the period required to issue by 8 days compared to issuance by SRS¹.

In case of companies that are listed in the securities exchange (or over-the-counter), they can utilize this system to issue bonds if they meet the following two criteria by submitting the statement and attachments.

<1> continuous disclosure

The issuer must have submitted a financial report continuously for at least a year.

<2> public information

In addition to <1> the issuer must meet at least one of the following four criteria.

- Market value at the time of primary filing is 25 billion yen or more.
- Market value and stock trading value of the annual basis for past three years from the primary filing date is 10 billion yen or more.
- The issuer has two or more credit rating equivalent to or better than A- by designated rating agencies.
- The issuer is a company that can issue general mortgage bonds (Companies that come under the category are electricity companies, NTT, etc. Normal corporate entities do not apply)

Regarding the <2> public information criteria, initially there was a proviso that said that “the non-listed domestic companies could be eligible of primary filing by meeting the credit rating standard” but it was not applied to non-listed nonresident issuers. However, in the Cabinet ordinance reform of January 2003, the words “domestic companies” were deleted from the text. This enabled non-listed foreign companies to use the Shelf as long as it acquired the required credit ratings, in the same way that non-listed, non-over-the-counter domestic companies do. This increased the number of issuers that can take advantage of this method.

As a result of the various system reforms, the conditions for issuing Samurai bonds were improved to about the same standard as those for euro-yen bonds. There is still a disparity between the two issuances in the required fixed costs such as the lawyers’ fees for producing contracts and other documents required for issuance. This means that euro-yen bonds are preferred to Samurai bonds except for large scale issuances by issuers who can lower the per unit issuance cost.

(3) Types of bonds

The corporate bond registration system is a system unique to Japan and said to have been an unfamiliar system for foreign investors. But this system would make a shift to paperless. Following are the 3 types of bonds and the difference in the system depending on those types.

<1>Physical bonds

¹ In the case of issuance by Shelf, the issuer can launch a bond on the day when the issuer submits Supplement, provided that 8 calendar days have passed since the issuer had submitted the shelf registration statement.

Actual certificates which are issued unlike recorded bonds or book-entry transfer bonds.

<2> Registered bonds

Registered bonds are bonds whose holders are recorded at the registration institution (Bank of Japan for government bonds, private banks for others) in accordance with the book-entry system, instead of issuing physical bonds. The holders of bonds hold a “statement of registration” (registering the security name, face value, reference numbers, etc.) instead of the physical bonds, and the registration institution notifies the interest payment and redemption to the holders. On selling the bond, the settlement is made by changing the registered name from the transferor to the transferee (registration of transfer).

The current registration system for bonds, etc. is to be abolished on the date specified by a government ordinance to be issued by January 5, 2008. Then, all bonds should be issued as book-entry transfer bonds or physical bonds. As for the registered bonds and physical bonds that have already been issued, those that will be redeemed by the end of 2007 need not be transferred, but the others should be transferred to the book-entry transfer system by the end of 2007 to keep them eligible of special tax preference.

Until now, most of the corporate bonds issued by domestic business corporations were issued as registered bonds, and all nonresident issuances are the same.

<3> Book-entry transfer bonds

This is a system where information such as records on transactions are managed in the transfer account book (kept at the Bank of Japan for government bonds and Japan Securities Depository Center for corporate bonds and others) on the computer instead of issuing certificates in accordance with the “Transfer of Corporate Debt Securities Law”. Transfer of ownership rights of book-entry transfer bonds are conducted in a completely paperless method (electronic means) through a transfer between accounts and investors cannot request the issuance of actual certificates. This enables the issuers to decrease the cost of issuance because it is needless to issue physical bonds, including sample and reserve certificates, which was required under the registration system for corporate bonds² and others.

It is said that the need to confirm whether the bond holder is subject to tax payment or not is the obstacle to promote utilizing book-entry transfer bonds. This subject will be mentioned on later in the taxation part of this chapter.

2. Environment for the Nonresident Investors

(1) Developing the Market Environment

<1> Investment diversification

For nonresident investors who manage global bond portfolio, the most basic way to manage their assets is “diversified investment”, which aims to diversify issuer risks and improve yields. For these

² Currently, since there are registered bonds that were issued in the past still exists in the market, book-entry transfer and registered bonds exist in parallel. But by January 2008, the systems will be unified into the Book-Entry Transfer system for “corporate bonds”. (Some of the issued bonds would be redeemed and the others should be transferred into book-entry transfer bonds in order to maintain the same preferential tax treatment.)

nonresident investors, it is important the market has a developed infrastructure that enables “diversified investment”. The yen bond market is not highly regarded by nonresident investors because tax exemption scheme is applied only to Japanese government bonds (JGBs).

Diversification of investment to products other than US Treasury started in 1997-98 in the United States when the agency bond market began to expand. After a wide range of investors started to adopt the Lehman Brothers Index, it became quite notable that investors started to diversify their investment from investing only to sovereign and government agency bonds but also to private company mortgage bonds. The needs for bonds such as ABS and mortgage bonds are quite high, to such extent that the central banks, whose investment is on the conservative side, started to invest in the United States mortgage bonds. It is also said that some investors are even considering investing in RMBS of the Japanese Government Housing Loan Corporation.

<2> Credit products

Credit products issued by non-government issuers play an important role as investment tools.

Reflecting the demand for credit products that aim to meet the need for investment diversification and higher return, credit spread is tightening around the world. It is said that increasing oil money due to higher oil prices are also flowing in the credit products market

<3> Beginning of investment

(a) Japanese Government bond (JGB) transaction

To start JGB investment, a nonresident should either open a direct custody account at a domestic financial institution, which is a participant of the JGB book-entry system, or open a custody account at a financial institution which is a global custodian, then open a custody account at a domestic financial institution through the global custodian.

JGB transactions by nonresidents are currently exempt from withholding tax as long as they meet certain criteria. But it often happens that it takes a considerable time to open accounts and going through the procedure of being eligible of tax exemption, due to confirming whether the entity is subject to taxation or not.

(b) Transaction of corporate bonds and others

In the case of central banks, government agencies and international institutions, which are exempt from withholding tax:

About 10% of the foreign reserves in Asian economies are yen denominated. Since the interest rate for JGBs are very low at the moment, there are high potential needs for investing in corporate bonds and others with higher interest rates. Although many central banks and government agencies have custody accounts at the Bank of Japan, corporate bonds and others cannot be settled at the Bank of Japan. So they have to open custody accounts at private financial institutions, but arise of cost and credit risks become the issue then. As a result, some central banks have difficulty in opening the accounts.

In the case of private, nonresident investors:

Since withholding tax is applied, most of the private nonresident investors refrain from investing in corporate bonds and others, that is to say, government guaranteed bonds, local government bonds and corporate bonds and so on.

<4> Bond holding

Since there is a blackout period for name transfer twice a year, about three weeks per each, it is necessary to construct a portfolio consistent with this restriction when holding registered bonds. However, such considerations will not be needed after the corporate bonds and others shift to the book-entry transfer system.

<5> Settlement

(a) Settlement of JGBs

In the settlement of JGBs (including TB/FBs)³, the Bank of Japan Financial Network System (BOJ Net) is used both for funds and securities. Real time Gross Settlement was introduced in January 2001 and DVP settlement is applied on the BOJ Net.

(b) Settlement of corporate bonds and others

Since the book-entry transfer system for “corporate bonds” was launched on January 10, 2006 , book-entry transfer bonds are settled in the gross-gross DVP method at the Japan Securities Depository Center (JASDEC). The BOJ Net is used for fund settlement and the JASDEC for securities. Settlements are made by linking these two systems to manage account balances by recording the changes in the transfer account books held at JASDEC and the account management institutions.

(c) Utilizing Euroclear

Although Euroclear is a settlement system used by most of the nonresident institutional investors, yen bonds (JGBs, corporate bonds and others) cannot be settled through the system. One of the reasons for this is the issue regarding confirmation of the status of final investor, whether they are subject to withholding tax or not⁴.

If yen bonds (JGBs, corporate bonds and others) could be settled at Euroclear, it would increase the opportunities for nonresidents to acquire funds since it enables agile investment as soon as the decision was made. Actually, there are some nonresident investors who would like to consider investing in yen bonds if all yen bonds could be settled at Euroclear.

(2) Tax Issues

<1> Current tax exemption scheme

According to the current taxation, interest on book-entry transfer JGBs are tax exempt for nonresident and foreign corporations. However, for other government bonds and corporate bonds, interest incurs a national withholding tax of 15% except for foreign governments, central banks and some international organizations⁵.

There are two types of bonds in the secondary market for public and corporate bonds. One is the bond subject to withholding tax (taxable bonds) on interest and those that are not (non-taxable

³ Book-entry transfer system is not corresponding to inflation-indexed securities yet.

⁴ Other problems include an extensive system adjustment by Euroclear for the investment horizon calculation, which is required by the Japanese corporate bond transfer settlement law.

⁵ Withholding tax is exempt from interest received by domestic corporations with a capital of 100 million yen or more such as financial institutions, securities companies and public corporations.

bonds). Most transactions in the secondary market are in non-taxable bonds. This means that even among bonds with the same security name, taxable ones are less liquid than non-taxable ones⁶, which makes it difficult for entities that are subject to withholding tax, to participate in the secondary market of public and corporate bonds.

There are some nonresidents who cannot enjoy the tax exemption, due to the status of the final investor. Such cases are seen in nonresidents who settle through global custodians. Especially in the case of investment companies which are mandated asset management from the third party.

(Reference) Transaction of taxable government and corporate bonds

Since taxable bonds incur withholding tax at the time of interest payment, calculating the accrued interest becomes complicated for financial institutions. And also, since non-taxable bonds are the major products traded in the secondary market, it tends to be difficult to find a buyer for taxable bonds. Sometimes it cannot be sold. Consequently, the taxable bonds holders tend to hold them until the day of interest payment (name transfer date) and holding costs and repo-costs accrue. When securities companies buy taxable bonds, there are practices to offer a price after deducting such costs. As a result, the price of taxable bonds would be lower than that of non-taxable ones.

<2> Procedures for applying the non-taxable system for JGBs

To be eligible for tax exemption on interest arising from book-entry transfer JGBs, the “Application Form for Withholding Tax Exemption” must be submitted to the Director of the Nihombashi Tax Office. In the case of opening a transfer account with a domestic JGB Book-entry System participant (sub-custodians like domestic financial institutions or securities companies, which are the account management institutions of JGBs), the application should be submitted through the participant and the Bank of Japan. In the case of opening an account with a Qualified Foreign Intermediary (QFI), the application should be submitted through the QFI, its upper-positioned participants in Japan and the Bank of Japan. Although procedural requirement for interest tax exemption for nonresident holders of JGB was streamlined with the FY2005 tax reform, it is still pointed out that it is still complicated⁷.

The Law Concerning Book-Entry Transfer of Corporate Bonds, Etc. (the Law) requires the “account management institutions” to keep the “Transfer Account-Book”, and in the case of global custodians, who are foreign indirect participants, they are obliged to keep a ledger of all participants even when there are multiple indirect lower-positioned participants. This rule is said to exist to enable comparing them to the account books kept at the Bank of Japan. However, the Bank of Japan reviews all indirect participants at the time when they apply as the Foreign Intermediate Participants (FIP)⁸ and the necessity of asking the global custodians to keep the account-books of all participants

⁶ Sale price of taxable bonds are also lower than non-taxable bonds, because liquidity premium and tax and so on are deducted from the non-taxable bond price.

⁷ When the applicant first intends to be exempt from taxation, the entity should submit the “Application Form for Withholding Tax Exemption”. If there is a change in name or address after the application has been submitted, a “Application Form for Amendment” should be submitted at least one day preceding the date of the first interest payment after the change has been effected. It is necessary to submit the “Statement of the Holding Period” at least one day preceding the interest payment date of the book-entry transfer JGB, but the statement may be prepared and submitted by the JGB Book-entry System participant in Japan or the QFI which has received the Application Form for Withholding Tax Exemption. .

⁸ This is a qualification status that the Bank of Japan created in April 2001, for foreign financial institutions etc., such as a global custodian. In cases that transactions proceed in the order as, the Bank of Japan – direct depository –

seems to be low.

There are other procedural requirements that should be streamlined: administrative procedures to receive preferential tax treatment on dividends received by nonresidents based on tax agreements, authorization procedure for a QFI⁹, procedure for nonresident individuals and foreign corporations to be eligible for tax exemption on interest arising from book-entry transfer JGBs (coupon-bearing bonds) and procedures for being certificated as FIPs. It is also important to facilitate the judgment whether an entity is a non-taxable entity or not and to make the application form required for tax exemption unified.

<3> Tax exemption scheme for JGBs (treatment of foreign investment trusts)

“According to the tax exemption scheme on interest of coupon-bearing JGBs held by nonresident individuals or foreign corporations, the interest paid to foreign investment trusts that the offer for subscription of beneficiary certificates for the establishment of the foreign investment trust is made outside Japan (and has not been made in Japan), will be the subject of tax exemption scheme provided that the trusts fulfill certain requirements.”

In order to clarify whether the foreign investment trust comes under the category of “foreign investment trusts which come into the category of securities investment trust”, it is sometimes necessary to consult with the Nihombashi Tax Office or the National Tax Agency (division in charge of withholding tax) by handing over a prospectus with an establishment document attached (in Japanese). The concrete standard for qualification is listed as “eligible foreign securities trusts”, in the “expansion of the special tax treatment on interest on coupon-bearing JGBs¹⁰”, which is a part of tax reform related to coupon-bearing JGBs. The entity is eligible if <a> the foreign investment trust is (i) a securities investment trust or (ii) a public or corporate bond management investment trust (as prescribed in the Japanese tax laws), the offering of the beneficiary certificate related to the establishment of the foreign investment trust is made outside Japan, in addition, the prospectus for the foreign investment trust and other documents similar thereto contain statements to the effect that the solicitation for the subscription is equivalent to solicitation made pursuant to the same provisions, and <c> the offer for subscription of beneficiary certificates for the establishment of the foreign investment trust has not been made in Japan. However, these descriptions do not provide clear standards for entities without corporate status that is ineligible for this exemption.

<4> Confirming the status of the holder (question of the taxation status)

Since the taxation differs by the status of the holder, whether the holder is subject to withholding tax or is eligible for tax exemption, there is a definition that determines the entity legally responsible for tax withholding, according to the types of bonds. In particular, the entity responsible for withholding tax is; the place of principle and interest payment for physical bonds the designated

indirect depository – customer, then unless the foreign indirect depository acquires a FIP status, the associated foreign customers cannot be eligible for tax exemption.

⁹ A QFI is a foreign financial institution, etc., such as a global custodian, which has been: (a) designated as the account management institution prescribed in the Law Concerning Book-Entry Transfer of Corporate Bonds, Etc.; and (b) approved by the Bank of Japan as a Foreign Indirect Participant (FIP) in the JGB Book-entry System, and approved by the District Director of the Nihombashi Tax Office as satisfying the requirements, including having a head office or main office in a counterparty country that has a tax treaty with the article on the exchange of information with Japan.

¹⁰ The current system was originally implemented as “special treatment of tax on interest for a blanket registration of JGBs” in 1999 and has been reformed a number of times over the years.

place of payment for registration bonds, the issuer and issuing agent for the national tax and account management institution for the local tax for book-entry transfer bonds.

In the case of registered bonds, the designated place of payment confirmed the status of the final bond holder, by utilizing the bond holder information disclosed by the registration institution. But actually, it was difficult because of the confidentiality of the registration institution.

As for book-entry transfer bonds, it is understood that “It is taken that, interest payment information including whether the investor is subject to withholding national tax or not, must be provided to the issuer by the Securities Depository Center. The fee for this information is included in the new issue recording fee paid by the issuer to the Securities Depository Center through the issuance agent (although it is not written on the schedule of fees).”¹¹

<5> Tax exemption scheme for corporate bonds

To diversify investment, institutional investors generally exclude products that are subject to tax. The fact that only JGBs are tax exempt and all other domestic bonds (excluding Samurai bonds) such as government guaranteed bonds, local government bonds, corporate bonds and coupon bank debentures, are subject to withholding tax. And this is an obstacle for nonresidents to invest in Tokyo Financial Market.

Hedge funds perform active arbitrage transactions among government bonds, stocks and corporate bonds in the European and American markets. But it is said that there are many funds that refrain from starting investment in Tokyo Financial Market due to the taxation issue. For the Tokyo Financial Market to be preferred by non-resident investors, not only JGBs but also, corporate bonds and others should be eligible for tax exemption.

Recently, there is a debate led by the Ministry of Internal Affairs and Communication to study the possibility of making local government bonds eligible for tax exemption. Tax exemption should be applied widely to corporate bonds and others including government guaranteed bonds, FILP Institution bonds, corporate bonds, coupon bank debenture. If only local government bonds would be eligible, and others remain ineligible, it would be confusing for the market participants. It will also make the nonresident investors concerned about the basic attitude of the policy makers regarding the internationalization of Tokyo Financial market.

(a) Benefits for issuers

If products eligible for tax exemption increase, it will contribute to achieve higher yield. It will also meet the potential needs of nonresident investors who aim for efficient diversification of investment products, which leads to the expansion of investors of the Tokyo Financial market. The diversified investors would lead to stable fund raising funds.

(b) Benefits for investors

- Diversification of portfolio and credit

Tax-exempt will lead to a significant diversification in investment products. The variation of investment products, to such as short-term bonds which are rarely liquid in euro yen bonds, and bond issues that have a wider spread than euro yen bonds (such as government guaranteed bonds) would

¹¹ Kigyō no Shikin-chūtatsu no Enkatsuka ni Kansuru Kyōgikai. (2005).

enable investors ideal portfolio and ALM management.

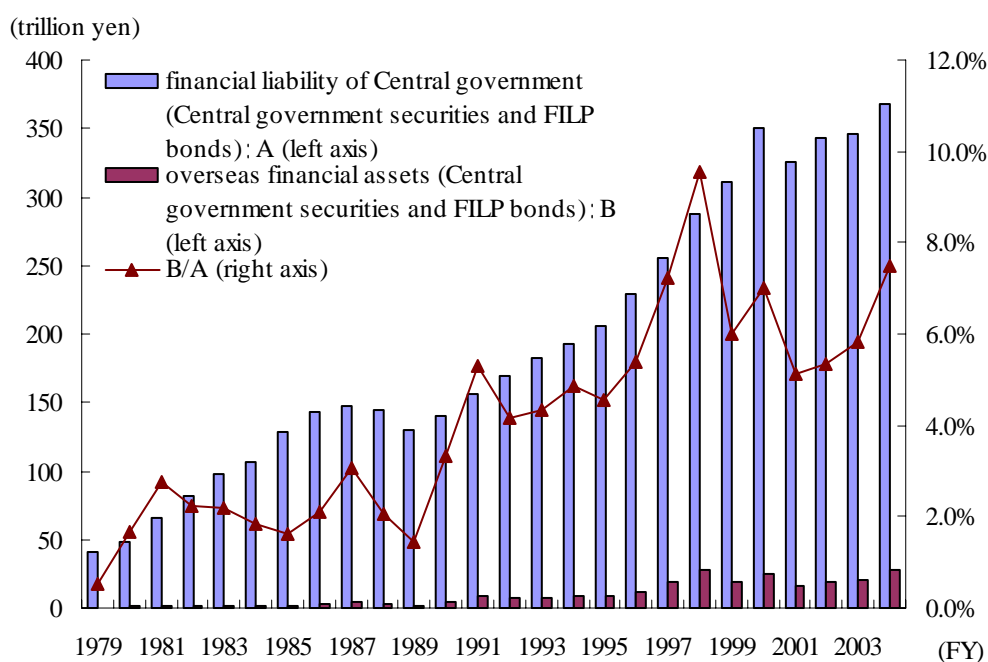
- The development of the derivatives market

Since the diversification enables ensuring the spread that reflects credit rating of the issuer, corporate bonds and others could be used for hedging the cash bonds of interest swaps and credit swaps.

It is difficult to give concrete figures of the increase in nonresident bond holders when tax exemption scheme were applied to corporate bonds and others. However, the increase in non-resident bond holders of JGBs could afford an instance of the figures.

Before and after 1999, when the tax exemption scheme was applied to JGBs, the holdings ratio increased from 3.5%, which was the average for the previous 20 years, to around 5%. (Figure 2). So, in the corporate bonds, we could expect the similar increase in the holding ratio.

Figure 2: Holdings of JGBs by nonresidents



(note) central government securities and FILP bonds held by Bank of Japan and the general government are deducted from financial liabilities of the central government
 compiled from the FLOW of FUNDS data, Bank of Japan

Besides the increase in holdings ratio, the change in taxation treatment could lead to a more active secondary market for corporate bonds.

Transaction shares of foreigners in the JGB secondary market was at average 5-7% before the abolition of withholding tax in September 1999, but after the abolition, it increased to 15-20%. Recently, the figures sometimes go up to 30%. Foreign investors have come to create a large a group as major domestic investors, such as city banks, trust banks and life insurance companies. Judging from this development, nonresidents can be expected to become major players in the corporate

bonds secondary market with the introduction of tax exemption scheme. This could lead to a significant increase in number of participants in the yen bond market, including JGBs, and stimulate the domestic yen bond market as a whole to become more active. And this would lead to the rise in position of the yen bond market, for the non-resident investors.

3. Conclusion

In order to make Tokyo bond market more active, it is important to make the yen bond market more attractive for nonresident issuers and nonresident investors. As has been discussed in this chapter, for issuers, the market environment equivalent to the euro yen bond in terms of costs should be prepared. Then it would lead to make the market attractive for institutional investors around the world to consider this market as one of the useful options for investment diversification. In concrete terms, <1> corporate bonds and others should be eligible for tax exemption in addition to JGBs and <2> the options for settlement system should be widened (for example, to begin yen bond settlement at Euroclear).

By taking these measures, the reputation of the Tokyo bond market should rise significantly from the viewpoint of nonresidents. Then increase of nonresident participants in both issuance and secondary markets could be expected, which will lead to the activated Tokyo financial market as a whole.

Chapter 3: Practical Steps toward Promoting the Use of the Japanese Yen for Trade Finance in Vietnam

Following the outcomes of the FY2004 research project “Study on Extending Yen-Denominated Trade Finance to Vietnamese Exporters to Japan” commissioned by the Ministry of Finance of Japan to the Institute for International Monetary Affairs (“IIMA”), the IIMA has provided technical assistance to the Socialist Republic of Vietnam (“Vietnam”) under the FY2005 research project “Promotion of the Use of the Japanese Yen for Trade Finance in Vietnam” commissioned by the Ministry of Finance of Japan to the IIMA, with a view to materializing pilot transactions of yen trade finance for Vietnamese enterprises. This chapter reviews the activities of the FY2005 research project and examines the outcomes.

1. Preparatory process for the FY2005 research project

The IIMA was commissioned in 2004 by the Ministry of Finance of Japan to conduct the research project for the FY2004 entitled “Study on Extending Yen-Denominated Trade Finance to Vietnamese Exporters to Japan.” The project focused on studying the feasibility of financial scheme on commercial basis (i.e. without any official support) in which Japanese banks in Vietnam provide with yen funds to Vietnamese commercial banks which in turn extend yen trade finance to Vietnamese exporters/importers. In the course of conducting the feasibility study, a number of parties participated in several meetings both formal and informal. Such parties included from the Vietnamese side the State Bank of Vietnam (“SBV”), the Ministry of Planning and Investment, the Ministry of Finance and the Ministry of Trade, state-owned commercial banks, joint stock banks, and exporters and importers; and from the Japanese side the Ministry of Finance of Japan, the Japan Bank for International Cooperation, Japanese banks in Vietnam and the IIMA.

The FY2005 research project “Promotion of the Use of the Japanese Yen for Trade Finance in Vietnam” has been intended to capitalize on the outcomes of the FY2004 research project. In order to have preliminary discussion on the FY2005 project with Vietnam, the IIMA visited Hanoi to meet with the International Cooperation Department (“ICD”) of the SBV in early September 2005. At the meeting, the IIMA proposed, in response partially to the requests made by the SBV at the final meeting of the FY2004 research project, that the activities under the FY2005 research project should cover within its basic framework the following points: (i) the IIMA and the SBV co-chair a working group to be formed with members from the relevant key Japanese and Vietnamese institutions; and (ii) the working group conducts a case study to review overall operational workflows of export and import transactions in Vietnam with a view to identifying operational issues relating to trade finance and settlement in general and any technical issues arising from using Japanese yen in trade finance and settlement instead of other currencies.

The ICD responded that it would have to carefully review the IIMA’s proposal, as the ICD would need not only to coordinate with the other SBV’s departments concerned and subsequently clear the Governor’s approval, but also to discuss the matter with the relevant Vietnamese ministries such as the Ministry of Finance and the Ministry of Trade. The ICD, however, indicated at the meeting its tentative comments as follows: (i) given the very limited use of the Japanese yen by Vietnamese enterprises, there would be little need for yen trade finance in Vietnam; and (ii) the project would meet to Vietnamese actual needs more effectively if it focused on capacity building for Vietnam in

such areas as foreign exchange risk management, use of hedging instruments, and introduction of best practices of Japan and other foreign countries in this regard.

After subsequent several discussions between the IIMA and the SBV in the following months, the both parties agreed on the basic framework of the new project that was broadly in line with the initial IIMA's proposal made in September. The IIMA, in consultation with the Ministry of Finance of Japan submitted to the SBV an official letter describing the details of the proposal of the FY2005 research project. The SBV accepted the IIMA's proposal in late November, which paved the way to the official start of the FY2005 research project.

2. Launching Meeting

The Launching Meeting was held at the SBV on December 9, 2005. The meeting was attended from the Vietnamese side by the SBV, state-owned commercial banks, joint stock banks, the Ministry of Trade, the Ministry of Finance and state-owned enterprises, and from the Japanese side by the IIMA and Japanese banks in Vietnam.

The meeting started with the opening remarks by the SBV, in which the SBV briefly reviewed the activities and outcomes of the FY2004 research project, and expressed its desire to see further progress under the 2005 project such as materialization of pilot transactions of yen trade finance.

Following the opening remarks by the SBV, the IIMA made a presentation in which the IIMA proposed to form a working group, comprising of the IIMA, the SBV, state-owned commercial banks, joint stock banks and Vietnamese exporters/importers, with a view to: (i) identifying problems of export/import transactions relating to trade finance in Vietnam in general, and finding solutions thereto; (ii) identifying problems relating to trade finance in Vietnam arising from using Japanese yen in export/import transactions, and finding solutions thereto; and (iii) pursuing the possibility of materializing actual transaction of yen trade finance in Vietnam.

In response to the IIMA's presentation on the proposed FY2005 research project, the SBV emphasized that Vietnamese businesses would benefit from yen trade finance in the following points:

- It will diversify financial tools available to Vietnamese exporters/importers;
- It will improve foreign exchange risk management skills of Vietnamese businesses including financial institutions with the Japanese yen being added to transaction currencies along with the Vietnamese dong and the US dollar;
- It will improve trade finance workflows for Vietnamese enterprises; and
- It will promote trade between Vietnam and Japan.

The SBV, based on the above arguments, proposed that the FY2005 research project should focus on: (i) materializing pilot transactions of yen trade finance; (ii) formulating workflows of yen trade finance; and (iii) identifying problems of yen trade finance through pursuing the implementation of pilot transactions, and finding solutions thereto. It also proposed to establish a working group as a task force team for the project.

After the subsequent discussion at the meeting between the IIMA and the SBV, it was agreed that the FY2005 research project should broadly follow the SBV's proposal and the activities should focus on pursuing materialization of pilot transactions of yen trade finance, and identifying problems arising from the pilot case and finding solutions thereto.

The IIMA was requested at the meeting by the SBV to select participating Japanese bank(s) and to

intervene in the negotiation process of the terms and conditions applicable to the yen loan(s) to be extended by participating Japanese bank(s) to Vietnamese bank(s). The IIMA, however, made it clear that the IIMA did not want to get involved in the selection process of participating Japanese banks as it intended to treat all the three Japanese banks in Vietnam at arm's length and to keep them informed of each development at the working group. It also made it clear that the terms of the transactions should be directly negotiated between the participating Japanese and the Vietnamese banks. The SBV understood and accepted the IIMA's position.

The SBV, emphasizing that yen trade finance transactions would need to be cost effective, stated in this connection that the project would also provide an opportunity to enlighten Vietnamese businesses including commercial banks in respect of cost comparison between financial terms including foreign exchange derivatives (e.g. forward contract) and to improve their risk management capabilities. The IIMA, in response to the SBV's request, stated that it would be ready to cooperate with the SBV by organizing a seminar or workshop on foreign exchange derivatives.

3. Activities of the Working Group

(1) The first meeting of the Working Group (held in late December 2005)

Following the Launching Meeting on December 9, the Working Group was formed between the SBV and the IIMA, and its first meeting was held in late December to discuss how to proceed with pilot transactions. The meeting was attended by the SBV and the IIMA, as the Working Group's members, and by the Vietnam Chamber of Commerce and Industry ("VCCI"), the Bank for Foreign Trade of Vietnam (Vietcombank, "VCB"), Agribank and VIETBID (local consulting company), as observers.

The VCB expressed their concerns about the difficulties of materializing pilot transaction of yen trade finance indicating that, given their clients were currently satisfied with finance in the US dollar there would be no incentives for them to use yen trade finance unless the yen financing package included official support such as interest rate subsidy and credit enhancement .

The IIMA clarified that the pilot transactions were intended as pure commercial deals that would not involve official support of any kind, and that the participating Japanese banks were to take the credit risks of the participating Vietnamese banks while the participating Vietnamese banks were to take the credit risks of participating Vietnamese enterprises. In response to the concerns expressed by the VCB about the difficulties of materializing pilot transactions, the IIMA argued that the concerns would appear irrelevant at least with regard to existing export transactions denominated in the Japanese yen. The IIMA's argument was based on the following. The share of yen denominated trade transactions as percent to total Vietnamese trade is estimated at around 5%, indicating that there exist Vietnamese enterprises that are already engaged in yen denominated trade transactions. The pilot transaction should aim at encouraging such enterprises to finance existing yen denominated trade transactions in the Japanese yen, not at encouraging Vietnamese enterprises in general to switch the denomination of trades from the US dollar (or other non-Japanese yen foreign currency) to the Japanese yen. If Vietnamese exporters use the Japanese yen to finance their yen denominated exports, they should be able to benefit from low interest rate of the Japanese yen, without being exposed to foreign exchange risk, as the exporters would be able to repay the borrowed money of yen trade finance by using the export proceeds in the Japanese yen to be received from Japanese importers. Such merit of yen trade finance, however, is not straightforward for yen denominated imports, as the

importers would be exposed to foreign exchange risks when they borrow in the Japanese yen to import goods from Japan to be sold in Vietnamese market in the Vietnamese dong. The importers need to compare financing cost on all-in basis including hedging cost before they decide on whether yen trade finance is more attractive than dollar or dong finance. Nevertheless, it should be noted that Vietnamese importers are going to have an additional financial option (i.e. yen finance) they can use for their imports. The IIMA, reiterating high feasibility of pilot deals, in particular for export transactions for the reason mentioned above, emphasized that the project should start with preparing a short list of enterprises that have already been engaged in yen denominated trade transactions. The Vietnamese side agreed to this approach.

The IIMA and the SBV agreed at the meeting that, in order to materialize pilot transactions, the following steps needed to be taken: (i) identifying enterprises that have already been engaged in yen denominated exports or imports; (ii) selecting participating Vietnamese bank(s); and (iii) starting bilateral talks between the relevant Vietnamese and Japanese banks. The IMA and the SBV also agreed that that they would meet again in early January 2006.

(2) The second meeting of the Working Group (held in early January 2006)

The IIMA and the SBV attended the meeting, at which the following points were discussed.

- The SBV announced that the VCB had been selected as the Vietnamese participating bank for pilot transaction(s), citing the reason for the selection that the VCB fully understood the background of the project and is a leading Vietnamese commercial bank in trade finance with strong credit standing. Accordingly, the VCB joined the Working Group as an official member.
- In reply to the IIMA's inquiry, the VCB indicated that the assumed size of the pilot transactions would be Japanese yen equivalent to approximately US\$200,000 for a finance period of one to two months.
- As to the participating Japanese bank(s) in pilot transaction(s), the IIMA strongly recommended that it would be desirable that all Japanese banks in Vietnam should be invited to the project by the Vietnamese participating bank, namely VCB, and that, even if the VCB had to reduce the number of participating Japanese banks at later stage due to limited number of pilot transactions, there would be no merits in attempting to narrow down the number of participating Japanese banks at this stage, in particular before the VCB started bilateral talks with each of the Japanese banks in Vietnam. The SBV and the VCB indicated that they would follow the IIMA's recommendation.
- The IIMA, the SBV and the VCB agreed that (i) the IIMA would inform the Japanese banks in Vietnam of the SBV's decision on selecting the VCB as the Vietnamese participating bank and of the VCB's acceptance, together with the information on the assumed size and term of pilot transactions; (ii) the IIMA would feed back to the SBV and the VCB about each Japanese bank's response to (i) above; and (iii) the IIMA, the SBV and the VCB would meet again thereafter to discuss how to proceed with bilateral talks between the VCB and each of the Japanese banks.

(3) Bilateral talks between the VCB and the Japanese banks

As agreed between the members at the second meeting of the Working Group, the IIMA visited all the three Japanese banks in Vietnam, namely, The Bank of Tokyo-Mitsubishi UFJ, Ltd., Mizuho Corporate Bank, Ltd., and Sumitomo Mitsui Banking Corporation (in alphabetical order) to inform

them separately of (i) above. All three Japanese banks indicated separately that they would positively consider their participation in the project. The IIMA reported to the SBV and the VCB about the Japanese banks' positive responses. The IIMA recommended the VCB should start bilateral talks with each of the Japanese banks as soon as possible, adding that the IIMA was willing to provide the VCB with necessary support to expedite the process.

The Working Group initially envisaged that the bilateral talks between the VCB and the Japanese banks would have started in late January before Vietnamese new-year holidays (the Tet). However, the bilateral talks took place after the Tet in the second week of February, as the VCB needed more time to go through internal procedures than it had anticipated. The discussion points at each bilateral talks included standby lines for the VCB for yen funds to be extended by each of the Japanese banks and hedging foreign exchange arrangements. As the bilateral talks were part of negotiation process for subsequent commercial deal between the VCB and each of the Japanese banks, the IIMA was not involved in the process.

In mid-February, the IIMA was informed by the VCB that the VCB and each of the three Japanese banks in Vietnam agreed in principle on the arrangement between them with regard to yen funds, and that the VCB would move as a next step toward starting negotiations with potential customers with a view to materializing pilot transactions.

(4) Bilateral negotiations between the VCB and its customers

In parallel with the bilateral talks with the Japanese banks in Vietnam, the VCB conducted extensive internal discussion about the yen trade finance schemes (e.g. financing structure, workflows, terms and conditions) that would be proposed to customers. In early March, a draft report was presented to the VCB's Board of Management. Further internal discussions were conducted among the departments concerned at the VCB (i.e. Financial Institutions Department, Corporate Banking Department, Trade Finance Department, Credit Risk Management Department, Export Payment Department, Import Payment Department and Treasury Department) to fine-tune their financial schemes. At the meeting among the departments concerned held in mid-March, the VCB officially agreed on the financial schemes of the yen trade finance covering pre-export financing, export bill negotiation, and import financing together with the relevant workflows.

After the board's approval, the VCB started official negotiations with potential customers with strong credit standing. In fact the VCB had already had preliminary discussions with such clients, as they had previously shown to the VCB their basic interest in yen trade finance. As is mentioned later in this report, a workshop on yen trade finance was held for the VCB's clients in the week of the Final Meeting held on March 21.

The IIMA, while paying due attention to confidentiality obligation, supported the VCB in their preparing for bilateral negotiations process. Such support included providing advice and information to the VCB on deal structure of yen trade finance and yen financing cost on all-in basis in comparison to other financings.

4. Seminar on foreign exchange derivatives

The IIMA and the SBV jointly organized a seminar on foreign exchange derivatives on March 21 morning with a view to improving foreign exchange risk management skills of Vietnamese businesses in particular banking institutions as it should be indispensable in utilizing yen trade finance.

The seminar was attended by the representatives from four state-owned commercial banks and four joint stock banks.

The IIMA's presentation focused on foreign exchange forward contracts and currency options, giving explanations on (i) how such derivatives' mechanisms work, (ii) how exporters or importers can make use of them, and (iii) how spot, forward and option markets are inter-related through arbitrage transactions and why the spot and forward markets need to be functioning effectively to make option market develop properly.

The SBV's presentation focused on Vietnam's current regulatory situation of foreign exchange derivatives, giving explanations by product (e.g. forward contract, options) as to restrictions, approval procedures and reporting requirements applicable to each of the derivatives. The SBV emphasized it had been steadily deregulating restrictions to promote the use of foreign exchange derivatives in Vietnam.

In answering the question from the audience as to the level of hedging cost of the Japanese yen and the Vietnamese dong, the IIMA admitted its rather high cost level, but explained that, should the size of foreign exchange transactions between the Japanese yen and the Vietnamese dong increase, the cost would be expected to decline eventually, and that, should Vietnam revise the current de facto US dollar-pegged Vietnamese dong foreign exchange system and make it more flexible one, more foreign transactions between the Japanese yen and the Vietnamese dong would be expected to take place in the market, which would result in reduced hedging cost between the two currencies.

5. Final Meeting

While the VCB had yet to negotiate pilot transaction(s) with potential customers, the Final Meeting was held on March 21 afternoon to receive reports from the members of the Working Group on their activities under the FY2005 research project and discuss the outcomes. The meeting was co-chaired by the SBV and the IIMA, and was attended by other officials from the SBV and the representatives from the VCB, the relevant Vietnamese ministries and the three Japanese banks in Vietnam.

(1) Opening remarks by the SBV as the co-chair of the meeting

The cooperative relations between Vietnam and Japan are reflected in three areas, namely ODA, Japanese foreign direct investment ("FDI") into Vietnam and trade relations between the two countries. In terms of ODA, Japan has consistently been the largest provider, followed by the World Bank Group and the Asian Development Bank. Japan has also been one of the three largest FDI investors into Vietnam. As for trade, the volume between the two countries reached a record high of US\$7 billion in 2005. Despite such close relationships between the two countries, the use of the Japanese yen in trade transactions has been quite limited. This raised two questions: (i) Why the Japanese yen has not been so popular in Vietnam? (ii) How we can promote the use of the Japanese yen in trades between Vietnam and Japan?

In 2004, the SBV and the IIMA conducted a research on the use of the Japanese yen in Vietnam, and interviewed banks and businesses. Banks we interviewed generally responded that the use of the Japanese yen would be feasible but indicated that it would depend on trade contracts between importers and exporters in the two countries. Vietnamese enterprises interviewed by us responded, however, that they would be reluctant to use the Japanese yen, indicating their past experience of

large fluctuation of Japanese yen exchange rate and resulting adverse effects on their imports denominated in Japanese yen. The 2004 research project concluded that further research need to be conducted through pilot transactions.

Yen denominated trade finance facility is a commercial instrument with natural hedging effect. In the context of under-developed forex derivative markets in Vietnam, this facility will provide an additional hedging tool in addition to other conventional hedging instruments. By using the Japanese yen in trade finance activities, it would be expected that Vietnamese businesses would obtain more hedging skills.

The SBV expects this meeting will provide an excellent opportunity to help Vietnamese businesses understand the advantages of using the Japanese yen in commercial activities in general and trade finance in particular. The presentations made by the members of the Working Group will illustrate progress of the project.

(2) Presentations by the IIMA, the SBV and the VCB

The outlines of the presentations by the IIMA, the SBV and the VCB are as follows:

<1> The IIMA's presentation "Promotion of the Use of the Japanese Yen for Trade Finance in Vietnam 2005-2006"

The IIMA emphasized the following points as advantages for Vietnam of using yen trade finance: (i) Using the Japanese yen to finance export/import contract denominated in Japanese yen will be a natural hedge against foreign exchange risk and reduce interest payment cost; (ii) It will provide major Vietnamese banks with additional financial products, thus enhancing banks' ability to meet potential needs of their clients; (iii) It will facilitate major Vietnamese banks to improve their institutional capacity, and eventually strengthen their position in international financial market; (iv) It will diversify financial tools available to Vietnamese exporters and importers; (v) It will improve foreign exchange risk management skill of Vietnamese businesses with the Japanese yen being added to transaction currencies along with the Vietnamese dong and the US dollar; and (vi) It will promote trade between Vietnam and Japan, and enhance further economic ties between the two countries.

The IIMA, referring to the changing economic and financial environments in several Asian countries (e.g. moves to managed float system by China and Malaysia) and increasing trend of regional cooperation among the East Asian countries in coordinating foreign exchange rate policies, pointed out that Vietnam would need to follow up such developments in the region, and that Vietnam would eventually find it useful and necessary to add the Japanese yen to its transaction currencies along with the Vietnamese dong and the US dollar. The yen trade finance would provide Vietnam with a good opportunity to make steady progress in this regard.

The IIMA, in its slide presentation, detailed the deal structure of yen trade finance, and explained the exporters of yen denominated trade contracts would not be exposed to the Japanese yen versus Vietnamese dong exchange rate risk and would therefore secure low interest rate of the Japanese yen without hedging cost.

The project development since the Launching Meeting on December 9 was also reported by the IIMA, in particular the bilateral talks between the three Japanese banks in Vietnam and the VCB. The IIMA made a special mention in this connection on the three Japanese banks' accommodative

stance with respect to yen funds for the pilot transactions to come, adding that the IIMA hoped that all three Japanese banks would be able to participate in the transactions.

<2> The SBV's presentation "Implementation of Pilot Yen Denominated Trade Finance Transactions 2005 Project"

After the SBV stated the 2005 project had planned to select banks and customers to join the pilot transaction, to realize one to two pilot transactions, to identify problems and solutions for Vietnamese banks and exporters and importers, and to transfer know-how and techniques in dealing with derivatives for hedging purpose, it listed the following points as the project's outcomes: (i) a creditworthy bank had been selected to conduct the pilot transactions; (ii) negotiations between the participating bank and Japanese banks had been completed successfully; (iii) a scheme of the new product named as "yen-denominated trade finance product" had been prepared; (iv) a list of potential customers had been made; (v) a workshop between the VCB and its potential customers would be held; (v) most important features of transaction with importers and exporters had been designed by the VCB.

The SBV, on the other hand, cited the following as the challenges which Vietnam had encountered: (i) unexpected problems in preparing new and complete scheme for yen denominated trade finance facility at the VCB in terms of workload and timeframe; and (ii) difficulties in identifying customers with potential needs to use yen finance for their yen denominated commercial contracts (although 1% of total Vietnamese external payment transactions are denominated in the Japanese yen, it was not easy for Vietnamese banks, even a big bank like the VCB, to find the right targeted customers.) The SBV stated that, although pilot transactions were unlikely to be materialized before the current project would expire toward the end of March, it would undertake to see to it that the VCB would pursue the materialization of the pilot transactions thereafter.

The SBV ended its presentation by expressing its expectations for the phase after the current project, in particular the prospects for broadening the base of yen trade finance in terms of both participating Vietnamese banks and enterprises.

<3> The VCB's presentation on "Promotion of Trade Finance in the Japanese Yen: a Pilot Case with Vietcombank"

The VCB summarized the developments of the project at the bank as follows: (i) the VCB was officially selected by the SBV for pilot transactions and became a member of the Working Group; (ii) bilateral negotiations with the individual Japanese banks for yen financing; (iii) constructing the scheme of the yen trade finance for customers; (iv) bilateral negotiations between the VCB and its customers; and (v) holding a workshop for the VCB's customers. The VCB reported process (iv) above was more difficult than they had expected, as yen trade finance was totally new financial product for the VCB's customers and the customers were not readily willing to accept yen trade finance. As such, the internal process to develop new products became more time-consuming than they had anticipated, the VCB cited. (The author of this report would guess the reason for such time-consuming process within the VCB might be that, given the high volatility of the Japanese yen versus the Vietnamese dong exchange rate compared with stability of the exchange rate between the US dollar and the Vietnamese dong, changing the denomination of trade finance from the US dollar to the Japanese yen would require the VCB to make radical changes to the bank's whole business

process of trade finance.) The VCB stated that it would continue its ongoing efforts to reach basic agreement on the pilot transactions promptly and expressed its desire for the continued supports to the VCB from the SBV, the IIMA and the Japanese banks.

(3) Question and answer session

Following the presentations by the SBV, the IIMA and the VCB, the floor was open to question and answer. The following comments and remarks were made during the Q&A session.

The IIMA commented that the institute was prepared to provide the VCB with its continued support to the materialization of the pilot transactions from Tokyo by e-mails, although the current project would be expiring toward the end of March.

The SBV commented as follows. One of the most important factors deciding on the current limited use of the Japanese yen in Japan-Vietnam trade financing is the big fluctuation of Japanese yen exchange rate in the past, causing many Vietnamese trading companies and financing banks then to double their indebtedness. That phenomenon brought in the relevant companies' painful psychological effect that long-lasting up to now that many companies are still reluctant to use the Japanese yen. Given the above, the following should be addressed. First, the financial advantage of using the Japanese yen, with new developments in Vietnamese operating environment (namely, increased trade between Japan and Vietnam; improved legal framework in foreign exchange derivatives and enhanced capacity of banks in this field), needs to be proved evidently. This can be shown by the result of pilot transactions in the Japanese yen in which the participating companies can compare the result of using the Japanese yen with that of using the US dollar. The overall advantage of using the Japanese yen will be decided by the combination of the interest rate of the Japanese yen which is quite low at the moment and the cost for foreign exchange hedging instrument. Secondly, if and when the financial advantage of using the Japanese yen, through the result of the pilot transactions, shall have been evidenced, the next step should be focusing on persuading customers on the proved advantages so that they could overcome the psychological effect of using the Japanese yen in the past and change their mind. With that aim, the SBV expects that Vietcombank could soon complete its deals of pilot transactions successfully.

The VCB commented as follows. The VCB started meetings with its customers right after it was selected as the participating pilot bank by the SBV. Generally, their feedback is positive. However, customers all are cautious on hedging products since they are worried about the fluctuation of the exchange rate of the Japanese yen versus the Vietnamese dong. In order to persuade customers, the VCB is also offering to provide them with arrangement to protect against such risk. The VCB expects the customer to take into account such protection mechanism, though they need some more time to examine the benefit if they accept VCB's proposed financial scheme.

The SBV wrapped up the question and answer session as follows. "The SBV believes all the presentations made so far have provided the participants with clear understanding of the project. The VCB has explained the challenges in realizing the pilot transaction. But, most of the basic elements for the transaction have already been in place. The SBV will follow up closely the negotiation and agreement process between the VCB and its customers. The SBV and the VCB will stay committed to the realization of the pilot transaction. The SBV will work closely with the VCB on this matter and will keep the IIMA posted of any progress of the pilot transactions."

(4) Closing remarks by the IIMA as the co-chair of the meeting

The IIMA delivered the closing remarks for the Final Meeting as follows. “When the preparatory work for the project on pilot transaction started in December last year, we hoped that the parties concerned, namely Vietnamese bank and traders, and Japanese banks would reach agreement in principle on a couple of pilot transactions of yen trade finance before the Final Meeting. Unfortunately, that has not happened. However, we know very well that each of the parties concerned did their best to try to materialize the deals. Firstly, the IIMA appreciates very much for the cooperation extended by the three Japanese banks in Vietnam with respect to yen stand-by facilities for the VCB for the pilot transactions to come. The IIMA is aware that the three Japanese banks have been eagerly waiting for the VCB to come with actual transactions. Secondly, the IIMA also appreciates that the VCB has been doing its best for the project. The VCB has organized a bank-wide project team and has conducted comprehensive studies on the new products as well as internal workflows, and now has started marketing the products to the bank’s potential customers. The IIMA is aware that VCB has strong commitment to doing its best towards the implementation of the pilot transactions, and intends to reach basic agreement promptly. Thirdly, the IIMA also appreciates that the SBV has made every effort in providing guidance to the parties concerned and encourage them to overcome the challenges. As we emphasized in our earlier presentation, it is important for the Vietnamese monetary authorities, financial communities and businesses, to get prepared for changing financial and economic environment. It is in this perspective that pilot transaction of trade finance in yen will have a significant meaning as part of the efforts for such preparation by all the Vietnamese parties concerned. Although the current project expires toward the end of March, it should be noted that the Japanese authorities concerned will continue to closely follow up what will happen with the ongoing pilot cases. Should the pilot transactions go well, the IIMA believes it will definitely have a positive implications for considering programs for next year. The IIMA therefore would like the SBV and the VCB to fully inform the IIMA of the progress of the ongoing negotiations of the pilot transactions.”

6. Bilateral meeting between the SBV and the IIMA after the Final Meeting

As the pilot transactions did not materialize on or before the Final Meeting, the IIMA and the SBV had a bilateral meeting on the following day to discuss how the pilot transactions should be followed up after the FY2005 research project would expire toward the end of March 2006. The IIMA requested the SBV to follow up the subsequent negotiation process between the VCB and its potential customers on the transactions and to inform the IIMA of the status of the progress, which the SBV accepted. The two parties also discussed public relations issues which they would have to consider if and when the pilot transaction materialized.

7. Workshop on yen trade finance by the VCB for its customers

As part of the FY2006 project, the IIMA sponsored a workshop on yen trade finance that was held by the VCB for its customers in the week of the Final Meeting. The workshop was attended by 12 VCB’s clients. The VCB made presentation on its proposed yen trade finance scheme, giving detailed numerical explanations on each of the financing cost of the three financing cases, namely US dollar denominated finance, Vietnamese dong denominated finance, and Japanese yen denominated finance, together with hedging costs that should be required for protecting against

relevant currency fluctuation, for assumed export and import transactions, and emphasized the attractiveness of yen trade finance. The VCB also gave explanation to its customers about foreign exchange hedging instruments such as forward contracts and options in accordance with case examples. The VCB indicated its customers at the meeting responded positively to VCB's yen trade finance schemes.

8. Achievements

Following the preparatory process for the period from September to November 2005, the project officially started at with the Launching Meeting on December 9, 2005. The project went into full swing with the formation of the Working Group by the SBV and the IIMA toward the end of December. The activities of the Working Group moved to a second phase with the VCB's joining the Working Group in early January 2006. In order to pursue materialization of yen trade finance with Vietnamese enterprises, the VCB started bilateral talks with Japanese banks in Vietnam in respect of yen funding related issues while it made bank-wide efforts to develop new product (i.e. yen trade finance) and workflows. The VCB also prepared for commencing bilateral negotiations with potential customers. The SBV and the IIMA actively provided indirect support for the project.

While the scope of the research project of the FY2004 had been contained to discussing the feasibility of yen denominated trade finance, the FY2005 project made a big step forward toward materializing pilot transactions of yen trade finance, including formation of the supporting framework. The achievements under the FY2005 project could be summarized as follows:

- (i) It was confirmed that each of the three Japanese banks in Vietnam was ready to provide the VCB with cooperation in connection with the necessary yen funding for the VCB for its pilot yen trade transactions with its customers.
- (ii) The project helped the Vietnamese participating bank gradually recognize that yen trade finance would provide a good opportunity for the bank to improve its institutional capacity for diversified financial products and risk management.
- (iii) The VCB made marketing efforts to materialize yen trade finance with potential clients. These efforts included organizing a workshop to enlighten its clients by giving detailed numerical explanations on each of the financing cost of the three financing cases, namely US dollar denominated finance, Vietnamese dong denominated finance, and Japanese yen denominated finance, together with hedging costs of the derivatives to be used (e.g. forward contracts and options), for assumed export and import transactions.
- (iv) Although the pilot transactions have not been materialized before the expiry of the current project, the VCB is still continuing its efforts to reach basic agreement with its potential clients. The SBV is also continuing to provide its support to the VCB.

9. Conclusion

If we put the FY2005 project in retrospect, we were initially concerned about what we had felt in the level of enthusiasm of the Vietnamese side toward materializing pilot transactions. However, we were convinced that such concern disappeared completely at later stage.

We would like to point out that the development of the sense of strong ownership of the project on the part of Vietnam has made the Vietnamese side more committed to the project. Indeed, fostering the sense of ownership by Vietnam has been the very point to which the IIMA, as the commissioned

promoter, has taken the utmost pain in the process of promoting the project. From the perspective of the importance of building sense of ownership on the part of the recipient country of technical assistance, we would like to note particularly the following points.

(1) The project has been promoted by the IIMA as part of the bilateral technical assistance budgeted by the Japanese government, taking fully account of Vietnam's needs and requests. In addition, the project has been fully participated by the Vietnamese side. It is of note that this project has been jointly promoted right up until the last stage of the program, which we believe would make this technical assistance project unique and substantially different from those technical assistances traditionally provided by the multinational agencies, or by Europe or the United States.

Technical assistances are typically conducted by international consultants who would prepare prescriptions for the recipient countries in accordance with the commissioned projects, without active participations by the countries in the relevant projects. Once such prescriptions by the consultants are completed, they tend to be left ignored without any follow-up actions by the recipient countries.

Under the FY2005 research project, the IIMA, being commissioned by the Ministry of Finance of Japan, through close consultation and co-work with the SBV (the Vietnam's counterparty of the project), focused to identify the needs of Vietnam's side in drawing up the details of the project. The major points so identified through the process of the close co-work between the IIMA and the SBV are described below together with the subsequent developments in each area.

(i) The SBV had keenly realized the lack of experiences and skills of Vietnamese businesses with respect to foreign exchange risk management and felt the need for capacity building in banking and corporate sectors in this regard. As described in the preceding section, the IIMA and the SBV organized, as part of the current project, a seminar on foreign exchange derivatives.

(ii) It was initially assumed that the project would conduct simulations for hypothetical export and import transactions using market-based rates that would be applicable to real transactions. However, it was subsequently recognized strongly by the Vietnamese side that ensuing materialization of real transactions for pilot case would be more conducive to capacity building. Such recognition apparently motivated the SBV to provide its strong support to the whole process of the project and tenuous encouragement to the VCB.

(iii) The IIMA, on the other hand, emphasized the merits of providing yen trade finance for the VCB, by appealing it would diversify the financial products by the VCB and lead to the enhancement of bank-wide institutional capacity in foreign exchange risk management, and strongly encouraged the VCB to pursue such merits through materializing pilot transactions. We believe that the sense of the ownership of the project by the VCB was fostered with increasing recognition by the VCB of such merits.

(2) What we became painfully aware of through conducting the FY2005 research project was the fact that Vietnamese businesses (both banks and companies) have been, and still are, extremely cautious about the high volatility of the Japanese yen, as they saw at one stage back in late 1990s the Japanese yen hit its strongest against the US dollar below 80. This cautiousness is the major cause for the reluctance of the use of the Japanese yen by the Vietnamese businesses. As was commented by the SBV during the Q&A session, the Vietnamese businesses' memories about the high volatility

of the Japanese yen, which had caused huge losses on their import transactions in the past, have been so vivid that they are still reluctant in using the Japanese yen. However, as was also stated by the SBV, the business operating environment has changed and improved substantially in recent years, with new developments in regulatory framework of foreign exchange transactions including risk hedging instruments (e.g. derivatives) and enhanced capacity of commercial banks in this regard. We would like to note that the SBV commented to the effect that Vietnamese enterprises' psychological resistance to use of the Japanese yen would be eventually overcome if and when the Vietnamese enterprises would be offered evidently by the Vietnamese banks with the detailed yen financing terms which would be effective in terms of all-in cost compared with other financing methods and that it therefore hoped the VCB would successfully complete the pilot transactions. Please refer to section 5 (3) for Q&A session.

In the process of promoting the FY2005 research project, the IIMA focused to draw SBV's attention to the following points so that the project would have implications for potential important needs for Vietnam in the future from a longer range perspective.

(i) With expected further developments of coordination in foreign exchange rate policies among the countries in the Asian region, the currencies in the region are likely to move in a relatively stable range vis-à-vis the other regional currencies whereas they are likely to fluctuate freely vis-à-vis non-regional currencies (e.g. the US dollar and the euro).

(ii) It is important that the SBV, as the monetary authority, and Vietnamese banks and enterprises should get prepared for the expected economic and financial developments in the Asian region as envisaged in the above.

(iii) Adding the Japanese yen to Vietnam's transaction currencies along with the Vietnamese dong and the US dollar should be a useful and necessary step for the country's economy. Promoting the use of yen in trade finance in Vietnam should have significant meaning from this perspective.

We believe the SBV's awareness of the needs in the future from a longer range perspective as discussed above should have enhanced the sense of the ownership of the project by the SBV.

(3) The SBV, as a member of the Working Group, exercised its leadership on the part of Vietnam in encouraging the ministries concerned, commercial banks and enterprises to participate in the public discussion process. The public discussion process proved to be very successful in that it provided the participants with excellent opportunities for exchanging views and building capacities by educating each other. In addition, the public discussion process clearly created the sense of the ownership of the project among the Vietnamese participants as a whole.

The pilot transactions of yen trade finance have yet to materialize at the time of this writing. Should the transactions materialize, it will definitely have an epoch-making significance. It should also be pointed out that a strong sense of the ownership of the project by the Vietnamese side, both public and private, has been clearly fostered in the process of pursuing the pilot transactions, which we believe will have a very positive bearing on the eventual materialization of the transactions. We also believe that a leading role played by the Japanese side to foster the sense of ownership by Vietnam would offer a valuable insight for the way in which technical assistance is to be implemented.

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