JAPANESE OFFSHORE BANKING: TOWARD A WORLD FINANCIAL CENTER IN TOKYO

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As part of a movement toward deregulation and internationalization of the Japanese financial system, policymakers in Japan are preparing to establish an offshore banking unit (OBU), similar to those already operating in New York, London, Singapore and Hong Kong. In this article, Dario F. Robertson examines (1) the probable institutional form of the Tokyo OBU; (2) its macroeconomic implications; and (3) suggestions for appropriate changes in Japanese policies to be pursued after the establishment of the OBU. He argues that the creation of an offshore banking facility in Tokyo is a feasible and desirable intermediate policy that will move the Japanese financial system significantly, if not inexorably, closer to complete deregulation. Robertson concludes that institution of an OBU in Tokyo will establish Japan in its rightful place as the predominant Asian financial center.

I. INTRODUCTION

Throughout most of the postwar period, Japanese regulation of capital markets has undergone slow and uneven liberalization. Close control of interest rates, capital outflows and domestic credit has been the hallmark of the Japanese approach to banking regulation. The deregulation of Japanese capital markets has historically proceeded at a pace lagging significantly behind unequivocal improvements in their inherent competitive strength and stability, as was the case in 1964 when Japan abandoned exchange controls over current transactions pursuant to Article 8 of the International Monetary Fund Agreement at the behest of impatient trading partners.[1] Japan is again being asked to speed the pace of deregulation

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1. Lawrence Krause and Sueo Sekiguchi, "Japan and the World Economy," in Hugh Patrick and Henry Rosovsky, eds., *Asia's New Giant* (Washington, D.C.: Brookings Institution, 1976), p. 426; G.C. Allen, *The Japanese Economy* (New York: St. Martin's Press, 1981), p. 168; Articles of Agreement of the International Monetary Fund, 27 December 1945, 60 Stat. 1401, T.I.A.S. No. 1501, 2 U.N.T.S. 39.

in the financial sector at a time when the pressing need for more extensive "internationalization" and its obvious feasibility are making the current regulatory regime increasingly difficult to justify. In response to these new pressures and possibilities, Japanese policymakers are preparing to institute an "offshore banking unit" (OBU) in Tokyo. With the liberalization of Japanese capital markets, Tokyo may finally assume its natural role as the financial center of East Asia. In light of the profound international economic ramifications of such a development, the new proposal warrants the close analysis of foreign policymakers and potential market participants.

II. OBU Institutional Form

The Ministry of Finance (MOF) has delegated the task of drafting the blueprint for the Tokyo OBU to a special study group headed by Tokyo University economist Ryutaro Komiya. The Komiya group is presently reviewing the findings of the MOF "survey mission" dispatched in the spring of 1982 to analyze the operation of offshore banking centers in New York, London, Singapore and Hong Kong.[2] The "Nisuikai Banks," a group of fourteen authorized foreign exchange banks, have also independently prepared an "interim report" on the operational requirements of the Tokyo OBU, and the report is expected to influence the final recommendations of the study group.[3] Whatever the specific details of the Komiya group's forthcoming recommendations, they will undoubtedly be framed within the policy parameters set by the political compromise presently being negotiated by the MOF and the Bank of Japan (BOJ) on the scope of permissible OBU operations.

Japanese policymakers must decide which functional attributes of other offshore banking centers should be incorporated into the Tokyo OBU. At a minimum, most offshore banking centers presently in operation offer nonresident (and sometimes resident) depositors the opportunity to open accounts with authorized banks in designated currencies. These accounts are usually free from withholding taxes, interest rate ceilings and foreign exchange controls. The funds invested in these deregulated international money markets are typically kept strictly segregated from domestic accounts and used for loans to other nonresidents on competitive terms, usually subject to the condition that credit be extended only for the purpose of financing external international transactions.

2. The MOF mission was headed by Takashi Hosomi, president of the Overseas Economic Cooperation Fund of Japan and former MOF vice-minister. Akira Arai, "Establishment of 'Tokyo Offshore Market' Will Fulfill Japan's International Obligation," *Japan Economic Journal* 12 October 1982, p. 34. Professor Komiya's Study Group for International Finance reports to the Director General of the MOF International Finance Bureau. Tochiro Matsutani, "Moves to Establish Offshore Money Market," *Oriental Economist*, August 1982, p. 18.
3. "Nisuikai Banks Present Interim Report," *Japan Economic Journal*, 24 August 1982, p. 3.

There are, however, wide-ranging differences in the specific operational characteristics and regulatory framework defining each of the several offshore centers dispersed throughout the world.[4] Given the immediate financing needs of Japanese banks, the basic characteristics of Japanese capital markets, and a variety of exogenous political constraints, the most likely institutional configuration of an offshore banking market in Tokyo would have the following attributes:

(1) the deregulation of offshore transactions in *both* foreign currencies (especially, the dollar) *and* yen;
(2) the segregation of transactions in the home currency into domestic and offshore accounts in accordance with conventional "out-out" bookkeeping criteria;
(3) the consolidation of *both* nonresident *and* resident foreign currency transactions in the offshore account;
(4) withholding tax exemption for interest earned on all nonresident deposits;
(5) the removal of interest rate ceilings on all OBU deposits;
(6) decontrol of nonresidential offshore fund management;
(7) exemption from reserve requirements for offshore yen deposits of nonresidents and residents;
(8) the exclusion of all offshore accounts from the domestic deposit insurance system;
(9) retention of the corporate tax on resident and nonresident income earned from offshore banking activities.

While this description of the probable regulatory framework of the Tokyo OBU may be optimistic, it is nonetheless a realistic projection in light of the most recent indications of the regulatory authorities and the operational prerequisites that must be satisfied to create an effective, competitive offshore banking market in Tokyo.

Despite recent reports that the Tokyo OBU would be initially limited to transactions in either dollars or yen, it seems more likely that use of *both* dollars (as well as other foreign currencies) and the yen will be allowed in offshore market transactions. First, a rule limiting OBU transactions to a specific currency could be circumvented through creative use of forward foreign exchange contracts. For example, to avoid restrictions on yen OBU

4. Offshore banking markets have been established in New York, London, Luxembourg, Hong Kong, Singapore, Bahrain, Panama, Nassau, Grand Cayman, and Bermuda. Their size and functions differ greatly. Arai, "Establishment of Tokyo Offshore Market," p. 34. For a more detailed analysis of the regulatory structure in each of the foreign offshore centers, see Walter H. Diamond and Dorothy B. Diamond, *Tax Havens of the World*, 3 vols. (New York: Matthew Bender, 1983). Growth trends in North American offshore centers are documented in Rodney H. Mills, Jr. and Eugenie D. Short, "U.S. Banks and the North American Euro-Currency Market," *International Finance Paper No. 134* (April 1979) (on file Yale University Social Science Library).

deposits, a prospective yen depositor could arrange to have a bank sell yen for dollars in order to open the initial OBU account, while simultaneously entering into a forward contract with the foreign exchange department of the bank to buy back the deposited dollars and deliver yen on the date the deposit matures. By structuring the transaction in this way, the would-be yen depositor would receive essentially the same benefit as if he or she had opened a fixed-term yen deposit. While close government monitoring and administrative guidance might deter the use of such forward contracts, tighter supervision and control of the foreign exchange business could prove unacceptable not only to authorized foreign exchange banks, but also to the multinational concerns which patronize them.[5]

Second, both free yen and dollar transactions are important to the effective functioning of a Tokyo offshore market. To exclude either currency would construct a built-in operational imbalance that could conceivably threaten the market's long-term viability. As will be explained in greater detail in Section III, Euroyen must be attracted back to Tokyo so that Japanese authorities can oversee the currency's increasing use in international reserves, investment and trade settlements. OBU dollars are needed to finance oil imports and offset the invisibles deficit. These considerations strongly suggest that a viable full-service offshore center in Tokyo "must from the outset include Euro-yen transactions in addition to ordinary foreign exchange business."[6]

The segregation of transactions in the home currency into domestic and offshore accounts, following the practice in the newly created offshore banking facility in New York, would be necessary to insulate the domestic money supply from the unregulated capital flows of the offshore market. Japan might also adopt "use-of-proceeds" requirements, such as those considered by the U.S. Federal Reserve Board in planning the implementation of the New York facility. Proceeds requirements would help to insure that OBU loans were used only in external international transactions by mandating that certain classes of customers file statements explaining their reasons for seeking offshore credit. Minimum deposit requirements could also prevent undue leakage from the offshore market into the domestic money supply by limiting the flow of funds into the offshore market to large monetary aggregates that can be more effectively monitored by government authorities.[7]

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5. For a similar example in the context of the New York facility, see Beth M. Farber, "International Banking Facilities: Defining A Greater U.S. Presence in the Eurodollar Market," *Law and Policy in International Business* 13 (1981): 1036-37.
6. Matsutani, "Moves to Establish Offshore Money Market," p. 22.
7. *Ibid.* p. 24; "Greater U.S. Presence in Eurodollar Market," pp. 1034-35; Regulation D, 12 C.F.R. 204.2(t) (minimum deposit requirement for New York Facility).

The consolidation of *both* nonresident and resident foreign currency transactions in the offshore account, following prevailing bookkeeping practices in the Hong Kong and Singapore offshore centers, would be necessary in order to absorb the existing "dollar call money market" in Tokyo. As Stephen Bronte explains, the "market was created in April 1972 to improve the access of small Japanese financial institutions to dollar funds."[8] Only authorized Japanese foreign exchange banks and foreign banks with branch offices in Japan can participate in the dollar call market. Japanese banks, however, currently maintain an estimated 80 percent market share. Exempt from reserve requirements and the withholding tax, the dollar call money market operates like a "domestic version of offshore market transactions in foreign currency deposits" and helps meet the trade financing needs of Japanese firms.[9]

Due to Japan's extraordinary need to maintain a stable and accessible source of dollars, *resident* foreign currency transactions, in addition to those of nonresidents will probably be incorporated into the new offshore account. The inclusion of residents would depart from procedures followed in New York, where depositors and credit beneficiaries must be nonresidents in order to participate in foreign currency transactions.[10] The establishment of an offshore dollar market alongside the domestic call money market would be senselessly duplicative and inefficient. Furthermore, the successful absorption of the dollar call money market into the offshore market would entail little more than (1) liberalizing the eligibility requirements for depositors and borrowers, and (2) providing foreign banks without branches in Japan equal access to the market.[11]

The withholding tax exemption, the deregulation of interest rates, and the decontrolling of nonresident offshore fund management are basic regulatory features shared by all free deposit markets. The removal of reserve requirements on offshore yen deposits and the exclusion of offshore accounts from the domestic deposit system would enhance the international competitiveness of the new market by exempting participating banks from insurance assessments and by providing for more discretion in the management of OBU accounts. Such a policy would also increase the risk of overextension of credit and bank failures.

While abolition of the withholding tax on the interest earned on nonresident deposits is essential to the creation of a fully competitive offshore center, preferential corporate tax treatment, by contrast, is unnecessary

8. Stephen Bronte, *Japanese Finance: Markets and Institutions* (London: Euromoney Publications, Ltd., 1982), p. 223.
9. Matsutani, "Moves to Establish Offshore Money Market," p. 24.
.0. *Ibid.*
.1. Arai, "Establishment of Tokyo Offshore Market," p. 35.

for the viability of the Tokyo OBU. Multinational firms tend to view Japanese-style withholding taxes that range from 10 to 20 percent as "unfair penalties" on the profitable use of investment capital, but have come to accept corporate income taxes as an inevitable cost of doing business in most jurisdictions.[12] Furthermore, bilateral tax treaties typically contain provisions extending credits for taxes paid in foreign jurisdictions, avoiding the problem of the double taxation of corporate income earned in Japan.[13] Only "transit financial centers" such as Panama and Bahrain, which exploit time differences when major markets are closed, and "tax havens" such as Nassau or Bermuda need to offer corporate tax exemptions to attract foreign depositors. In view of the high growth potential of the Asia-Pacific, the appropriate models for the Japanese offshore center are the London and New York facilities where corporate taxes are retained without compromising competitive strength.[14] Corporate tax revenues would also be desirable from a fiscal standpoint in an economy running a burgeoning government deficit.

III. Economic Implications of the Tokyo OBU

The Ministry of Finance and the Bank of Japan seem to have reached different conclusions regarding the economic implications of offshore banking in Tokyo. Their disagreement provides an enlightening point of departure for more in-depth analysis.[15] The MOF favors the creation of an offshore banking unit because it would (1) assure a degree of control over the accelerating internationalization of the yen; (2) provide Japanese banks with a stable source of dollars to finance mounting energy and raw material imports; (3) offer a politically acceptable alternative to relying upon earnings from merchandise exports as the primary means of financing Japan's growing invisible deficit; and (4) help minimize "foreign country risk" for both resident and nonresident depositors in search of more effective means of yen-asset management. The BOJ has taken issue with the MOF position on the grounds that (1) the loss of government revenue resulting from

12. The withholding rate on interest earnings from bank deposits in Japan made by U.S. depositors is 10 percent. U.S. governmental entities, such as the Federal Reserve Bank and the Export-Import Bank, are exempt from withholding taxes on interest earned on Japanese accounts. Walter H. Diamond, *Foreign Tax and Trade Briefs: International Withholding Tax Treaty Guide* (New York: Matthew Bender, 1983), pp. 11-14.

13. For example, see the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Incomes, 8 March 1971, Japan-U.S., 23 U.S.T. 967, T.I.A.S. No. 7365. *See also* Yoji Gomi, *Guide to Japanese Taxes* (Tokyo: Zaikei Shoho Sha, 1981), pp. 204-205.

14. Arai, "Establishment of Tokyo Offshore Market," p. 35. *See also Corporation Tax Law of Japan* (Law No. 28, March 31, 1947), *as amended by* Law No. 12, March 31, 1981, in *EHS Law Bulletin Series*, vol. 4, Section DA.

15. "Finance Ministry and Bank of Japan Conflict on Offshore Banking Market," *Japan Economic Journal*, 24 August 1982, p. 3.

the creation of a withholding tax exemption for offshore interest earnings would exacerbate the difficulty in financing Japan's enormous fiscal deficit; (2) "leakage" from the Tokyo OBU would seriously impede domestic monetary policy effectiveness; (3) offshore banking would adversely affect the government's power to influence the exchange rate by impeding the control of capital outflows and inflows; and (4) a Tokyo OBU would draw business away from offshore centers in Hong Kong and Singapore, generating new trade frictions among the Asian states.

Upon closer analysis, the MOF appears to have a more persuasive argument. First, Japan can no longer afford to ignore the increasing use of the yen as a settlement currency, an investment (or finance) currency and a reserve currency. Yen-denominated exports have jumped dramatically from barely two percent of total exports in the early 1970s to over 30 percent in 1980.[16] As Japanese exports continue to grow in the decade ahead, buyers of Japanese products will need improved access to yen funds to settle their accounts. In contrast to the expanded use of the yen to finance exports, Japanese imports are still financed almost exclusively with foreign currencies, primarily the U.S. dollar. This is largely due to the conservative import financing ceilings set by the Bank of Japan and the absence of a "banker's acceptance" market in Japan.[17] Approximately three and a half percent of world reserves are held in yen.[18] In addition, the

16. While the percentage of yen-denominated exports has steadily increased, the Japanese figure is low compared to the share of home-currency-denominated exports from other major industrial states. Eric Hayden, "Internationalizing Japan's Financial System," An Occassional Paper of the Northeast Asia-United States Forum on International Policy of Stanford University (December 1980), p. 17, *reprinted in* Daniel I. Okimoto, ed., *Japan's Economy: Coping with Change in the International Environment* (Boulder: Westview Press, 1982).

17. Hayden, "Internationalizing Japan's Financial System," p. 18. As Hayden points out, unless a banker's acceptance market develops in Tokyo, "Japanese importers will continue to depend on the New York based U.S. dollar acceptance market." The creation of a refinance market concurrently with the institution of a Tokyo OBU would greatly enhance the ease and efficiency of trade financing. Professors Harold J. Berman and Kenneth W. Abbott explain the significance of rediscounting to the importer:

> The banker's acceptance adds the bank's credit to that of the seller's and it is obviously more readily marketable than the trade acceptance of all but the largest mercantile concerns.... Banker's acceptances can also be used to refinance importations when the exporter has drawn a sight draft on the buyer. If the importer finds that additional financing is necessary he may draw a sight draft on his bank payable at 30, 60, or 90 days, depending on the period required to liquidate the underlying transaction. The bank will accept the draft and the proceeds will be used to pay the sight draft. This kind of arrangement is subject to the conditions of an acceptance agreement executed by the importer in favor of the bank. The importer holds the goods ... at the disposal of the bank and he must meet his obligation not later than the date on which the draft matures.

Harold J. Berman and Kenneth W. Abbott, *The Law of International Trade*, (unpublished cases and material used at the Northwestern University School of Law, Spring Semester, 1980), p. 248.

18. Organization for Economic Cooperation and Development (OECD), *Economic Surveys: Japan* (July 1982), p. 45.

Euroyen market has grown rapidly in the last five years from $5 billion in 1978 to over $30 billion today.[19] Offshore yen loans and yen-denominated foreign bonds (the "samurai" market) have also contributed critically to the yen's increasing internationalization.[20] "As any currency becomes internationalized," explains Eric Hayden, "one effect is for an offshore market in that currency to develop."[21] The question facing Japanese policymakers today is whether the "offshore market" should be literally situated overseas and beyond direct control, or in Japan, where the term "offshore" would amount to little more than a curious metaphor rather than an absolute geographic barrier to effective government supervision of the internationalization of the yen.

Second, the MOF is justified in arguing that an offshore banking market in Tokyo would provide Japanese banks with a greatly needed source of dollars to finance oil and raw material imports. In 1980, Japan had to finance 98 percent of its imports and about 70 percent of its exports in dollars.[22] Most bankers have already reached the conclusion that "the dollar call market is still too small to supply adequate amounts of funds."[23] With outstanding transactions of $15 billion, the dollar call money market is only one and a half percent the size of the Euromarket. Even the Asian dollar market in Singapore is three times as large.[24] Other methods of raising dollar deposits employed by Japanese banks overseas — such as issuing foreign currency bonds, selling negotiable certificates of deposits, lengthening dollar deposit maturities and actively expanding their offshore branch networks — have all failed to provide a permanent solution to the perennial problem of financing imports in dollars.[25] Even petrodollar purchases of Japanese equities and bonds by the Organization of Petroleum Exporting Countries (OPEC), while providing some short-term relief, are ultimately too volatile to sustain Japanese trade financing and dollar lending in the longer term.

When dollars are in short supply, because of monetary stringency in the United States or because of a periodic lack of international liquidity, Japan experiences great difficulties in financing foreign trade, as Stephen Bronte elaborates:

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19. Matsutani, "Moves to Establish Offshore Money Market," p. 22.
20. Hayden, "Internationalizing Japan's Financial System," pp. 9-14, 16-17 (discussing the effect of the rapid expansion of offshore lending and *samurai* bond issues in the 1970s). Issues of yen-denominated foreign bonds peaked in 1978 at 739 billion yen. Industrial Bank of Japan, *Handbook of the Japanese Bond Market* (Tokyo: Institute for Financial Affairs, 1981), pp. 186-187. Total overseas loans reached the yen equivalent of $58 billion in September 1982. Anthony Rowley, "Tokyo Banks Swing Into Action," *New York Times*, 8 March 1983, p. D18.
21. Hayden, "Internationalizing Japan's Financial System," p. 25.
22. Bronte, *Japanese Finance, p. 247.*
23. *Ibid.*, p. 224.
24. *Ibid.*
25. Hayden, "Internationalizing Japan's Financial System," pp. 9-14.

> During 1974-75, . . . Japanese banks [were forced] to compete with each other to obtain dollars at any cost, inviting foreign banks to charge *Japan rates*, which included a premium of up to two percent over the regular cost of funds which was charged to Japanese borrowers. During both oil crises, the Ministry of Finance banned any new syndicated dollar loans by Japanese banks to conserve these funds to finance the country's higher import bills. . . . The creation of a Tokyo OBU would establish a local source of dollars, removing the sword hanging over the heads of Japanese banks.[26]

A Tokyo OBU would help Japanese banks and trading companies with the needed liquidity during the inevitable periods when there is an acute shortfall in dollar funds.

Third, Japan must develop the OBU as an alternative means of financing the invisibles deficit. Export earnings in the merchandise trade will probably prove to be a less reliable method of offsetting the invisibles deficit in the 1980s. Slower economic growth may reduce the rate of world trade expansion and increase the attractiveness of protectionism in the West.[27] Upward pressure on the yen may reduce the price competitiveness of Japanese products abroad.[28] Also, export competition from developing countries in Asia and elsewhere may intensify.[29] Finally, oil price increases may continue to reduce net gains in export earnings.[30]

In fiscal 1980, the invisibles deficit was well over $12 billion and by the end of fiscal 1981 it had easily surpassed $15 billion.[31] This trade gap might be filled through the creation of a Tokyo OBU which could transform Japan into a major creditor nation by attracting a greater inflow of funds from abroad and by making possible higher interest earnings from offshore dollar loans. As Andreas R. Prindl explains, this kind of banking structure is "designated a 'turn-table' market — taking other countries funds and lending them on again while profiting from the resultant spreads and management fees."[32] Just as Britain was able to

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26. Bronte, *Japanese Finance*, p. 247.
27. "Senate Offers Weapon Against Japanese Trade," *New York Times*, 23 December 1982, p. D14; "Japan's Trade: Showing Its Hand for GATT," *The Economist*, 20 November 1982, p. 77; Clyde H. Farnsworth, "What the U.S. Achieved at Trade Conference," *New York Times*, 30 November 1982, p. D1.
28. The yen was expected to appreciate by as much as 11 percent of late 1982 levels by mid-1983 as a result of the relatively strong performance of the Japanese economy. "More Chills Than Thrills in the Foreign Markets," *Business Week*, 27 December 1982, p. 123.
29. Hayden, "Internationalizing Japan's Financial System," p. 27.
30. *Ibid.*
31. OECD, *Economic Surveys: Japan*, p. 20.
32. Andreas R. Prindl, *Japanese Finance: A Guide to Banking in Japan* (New York: John Wiley & Sons, 1981), p. 52.

capture the bulk of the Eurocurrency market pursuing such a turn-table strategy, Japan could undoubtedly win the lion's share of the $75 billion Asian dollar market and generate new business in the process.

Fourth, a Tokyo OBU would reduce sovereign risk for investors seeking an effective means of yen asset management. The reduction of sovereign risk was a major objective in establishing the New York offshore banking facility. A diversified home money market would seem to offer definite advantages for the Japanese investor in a world increasingly unreceptive to Japanese inroads into international trade and finance.[33]

By comparison, BOJ objections to the Tokyo OBU seem largely illusory. First, any incremental decrease in government revenues resulting from the creation of an offshore unit withholding tax exemption would probably be more than offset by increases in income tax revenues from buoyant corporate profits generated by the Tokyo OBU. Furthermore, as Bronte explains, withholding tax revenues constitute "phantom income because no one at present deposits funds in Japan because of the tax."[34]

Second, leakage of yen funds would not threaten monetary policy effectiveness. The possibility that leaks might upset domestic monetary controls was also a primary concern of the U.S. Federal Reserve Board in planning the New York offshore facility.[35] With over $700 billion Eurodollars then in circulation, a U.S. Federal Reserve Board staff study concluded that the potential magnitudes of the worrisome leakages would not be large enough to impede U.S. domestic monetary policy significantly.[36] While the conclusions of the Federal Reserve Board have limited relevance for Japan, which does not employ the variety of monetary policy instruments regularly invoked by U.S. authorities (e.g., treasury bills), the likelihood of serious monetary disruption is nonetheless miniscule.[37] In addition, as described in Section II, specific monitoring devices can be instituted to guard against leaks. Even assuming for the sake of argument that these devices are only marginally effective, the $30 billion Euroyen presently in circulation simply do not pose a serious threat to effective management of the Japanese money supply.

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33. "Offshore Dollars Move Onshore," *Business Week*, 29 June 1981, p. 100. For more on the investment significance of offshore banking in Japan, *see* Dario F. Robertson, "The Investment Implications of Tokyo Offshore Banking," *East Asian Executive Reports* 4 (December 1982): 6, 8-10.
34. Bronte, *Japanese Finance*, p. 247.
35. "Fed Clears the Way for Offshore Banking," *The Banker*, February 1981, p. 81; "Changing Financial Institutions and Monetary Policy," *American Banker*, 23 July 1981, p. 4.
36. "International Banking Facilities," Staff Studies of the Board of Governors of the Federal Reserve System (14 December 1978), pp. 2-3.
37. "Creation of Treasury Bill Market," *Mitsui Bank Monthly Review*, September 1982, p. 1-2; Yoshio Suzuki, *Money and Banking in Contemporary Japan* (New Haven: Yale University Press, 1980), pp. 149-200.

Third, the Bank of Japan's concern that a Tokyo OBU would adversely affect the government's ability to influence the exchange rate by impeding the control over capital flows seems unfounded.[38] If Japanese policymakers found it necessary to impose short-term capital controls in the onshore market in an effort to correct an inappropriate exchange rate, it is unlikely that a Tokyo OBU would obstruct the policy. Like every other offshore market in which yen are traded, the Tokyo OBU would, *ceteris paribus*, respond with adjustments in the rate of return on yen assets that would take into account the changes in the foreign availability of yen funds. While the resulting interest rate differential between domestic and OBU accounts might marginally intensify the stress on Japanese onshore capital markets (resulting from deficit-induced issuance of government bonds with subequilibrium yields), the short-lived effects of capital controls on yen exchange rates would not be neutralized by the existence of a new international money market. The Tokyo OBU would merely translate the changed equilibrium conditions in the assets market and the effects of the altered expectations of market participants in an adjusted exchange rate. However, there may be important long-term and short-term consequences of Tokyo offshore banking on the exchange rate which Japanese monetary authorities should take into consideration.[39]

In the long run, exchange rates ultimately reflect the relative efficiencies in production and relative price levels among nations, rather than transitory flows in international money markets. In the postwar period, yen exchange rates reveal a significant correlation between Japan's relative inflation rate and currency depreciation.[40] To the extent that the purchasing power parity hypothesis can explain long-term movements in exchange rates,

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38. Although the Foreign Exchange and Foreign Trade Control Law, which entered into force in December 1980, placed the Japanese financial system under a new regulatory regime in which foreign currency transactions would be free in principle from controls and directly restricted only in exceptional cases, the law would not impede an immediate return to foreign exchange controls where Japanese policymakers found that course of action expedient. By its terms, the law would allow the Ministry of Finance to require licensing of all exempt capital transactions where their execution might result in serious balance of payments disequilibrium, "drastic fluctuation" in yen exchange rates, or adverse effects on Japanese capital markets. In addition, the law failed to liberalize several important categories of capital transactions. *Foreign Exchange and Foreign Trade Control Law*, arts. 20-21 (Law No. 228, 1 December 1949) *as amended by* Law No. 65, 18 December 1979, *EHS Law Bulletin Series*, vol. 5, Section AA-AEB.

39. John Makin, "Determinants of the Yen-Dollar Exchange Rate: The Course of the United States and Japanese Policies," in Kozo Yamamura, ed., *Policy and Trade Issues of the Japanese Economy* (Seattle: University of Washington Press, 1982), pp. 297-324. For a careful consideration of the effects of liberalizing international capital flows, *see* Charles P. Kindleberger's essay, "The Pros and Cons of an International Capital Market," in his book *International Money: A Collection of Essays* (Boston: George Allen and Unwin, 1981), pp. 225-42.

40. Robert I. McKinnon, *Money in International Exchange* (New York: Oxford University Press, 1979), pp. 130-31; Peter H. Lindert and Charles P. Kindleberger, *International Economics* (Homewood, Illinois: Richard D. Irwin, Inc., 1982), p. 324.

the impact of a Tokyo OBU would obviously be negligible in the long term since a new money market would not fundamentally alter the performance of the Japanese economy in the world system.

In the short term, however, offshore banking promises to have a much more profound impact on the exchange rate. In contrast to the institution of offshore banking in the United States, the creation of a new international money market in Japan represents a fundamental shift toward a more open, competitive financial system. The promise of deregulation may result in more substantial short-term capital movements. As a recent economic survey of Japan conducted by the Organization for Economic Cooperation and Development (OECD) explains, "with foreign exchange controls largely abolished and large interest rate differentials between Japan and major financial markets, capital movements have played an important role in the determination of the exchange rate."[41] Outflow leakage into the offshore accounts could produce upward pressure on the yen but, as noted earlier, even if leakage does occur, domestic monetary policy effectiveness need not be compromised if exchange rate feedbacks are taken into account by Japanese economic planners. Even without leakage, new investment opportunities in yen assets made possible by the institution of the Tokyo OBU may significantly increase the attractiveness of holding those assets, bidding up the exchange value of the yen. In either case, an offshore center in Japan will probably produce a greater short-term impact on the exchange rate than the creation of the New York facility did in the United States.[42]

Rather than obstructing the development of rational capital outflow-inflow policy, a Tokyo OBU would seem to be a welcome complement to a general program of capital liberalization. The Reagan Administration has made strenuous efforts to secure greater foreign access to Japanese capital markets, apparently without giving a great deal of thought to the fact that the consequence of promoting Japanese loans to foreigners will be a weaker yen and more price-competitive Japanese exports to the United States. In the long term, greater foreign access to Japanese capital markets is clearly desirable, but in the short term it implies a weakening of the yen precisely at a time when upward movement is needed. To strengthen the yen under these circumstances there must be complete liberalization of the inflow of capital.

However, net capital inflows are unlikely because, as C. Fred Bergsten explains, (1) "the range of yen assets available to foreigners is much more

41. OECD, *supra* note 18, p. 48.
42. For a careful analysis of deviations from interest parity caused by Japanese capital controls, see Ichiro Otani and Siddarth Tiwari, "Capital Controls and Interest Rate Parity: The Japanese Experience, 1971-81," *IMF Staff Papers* 28 (December 1981): 793-815; *See generally* Arthur B. Laffer, *Private Short-Term Capital Flows* (New York: Marcel Dekker, Inc., 1975), pp. 33-48.

limited than the range of dollar (and other foreign) assets available to Japanese," and (2) Japanese interest rates are maintained by government regulation at subequilibrium levels.[43] The creation of a Tokyo OBU would probably resolve the capital inflow dilemma posed by Bergsten by offering investors an extremely attractive low-risk yen asset (i.e., an OBU account) that would earn internationally competitive interest returns. As noted earlier, the heightened attractiveness of the yen could result in substantial appreciation. In fact, a Tokyo OBU might strengthen the yen to the point of making Bergsten's recommended "moratorium on capital outflows" — such as Japanese purchases of foreign securities, loans to foreigners and direct foreign investment — entirely unnecessary.[44] Furthermore, the institution of a Tokyo OBU lacks the serious drawbacks of Bergsten's proposed moratorium. While a return to exchange controls would disrupt expectations and create new uncertainty in the exchange market, offshore banking would probably be prerceived as a major step toward the creation of a truly market-oriented financial system in Japan, generating new confidence in the yen rather than confusion. In sum, the most likely effect of an offshore banking market in Tokyo would be salutary upward pressure on the yen.

Finally, the Bank of Japan's concern that the creation of a Tokyo OBU would generate political rifts between Japan, Hong Kong and Singapore seems similarly unwarranted. As long as Japan does not introduce preferential corporate tax breaks in addition to creating a withholding tax exemption on offshore interest earnings, there will still be foreign investors willing to invest in other Asian offshore markets for tax savings and diversification reasons.[45] Not only is it doubtful that these rival offshore centers will suffer a permanent loss of business, but the Bank of Japan argument also overlooks the fact that the present ascendance of these markets is a consequence of Japan's reluctance to assume the role of the financial capital of the Asia-Pacific.[46]

There is one major macroeconomic ramification that has not been explicitly discussed in the public political debate over the Tokyo OBU. Government policymakers have been curiously reluctant to articulate their views concerning

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43. C. Fred Bergsten, "What To Do About the U.S.-Japan Economic Conflict," *Foreign Affairs* 60 (Summer 1982): 1072-73.
44. Ibid., p. 1071.
45. Arai, "Establishment of Tokyo Offshore Market," p. 35.
46. The extent to which a Tokyo OBU would result in net losses or gains for rival Asian centers would be difficult to determine before a Japanese market actually comes into existence. New York's new offshore facility has not appreciably discouraged the establishment of branch offices in neighboring markets and "of the $144 billion of Eurodollar money deposited in the first six months of existence, only about $20 billion is estimated to have been transferred from the Cayman Islands, Bahamas and Panama combined." Walter H. Diamond and Dorothy B. Diamond, *Tax Havens of the World*, vol. 2, p. 15.

the probable impact of an offshore market on interest rate controls. Their conspicuous reticence probably reflects both the high political stakes at risk in the deregulation decision and the substantial difficulty in predicting the actual consequences of offshore banking on Japan's rigid system of financial regulation. Bronte maintains that the Bank of Japan is "concerned that a Tokyo OBU would slow down, if not halt, its plans for domestic monetary reform which will eventually move Japan towards a market-oriented interest rate system."[47] This is a curious hypothesis, since Bronte's assertion runs counter to recent reports on the Bank of Japan's actual evaluation of the potential impact of a Tokyo OBU on interest rate controls.

The *Japan Economic Journal* reported in August of 1982 that the Bank of Japan felt the creation of a Tokyo OBU "would naturally disturb sellers and buyers in the regulated market" by offering more attractive investment returns.[48] In other words, the Bank of Japan was afraid that the creation of a liberalized international banking market on the periphery of a heavily regulated domestic financial system would bring the gross inefficiencies of rigid interest rate controls into stark relief.[49] Rather than quelling the mounting dissatisfaction with the present regulatory regime, as Bronte suggests, a Tokyo OBU would more likely generate powerful new pressures on interest rate controls as all eligible funds in the domestic and Eurocurrency markets gravitated toward the higher returns made possible by the Tokyo OBU. Yoshio Suzuki argues that the progressive "internationalization of Japan's capital markets" encourages rather than deters the transition to a system in which interest rates are determined by market forces.[50]

The introduction of offshore banking alone, of course, will not immediately bring about interest rate deregulation. As long as Japan continues to run enormous budgetary deficits and finances them by issuing interest-controlled government bonds, Japanese policymakers will remain divided over the advisability of removing interest rate ceilings. On the one hand, interest rate liberalization implies a massive increase in the government's debt service requirements in the short term. But maintenance of artificially low interest rate levels causes, in Suzuki's opinion, "an unfair transfer of income from households to the corporate sector and a reduction in the public's welfare."[51] Government policies fixing interest rates below market levels had previously accelerated capital investment to the point where gains in corporate and personal income resulting from economic growth

47. Bronte, *Japanese Finance*, p. 247.
48. "Finance Ministry and Bank of Japan Conflict on Offshore Banking," p. 3.
49. K. Miyazaki, "Pros and Cons on Tokyo Offshore Market," *Oriental Economist*, September 1982, p. 6.
50. Suzuki, Money and Banking in Contemporary Japan, p. 237.
51. Ibid., p. 236.

surpassed the disequilibrium costs of artificially low interest rates. With the deceleration of economic growth, however, the combination of low interest rates and inflation has unjustly depreciated the value of household savings while giving a windfall to the corporate sector.

In addition, movements toward interest rate liberalization have been obstructed by Japanese financial institutions whose business largely depends on the maintenance of the regulated rates. Long-term credit banks, trust banks, mutual banks, credit corporations and agricultural cooperatives would all stand to lose from interest rate liberalization. Debenture issues and trust deposits might be crowded out by higher interest yields on government bonds, drawing business away from the long-term credit banks and trust banks at a time when corporate borrowing is decreasing. Some of the smaller financial institutions which could not afford to offer competitive rates, due to their scale and management inefficiencies, might be forced out of the market.[52]

A Tokyo OBU would also have important international economic consequences. First, a Tokyo OBU might contribute to international liquidity inflation. Thomas D. Willett briefly describes the price effects of excessive international liquidity: "Because of their ability to create in effect international currency reserves by borrowing from private international financial markets, many countries were able to run more expansionary policies than would have otherwise been the case. As a result, the average level of world inflation was increased."[53] Free access to international capital markets by countries with current account deficits has enabled them to maintain artificially high exchange rates while depressing the exchange rates of stronger countries to subequilibrium levels. This has produced higher import prices for the stronger countries, complicating economic policies designed to abate inflation. The net effect of the direct price transmission of inflation, however, is minimal.[54] The existence of a Tokyo OBU might improve the efficiency of short-term capital movements, but would probably have little effect on the actual magnitudes of internatonal adjustments that produce international liquidity inflation.

Second, the institution of yet another offshore banking market within the international financial system could generate a long overdue international regulatory response to the spread of offshore centers. An international legal framework is desperately needed to define the appropriate role and responsibilities of participant financial institutions and their respective central banks in offshore markets, as was vividly illustrated by the Banco

52. Ibid., p. 239.

53. Thomas D. Willett, *International Liquidity Issues* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1980), p. 54.

54. Ibid., p. 56.

Ambrosiano incident in the summer of 1982. When the Luxembourg subsidiary of Milan's Banco Ambrosiano collapsed, Italy's central bank refused to bail out the insolvent institution, causing creditor banks an estimated $400 million loss. Under present regulatory arrangements, only creditor banks would have been entitled to the bailout proceeds, while the depositors of the failed bank would have had to suffer the loss without compensation. This incident highlights the need for an international offshore banking convention that would resolve the acute ambiguities which currently afflict financial relationships in international money markets. Closer central bank coordination and a broader-based empirical understanding of the operation of offshore markets are clearly in order.[55]

Third, a Tokyo OBU might promote greater international economic interdependence and thereby encourage greater international cooperation in formulating national economic policies. For structural reasons the aggregate impact would obviously be marginal, but a Tokyo OBU might promote better economic coordination between the United States and Japan by tying the two economies closer together through the liberalization of bilateral capital flows.[56] In the past, the United States and Japan have coordinated exchange rate intervention policies, but even a limited program of monetary policy coordination has yet to emerge. Although there are undoubtedly many inherent trade-offs in attempting to pursue both domestic economic objectives and coordinated bilateral policies, there is also a substantially unexplored domain of mutual compatibility.[57]

IV. Economic Policy Recommendations

In addition to establishing an offshore banking unit in Tokyo consistent with the nine operational requirements outlined in Section II, Japanese policymakers might also consider concurrently implementing several complementary economic policies. While the following suggestions are necessarily cursory, they do identify areas requiring more attention from government decisionmakers in Japan.

First, complete liberalization of capital inflows into the domestic financial market would help strengthen the yen at a time when its relative un-

55. Jeff Gerth, "Challenge for Central Banks," *New York Times*, 8 November 1982, pp. D1, D13.
56. On the critical importance of improved economic policy coordination between the U.S. and Japan, see Koichi Hamada, "Policy Interactions and the United States-Japan Exchange Rate," in Kozo Yamamura, ed., *Policy and Trade Issues of the Japanese Economy* (Seattle: University of Washington Press, 1982), pp. 271-95. Ralph C. Bryant offers some intriguing explanations for the lack of international economic cooperation even when such cooperation would be mutually beneficial to the states concerned in his book *Money and Monetary Policy in Interdependent Nations* (Washington, D.C.: Brookings Institution, 1980), pp. 453-81.
57. Hamada, "Policy Interactions," pp. 292-94.

dervaluation against the dollar is inflating Japan's incendiary bilateral trade surplus with the United States. Perhaps informal administrative discouragement of capital outflows from the domestic financial market might also be advisable, but curbs should be implemented only by moral suasion and not by an explicit legislative or regulatory moratorium on capital outflows. These policies would accentuate the role of the Tokyo OBU as an interim measure designed to move Japan's heavily regulated financial system toward market-oriented banking. Second, efforts should be made to encourage the formation of a banker's acceptance market for easier import financing in Japan.

Third, the momentum towards liberalization created by the introduction of offshore banking should be directed toward resolving the interest rate problem. More specifically, Japan may have to consider a complete restructuring of its banking system in order to dislodge the vested interests that have made a more market-oriented financial system an anathema for certain sectors of the domestic banking community. The high degree of specialization that has characterized Japanese banks in the past may have to give way to more uniform interbank operations. Furthermore, pressing needs for financing may make obsolete the distinction drawn in Article 65 of the Securities and Exchange Law, which prohibits banks from engaging in underwriting.[58]

Finally, monetary policy, in addition to being directed at anti-inflationary and growth objectives, must increasingly take into account the international monetary feedbacks resulting from offshore banking and the liberalization of capital flows. Japan should also consider the development of alternative monetary policy instruments to be used in the aftermath of interest rate decontrol. For example, Japan needs to develop a competitive treasury bills market modelled after the one in the United States. Similarly, complementary efforts should be made on the fiscal side to reduce the government's budgetary deficit and improve the potency of countercyclical economic policies.

V. Conclusion

The establishment of an offshore banking unit in Tokyo promises to be as beneficial to Japan as to its trading partners. In the contentious domain of Japanese foreign economic policy, such a mutually satisfactory policy alternative is rarely encountered. An offshore banking facility offers Japan a significant measure of control over the yen's progressive internationalization, a stable source of dollars to pay for burdensome oil imports,

58. *Securities and Exchange Law*, art. 65 (Law No. 25, 13 April 1948) *as amended by* Law No. 5, 3 March 1971, *EHS Law Bulletin Series*, vol. 6, Section MA.

a creative alternative to value-added exports as the primary means of financing the invisibles deficit, lower sovereign risks for the holders of offshore yen assets, and a needed buffer in the difficult transition to a market-oriented financial system. In addition, these advantages follow without any cognizable risk of undermining Japanese domestic monetary policy or government finance. While offshore banking will introduce a new variable into Japanese macroeconomic planning, far more dangerous complications would result from a policy of inaction that implicitly ignores the need to address the increasingly international dimensions of Japanese monetary policy. In this light, the Bank of Japan's objections to an international money market in Tokyo seem misplaced. While giving Japan a salutary respite from the rigors of an overregulated financial system, offshore banking would offer Japan's trading partners new opportunities in yen asset management and upward pressure on an arguably undervalued yen that will help reduce the artificial price competitiveness of Japanese exports.

Japan has made great strides in the last decade in liberalizing the regulation of trade flows. Japan's tariff schedules, quota structure and investment laws compare favorably to those of any other major industrial nation.[59] In the financial sector, however, Japan still lags far behind, retaining an inefficient system of direct controls that has long outlived its usefulness. The continued devotion to this outdated regulatory regime is the major impediment to Japan's emergence as the financial capital of East Asia. As Prindl correctly observes, "Japan presents a number of anomalies to the Western observer, but few as dramatic as the contrast between its economic size and strength and its self-limited role as a world . . . financial centre."[60] This prolonged self-denial of the enormous potential of Japanese financial markets may at last be coming to an end. The surest indication of a new commitment to the realization of this neglected potential would be the creation of an offshore banking center in Tokyo.

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59. Japan-U.S. Study Group, *Japan's Economy and Japan-U.S. Trade* (Tokyo: Japan Times, 1982), pp. 177-79; Dario F. Robertson, "Dispelling the Myth of the Closed Japanese Economy," *Daily Yomiuri*, 11 January 1983, p. 5.
60. Prindl, *Guide to Banking in Japan*, p. 50.