Negotiated Openness: U.S.-Japan Financial Negotiations and the Network of Financial Officials

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ABSTRACT

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This study examines the role of intergovernmental negotiations in facilitating liberalization of finance in terms of market opening to foreign business. The theoretical focus is on the significance of the international network of financial officials. Recognized as a highly technical area, the financial issues have been often separated from other issue areas in trade negotiations, and administered by a small number of governmental financial experts. However, in reality, the exclusivity of financial officials on this issue largely resulted from their preexisting international network; these officials behaved strategically to maintain this exclusivity in such an institutional context. Yet, financial issues became politicized overtime and more actors, including politicians and governmental agencies other than financial authorities participated in the negotiations after the late 1980s.

I argue that the structure of intergovernmental negotiations can have a significant impact on the outcomes of those negotiations. If negotiations are held exclusively among a small number of financial officials who share the understanding of the issues on the table and have long-term relationships with each other, the demands and offers in the negotiations tend to be more moderate and realistic, and the outcomes involve incremental changes. On the other hand, when the issues are politicized and

more actors are involved, the demands tend to be tougher and the negotiations often break off.

To assess this assertion, this study examines the United States–Japan financial negotiations, which were the world's first intergovernmental negotiations on financial liberalization, started in 1983. Initiated as bilateral negotiations, the financial negotiations were later incorporated into a multilateral framework, which changed the institutional settings. This study divides a series of bilateral negotiations into four periods. In the first period, the financial authorities started the bilateral negotiation. The second period followed in the late 1980s and the early 1990s, when the involvement of the American Congress had brought a considerable change in the nature and the outcome of the negotiation. In the third time period, the bilateral negotiations were held under the multilateral framework of the General Agreement on Tariffs and Trade (GATT). The case of financial services negotiations and that of insurance are compared in this period, as different sets of actors were involved in them.

In conclusion, the study discusses the implications of the United States–Japan financial negotiations for the more recent developments in opening up the financial markets of newly industrialized economies.

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Chapter 1 Introduction: Financial Globalization and Negotiated Openness

Today, national borders do not limit activities of powerful financial institutions, as capital is the most mobile economic factor. Because of technological innovations, especially in the field of information technology, financial services can be traded across national borders without any time and/or cost constraints. Thus, it is often argued that traditional policies of national control over the financial sector have lost their effectiveness, and that the worldwide trend for financial liberalization is an inevitable consequence of globalization.

Because of the special role the financial sector plays in any economy, it is one of the most heavily regulated and protected industries in most countries. However, several constraints imposed on the activities of financial institutions in domestic markets have been gradually lifted since the mid-1970s in many advanced industrialized countries. In many cases, the removal of restrictions on international capital flows preceded domestic deregulation, allowing local financial institutions and other types of firms to engage in international financial activities.

Letting foreign financial institutions operate freely in the domestic markets is a different story. The elimination of barriers to new entry into the financial industry,

which have protected existing financial institutions, has been generally slow at the domestic level. Foreign entry into financial markets has been even more difficult, as it was a controversial subject that has sometimes provoked nationalist sentiment and political upheaval in addition to the common resistance from the vested interests.

What determines the manner in which governments open their financial markets to foreign institutions? Is opening doors to foreign financial players an inseparable part of the broader trend of financial liberalization? Does economic globalization force governments to let them in? What are the other factors that explain policy outcomes? This study addresses these questions. More specifically, it examines the changes in the regulation of foreign financial institutions, focusing on the cases of the U.S. and Japan.

This study examines the political factors that affect governments' decisions on financial regulation and pays special attention to the institutional settings, in which intergovernmental negotiations were conducted. The popular argument of "race to the bottom" predicts that the globalized financial market urges governments to lower their level of economic regulation to keep up with international competition. Yet, there is no clear theory that explains how governments react to this pressure with respect to the restriction of foreign access to domestic markets. Do market forces compel governments to open up their financial sector to foreign competition? Or, is it left to governments to

decide? While pressure from the faceless financial markets seems to be the main driving force behind the global trend for financial liberalization, the pressure is insufficient to set the details and timings.

If the market forces still leave room for governments to decide policies, the next question would be: What determines the exact policy outcomes and timings? Actual policy changes are defined by various types of political factors. It is almost a cliché to say "domestic politics matters." Globalization deepens the division of interests between domestically oriented, smaller financial institutions and internationally oriented, larger ones. While the smaller ones need continuous protection, the larger ones tend to prefer freer markets. When the domestic interests are extremely divided, how do governments decide their policies to promote "national interests"? Whose interests are reflected the most? Many international political economy researchers have examined the interplay among various societal groups and effects of domestic political institutions.

This study alternatively stresses the importance of intergovernmental negotiations in facilitating financial deregulation. More precisely, I examine the role intergovernmental negotiations play in determining the degree of foreign entry into the domestic financial markets, using the case of the U.S.–Japan financial negotiations that occurred during the 1980s and first half of the 1990s. In this specific case, there had

been conflicts between the two countries over the degree to which domestic financial markets should be opened to each other's economic players and how they should be regulated. The issue was subject to intense intergovernmental negotiations. The series of talks between the two major economies located across the Pacific Ocean were the world's first bilateral negotiation on the issue. Following the success of the talks with Japan, the U.S. sought to negotiate market openings with several developing countries in the 1990s, making many of those countries perceive that they were being pressed by the forceful superpower. In addition to the fact that the bilateral relations between two of the biggest economies in the world are important in their own right, analyzing this particular case is also beneficial to understand the processes and outcomes of other cases of intergovernmental negotiations on financial openness.

Theoretically, this study focuses on two aspects of intergovernmental negotiations. First, it examines how the preexisting institutional arrangement affected the negotiation outcomes. More specifically, the international networks of financial experts in governments defined how intergovernmental negotiations were held and affected the policy outcomes. Second, it analyzes how the globalization of finance affected the negotiation process. It does not simply mean that globalization resulted in a convergence of national financial systems toward a neoliberal economic model. As

global finance came to play an increasingly significant role in the economy as a whole, financial issues became politicized. More actors from both within and outside governments began entering the policymaking process. As a result, the nature of negotiation and policy outcomes also changed.

1.1 Globalization of Finance

Globalization refers to the dramatic increase in cross-national economic transactions as well as political and cultural interactions that expanded in tandem with economic globalization. As economies have basically been managed along national boundaries, deepening globalization presents enormous challenges and new opportunities for national governments as well as economic actors. Greater flow of goods, capital, people, and knowledge across national borders has the potential to realize the best allocation of resources. Economic players can not only move into wide markets outside their home countries but also can sometimes take advantage of regulatory arbitrage to evade costly regulation. On the other hand, regulators at the national level have struggled to adjust to the new reality in which their regulatory oversight cannot keep pace with the expanding activities of international financial institutions.

The most straightforward method of measuring the degree of economic

globalization is to observe the increase in the volume of capital transactions across national boundaries.[1] The amount of global trade has continuously increased since the end of the Second World War. The growth rate of trade has surpassed the world GDP. The trade to world GDP ratio, which was 5.5 percent in 1950, increased to 17.2 percent in 1998 and 19.4 percent in 2005 (WTO 2007: 244, Table 15). Globalization of finance followed the expansion of trade in goods and has showed remarkable speed especially since the 1970s. According to the triennial research by the Bank for International Settlements (BIS), the daily average of foreign exchange trading was about $15 billion[2] in 1973. In 1980, the figure rose to $80 billion, and the ratio of foreign exchange trading to world trade was about ten to one. In 1992, the daily trading was $880 billion with a ratio to world trade of fifty to one. In 1995, the daily average was $1,260 billion with a ratio of seventy to one (Eatwell 1996: 1). In April 1998, the daily turnover increased to $1,490 billion that substantially declined between 1998 and 2001, but resumed increasing and reaching $3.2 trillion in April 2007 (Galati and Heath 2007).[3] The banking business has also considerably globalized since the 1970s. Cross-border inter-bank liabilities grew from $455 billion in 1970 to $5,560 billion in 1990 and to

1 One can also directly observe cross-border barriers or the degrees to which prices are equalized internationally (Frankel 2000).
2 In this thesis, the symbol "$" indicates the U.S. dollar.
3 The growth rate is at current exchange rates.

$8,998 billion in 2000. Net international bank loans as a percentage of world output were 0.7 percent in 1964, 8.0 percent in 1980, and 16.3 percent in 1991 (UNCTAD 1994: 128, Nayyar 2006: 142). Such a massive increase, inevitably, has tremendous impacts on political processes and policy outcomes.

1.2 Political Economy of the Banking Sector Opening

Banks can expand their operation either through cross-border provision of lending and other types of financial services, or through direct provision of services to customers through local presence. During the 1980s and 1990s, the local business of foreign banks tended to expand more rapidly than cross-border business (McCauley, Ruud, and Wooldridge 2002).

When financial institutions do business outside the country where they have their headquarters, they engage in foreign direct investment (FDI). The significance of FDI as the main driver of further economic globalization surpassed that of trade in the last quarter century, as the growth of FDI in general outpaced that of the world trade since the mid-1980s (UNCTAD 1991: 5, Figure I).[4] Yet, in the field of political science,

[4] The average annual growth rate was 23.0 percent between 1986 and 1990, 20.8 percent between 1991 and 1995, and 40.8 percent between 1996 and 1999 (UNCTAD 2001: 10). Then the amount of FDI flows dropped in 2001, 2002, and 2003, but began increasing sharply beginning in 2004 to reach a historical peak in 2007, when the total amount of inflows hit $1,976 billion (UNCTAD 2012: 2–3).

the scholarly attention paid to issues related to FDI began growing only recently. Compared to the vast literature on trade openness and monetary policy coordination, for example, analysis of political impacts of FDI has been limited, except for Marxist interests in the exploitative role of multinational corporations.[5] On financial openness, capital account openness has been at the center of analysis in the literature of international political economy (Simmons 1999), and the issues concerning FDI in the financial sector have rarely attracted attention, even though the growth rate of FDI in the financial sector further exceeded that of FDI in general.[6]

The details of existing theoretical attempts to address banking sector opening is discussed in the next chapter. Here, I summarize possible lines of argument on the factors that can explain the degree of banking sector openness.

First, one can attribute greater openings to market forces. In popular press, it is commonplace to assume that further financial openness in any subfield of finance is an inevitable consequence of globalized finance. In an integrated economy, financial institutions and their customers move across national borders in search of new business opportunities. For example, business corporations hope to raise funds in a country

[5] See Fieldhouse 1986. For a relatively recent study, see Jensen 2006.
[6] UNCTAD's *World Investment Report 2012*, Web Table 26, "Estimated world inward FDI flows, by sector and industry, 1990–1992 and 2008–2010," http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx, last accessed on September 28, 2012.

where the interest rate is the lowest and procedure is least costly. They want to receive advice from foreign investment banks if they have better expertise on international merger and acquisition (M&A) than their local counterparts. If governments try to protect local financial institutions from foreign competition either by restricting access from foreign players or constraining domestic companies going abroad to access financial services provided there, their economies weaken and resulting in losing out in the fierce international competition.

Second, *political* pressure, both from within and outside a country, can explain the tendency of liberalization. Domestic political processes matter, as the market pressure translates into policy changes only through domestic political processes. A big business, which wants to have access to foreign financial services, lobbies the governments; the groups that want to stay protected fight. According to the globalization thesis, internationally oriented businesses are expected to get what they want in the end, as deepening globalization gives them the exit option, and thus strengthens their power (Keohane and Milner 1996, Laurence 1999). In contrast, those who suffer from global competition win under certain conditions. They can, for example, take advantage of bigger organizations, stronger ties to policymakers, and more intense preferences.

International politics is a matter of concern. Externally, the banking sector opening has been subject to both multilateral and bilateral negotiations. It was also discussed at the regional forum, most notably in the European Union. International pressure for liberalization can be legitimatized based on the theoretical ground that observes greater access and competition as an effective way to enhance efficiency. However, most often, powerful interests are behind the pressure. During the 1990s, international organizations such as the International Monetary Fund (IMF) and World Bank encouraged less developed economies earnestly to open their domestic financial markets to foreign financial institutions. Later, renowned economist Jagdish Bhagwati highlighted the role of the "Wall Street-Treasury complex" in the financial liberalization of developing economies, which eventually led to the Asian Financial Crisis that began in 1997. In his argument, the Wall Street big financial institutions in the U.S. drove Washington through a dense network of people to press other governments to take advantage of the new opportunities (Bhagwati 1998). International institutions also promoted liberalization under the strong influence of the U.S. government (Wade 1998).[7] Bilateral pressure was also exerted especially by the U.S. government. As

[7] IMF pushed explicitly for capital account liberalization. Starting as "the steward of a system of pegged but adjustable exchange rate," the IMF found its new role as the advocate of international financial liberalization in the mid-1990s. In the World Bank/IMF annual meeting held in Hong Kong in September 1997, IMF's articles were amended to require member governments to eliminate capital controls and adopt full capital account convertibility, making capital account liberalization one of the purposes of the

stated above, the world's first bilateral negotiation was that between the U.S. and Japan in the 1980s. With the noticeable achievements in a series of talks with Japan, the U.S. government started encouraging other countries, most notably in the Asian region, in the 1990s. This leads us to examine the process of U.S.–Japan negotiations.

1.3 The Case: Why U.S.–Japan Negotiations?

Despite the conventional wisdom that financial deregulation has been driven mainly by the market pressure, intergovernmental negotiations did play a key role in governments' decisions on liberalization. At the multilateral level, negotiations over financial opening began in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). After years of deliberation in the 1980s over whether and how to incorporate the services sector in the multilateral framework of trade liberalization, substantial negotiations on the liberalization of respective sectors, including financial services, began in the early 1990s.[8]

The first bilateral negotiations started earlier in the first half of the 1980s between the U.S. and Japan. They began as an extension from a series of trade disputes

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IMF (Eichnegreen 2000: 186–87, Wade 1998).

[8] At the time of the conclusion of the Uruguay Round in December 1993, negotiations on financial services, together with telecommunications and maritime transport, remained incomplete. The extended negotiation on financial services was successfully concluded only in 1997. The details of the multilateral negotiations over financial liberalization are discussed in Chapter 6.

between the two countries, which originated in the 1950s and intensified by the 1980s. Starting with textiles in the 1950s, the U.S.–Japan trade friction occurred in specific industries, including color TV, automobile, and semiconductors, until the 1980s. The U.S. side criticized Japan for unfair trading practices, such as dumping and non-tariff trade barriers, in the respective sectors. During the 1980s, however, the focus shifted from concerns over specific industries exposed to the inflows of imports from Japan to the overall trade imbalances between the two countries. This shift reflected the upsurge of the bilateral trade deficits of the U.S. It resulted in two new focuses of the intergovernmental negotiations: access to Japanese markets and exchange rate. The issue of opening Japan's financial markets to foreign, especially American, financial institutions came at the intersection of the issues of market access and exchange rate. In this sense, the origin of the bilateral negotiations in this issue area can be considered as accidental. While there was certain societal pressure, especially on the U.S. side, on the governments to initiate intergovernmental talks concerning liberalization of the Japanese financial markets, it was only in the larger context of the long-lasting trade friction that financial liberalization became the subject of bilateral negotiations.

How bilateral negotiations were conducted and what determined the policy outcomes have important implications that go far beyond the bilateral relationship

between the U.S. and Japan. Since the 1990s, bilateral negotiations on financial market opening have occurred in many countries. Moreover, even under the multilateral framework of the GATT Uruguay Round, where access to the financial services sector was one of the important issue areas, the substantial negotiations were performed bilaterally, as the negotiations in the services sector were held based on the request-and-offer format (Cooper 2010). The opening of the financial sector has also become a part of many regional trade agreements since 2000 (Marchetti 2008: 300).

Unlike many developing countries, which launched their liberalization program to meet the conditionality imposed on them by international organizations, we can expect that the pressure on Japan to liberalize its financial markets is not very compelling. As the world's major creditor, Japan did not have to rely on external sources of finance. Consequently, there has been little need for it to obtain credit by complying with external pressure. Consequently, foreign countries, as well as international organizations, are expected to not assume that applying pressure on Japan would be effective. Given these conditions, it is interesting to observe that the world's first bilateral negotiations over the opening of financial markets occurred between the U.S. and Japan in the early 1980s. It makes a "hard case" as a case study.[9]

[9] In his comparative study of four emerging economies, Martinez-Diaz (2009) convincingly argues that economic crisis is the most important factor to facilitate opening of the banking sector. This point does

Focusing on specific cases allows a close look at idiosyncratic factors unique to each country. We cannot understand the dynamics of international negotiations without acknowledging the distinctive conditions of individual cases. In terms of case study methodology, this study adopts a combination of process tracing and controlled comparison. The small-N nature makes it possible to carefully trace the unfolding of events over time. In this sense, it employs the method of process tracing (George and Bennett 2005, Brady and Collier 2010). With this method, even a single case study can contribute to evaluating causal claims. By following the trajectories of policymaking, the causal link between variables can be examined.

Comparing cases is yet a powerful tool to evaluate the effects of explanatory variables. To ensure such a comparison, this study is divided into three periods. From 1983 to 1988, the two countries engaged in the first set of financial negotiations known as the Yen-Dollar Talks. Then, the framework for negotiation was renamed the "U.S.-Japan Working Group on Financial Markets," which lasted until 1991. Even though the new framework was created to shift the focus of discussion from specific measures to liberalize the Japanese markets to more global regulatory issues, in reality, the demands from the U.S. team became tougher. The third period is between 1992 and

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not apply to the case of Japan, as it does not have to rely on loans from international institutions.

1995, during which the bilateral talks were held under the umbrella of multilateral trade talks of the GATT Uruguay Round. This third period is divided into two cases: the financial services and insurance talks. This is because the two issue areas involved different set of negotiators.

In the first period, the negotiations were held among a limited number of officials from the U.S. Treasury and Japanese Ministry of Finance (MOF). This framework was established as a result of careful maneuvering by those officials to prevent intervention from other government agencies. In doing so, they took advantage of the existing network of international financial officials, which had discussed issues such as exchange rates and international debt crisis. In the second and third periods, however, the structure gradually changed. As the issues of international finance became more politicized, political intervention increased. Moreover, as a consequence of greater attention to the need of harmonizing regulation in the service sector across national borders, the issue became a subject in the multilateral trade negotiations under the GATT. In the process, there was more scope for other government agencies to interfere. By comparing these cases, we can evaluate the importance of the independent variable, the extent to which negotiations are held within the international network of financial officials.

Aside from the importance of these two economies, what is the significance of examining the cases of the 1980s and 1990s at this point? This bilateral framework anticipated the ongoing creation of a new international economic order in the 21st century, where the opening of service sectors to international players is a crucial issue. This point is further discussed in the concluding chapter.

1.4 Argument

If the pressure based on economic need is not expected to be effective, what led to the successful liberalization of the Japanese financial markets? This study focuses on the institutional characteristics of the intergovernmental negotiations.

Based on an in-depth case study, I argue that the existing institutional setting in which international negotiations occurred had a significant impact on the outcomes. More specifically, this study examines the role of the existing international network of government officials. In the case of bilateral financial negotiations that occurred between the U.S. and Japan from 1983 to 1995, the liberalization of the Japanese financial markets was discussed mainly between officials from the U.S. Treasury and Japanese MOF. Those officials were specialists on international financial matters in the respective governments. Because of this framework, the negotiation had a technical

nature. Moreover, the negotiators had built a long-term relationship as well as developed common knowledge and understanding through repeated exchanges (Risse 2000).

The consequence of such a structure is moderate success of the negotiations. Based on shared understandings of the issues in question, the requests become moderate and acceptable. In the first period of the negotiations, the talks resulted in gradual yet drastic changes in the Japanese financial regulation, combined with offers to grant preferential treatment of the American financial institutions in Japan.

However, the framework began changing in the late 1980s. As the salience of Japanese financial institutions in the U.S. increased, there was a political backlash. In Congress, elected politicians began demanding reciprocity, as they recognized that Japanese banks and other types of financial institutions were operating more freely in the American markets compared to the U.S. players in Japan. Technically, calling for reciprocity instead of national treatment was a double-edged sword for the American policymakers. Moreover, the requests were unacceptable for the Japanese officials. Because of the politicization of the financial issues, bilateral negotiations became more contentious and less productive.

Moreover, around 1990, the liberalization of financial services became the

subject of the multilateral trade negotiations under the GATT. As a result, other government agencies, most notably the United States Trade Representative (USTR) began participating in the financial negotiations. This also changed the nature of bilateral negotiations. In the third period, the financial negotiations were held on two tracks. The first, on financial services, was conducted mostly by the officials of U.S. Treasury and Japanese MOF, while the second on insurance was under the jurisdiction of the USTR on the U.S. side. When the two cases are compared, the first was more moderate, while the second was more contentious. The insurance talks took longer to reach the final agreement, since there were severe misunderstandings between the two sides.

The argument and cases are summarized in Figure 1.1.

[FIGURE 1.1]

1.5 Organization of the Thesis

This study is organized as follows. In the next chapter, I first discuss the relationship between economic globalization and financial liberalization in general, and then globalization and opening of the financial sector to foreign players in particular. In the

following chapters, cases are discussed in detail. In Chapter 3, I describe the beginning of the bilateral financial negotiations between the U.S. and Japan, which started in 1983. Chapter 4 discusses the process of politicization of the issue that occurred in the U.S. in the late 1980s. Chapter 5 deals with the bilateral negotiation in 1990 and 1991, when the call for reciprocity intensified in American Congress. In Chapter 6, I first discuss the process through which financial services became the subject of multilateral trade negotiations. Then, I examine the U.S.–Japan bilateral negotiations held under the umbrella of the GATT. Chapter 7 concludes the thesis and discusses its implications in the 21st century.

Figure 1.1 The cases

Cases		I (chapter 3)	II (chapters 4 and 5)		III and IV (chapter 6)	
Period		1983-1988	1986-1989	1990-1991	1992-1995	
Main issues		Liberalization of capital markets, Internationalization of yen, Foreign entry	Dealing of government bonds	Interest rate liberalization	Pension fund management, Asset management	Insurance
Negotiators	Japan	MOF	MOF	MOF	MOF, (MOFA)	MOF, (MOFA)
	US	Treaury	Treasury	Treasury	Treasury	USTR
Domestic players	Japan	banks, securities firms, big business	banks, securities firms	II +Small financial institutions	various financial institutions, Ministry of Health and Welfare	various financial institutions
	US	large banks and investment banks	financial institutions, Congress	financial institutions, Congress	wider-range of financial institutions, Congress	wider-range of financial institutions, Congress
Character		bilateral, financial authorities	bilateral, politicization	bilateral, greater politicization	multilateral, financial authorities	multilateral, other government agencies
Outcome		moderate: step-by-step libelalization & preferential treatments of U.S. financial institutions	contentious	contentious: breakoff	moderate: gradual liberalization	contentious: renegotiation

Chapter 2 Globalization, Governmental Negotiations, and Banking Sector Opening

In this chapter, I first review the literature on the relationship between globalization and financial liberalization. In doing so, I demonstrate why it is insufficient to use economic factors to explain policy outcomes. Then, I move on to the significance of intergovernmental negotiations and the factors that are the focus of this study. After discussing the general importance of intergovernmental negotiations, I move on to specifically discuss the institutional settings in and between the two countries under study: the U.S. and Japan.

2.1 Consequences of Globalization: Convergence or Remaining Idiosyncrasies?

State of economic globalization

As described in the previous chapter, the deepening of economic globalization is more than evident. After the Second World War, a liberal international economic order was established in part to prevent another world war from happening, although it covered only the Western camp in the Cold War. Following the establishment of the GATT regime, a remarkable expansion of world trade occurred in the 1950s and 1960s. The beginning of the expansion of international financial flows lagged behind, because most

countries retained capital control in exchange for trade openness under the Bretton Woods regime. This made a clear contrast to the nineteenth-century gold standard system, which put fixed exchange rate and capital mobility ahead of domestic macroeconomic health. The Bretton Woods system gave countries authorities to impose capital controls to balance the promotion of liberal international economic order and protection of domestic society from external shocks, the latter being crucial as the political influence of organized labor increased to counterweight the interests of capital by the end of the Second World War (Ruggie 1982).

However, the grip of individual states on cross-border financial flows started to loosen as the so-called Eurocurrency markets had developed since the 1960s.[1] Large amounts of funds flowed into these relatively unregulated Eurocurrency markets (Cerny 1993: 58–59). Then in the 1970s, the breakdown of the Bretton Woods system of fixed exchange rates and the oil crises provided greater opportunities for international financial actors; globalization of capital markets further accelerated. Another development during that decade that facilitated the expansion of capital market

[1] The American domination in world politics and the role of the U.S. dollar as the leading currency enhanced the use of dollar in international markets. The postwar Marshall plan and the U.S. balance-of-payment deficits of the 1960s resulted in accumulation of dollars in the hands of nonresidents. Moreover, restrictive financial regulations of the U.S. government, such as the Interest Equalization Tax Act of 1963, the Foreign Direct Voluntary Act of 1965, and Regulation Q also promoted the development of Eurodollar markets by driving U.S. banks and corporations to offshore markets. For detailed explanations and other factors, see Damanpour 1990: 77–78.

integration was growing budget deficits in most OECD countries, which swelled governments' need for international finance. Innovations in communication technology had also lowered the cost of cross-border economic transactions.

[Figure 2.1]

Foreign direct investment (FDI) also steadily increased since the 1980s, and that in the financial sector expanded especially after the 1990s. In 2007, annual FDI flows in the world reached a record high of $1,833 billion (UNCTAD 2008: 3). Directly related to the subject of this study, the growth of FDI in the financial sector, which reflects greater activities of financial institutions outside their home countries, is worth particular attention.[2] The volume of FDI inflows in the financial sector in the 2009–2010 period is almost 12 times as large than it was in the 1990–1992 period, while the total amount of FDI increased by eight times.[3] The faster growth rate of the financial sector FDI than the overall FDI resulted in the greater presence of the financial sector FDI in the total

[2] The following figures on the financial sector FDI are calculated based on UNCTAD's *World Investment Report 2012*, Web Table 26, "Estimated world inward FDI flows, by sector and industry, 1990–1992 and 2008–2010," http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx, last accessed on September 28, 2012.

[3] The FDI inflows in the services sector, of which the financial sector is a part, increased nine fold.

FDI. Inward FDI in the financial sector constituted 19.2 percent of the total in developed countries in 1990–1992. The ratio increased to 31.5 percent in 2008–2010. The growing significance of the financial sector in total FDI inflows is even more obvious in developing and transitioning economies. In developing economies, the share of financial sector FDI in the total FDI inflows increased from 6.5 percent in 1990–1992 to 11.8 percent in 2008–2010.

[Figure 2.2]

Effects of globalization

The huge flow of capital undoubtedly has a profound impact on national economies and economic policies.[4] Generally, mainstream economists would argue that financial globalization brings greater efficiency in economic activities, as lower barriers between national economies are expected to bring more efficient allocation of resources. On the other hand, even if globalization enhances the welfare of the society at large, some part of the society suffers disproportionately from greater competition caused by

[4] The effects of economic globalization have been the focus of the study of political economy. Comprehensive reviews of globalization literature in political science include Andrews and Willett 1997, Cohen 1996, and Dombrowski 1998. The first chapter of Mosley 2003 also provides a useful review.

globalization. The distributional effects of globalization routinely evoke bitter political controversy. Overall, increased mobility of capital is considered to favor the managers and owners of financial assets and transnational corporations, while less mobile labors would lose their political power (Frieden 1991, Keohane and Milner 1996, Kurzer 1993).

The role of states in the face of deeper economic integration is also subject to heated academic and political debate. In the mid-1990s, Strange (1996), in her book titled *The Retreat of States*, argues that states lost control of domestic issues. Pressure is sometimes regarded as one of the structural forces that determine states' fate (Andrews 1994, see also Ikenberry, Lake, and Mastanduno 1988: 4). It is a phenomenon that takes place somewhere out of the reach of national governments, but nevertheless determines their behavior. Although the degree of economic openness is left to decisions of the individual government, (Helleiner 1994), the pressure from global capital could be felt despite a small loophole. Moreover, "internationalization should affect even countries whose economies are not open," as increased international transactions changes opportunity costs for closed economies (Keohane and Milner 1996, 18–19. See also Andrews 1994).[5]

[5] The effects of globalization on domestic politics have been analyzed from the "second image reversed" perspective (Gourevitch 1978).

Since the 1990s, the view that excessive pressure from global capital market controls all corners of the world prevails in popular press. In the debate about globalization, many academics and policy analysts assume that globalization is likely to result in a convergence of national policies. Countries become more similar in issue areas ranging from fiscal and monetary policy to economic and social regulation to welfare policy. Various national economic systems are expected to converge on the neoliberal model including conservative fiscal and monetary policies and arms-length regulation. Economic integration has severely limited government options in making economic policies, since the global markets reward governments that followed the neoliberal prescription. The market punishes those that try to implement interventionist policies through capital flight and other forms of exercise of "exit" options.

What are the implications of globalization on economic regulations in particular? Generally, globalization has produced a spiral of competitive deregulation among states. This trend is called by such names as "race to the bottom" and "competition in laxity." Firms in a world where FDI is a viable option can move their business or capital to the country whose regulatory environment is the most favorable to them. In need to keep the business within its territory to secure jobs and tax revenue, governments have to relax their regulatory requirements (Keohane and Milner 1996: 19,

Kurzur 1993).[6]

Data supports this argument. According to United Nation's *World Investment Report 2010* (UNCTAD 2010: 77), 89 percent of 2748 FDI policy changes implemented between 1992 and 2009 favored investors (Figure 2.3).[7] There is also a trend to lower the corporate tax rate, including the introduction of flat tax rates toward the end of the 20th century (UNCTAD 2008: 11–12).

[Figure 2.3]

Such competitive dynamics can have both positive and negative impacts on social welfare. On the positive side, downward pressure on existing regulation is welfare enhancing if the regulation benefits regulated producers at the expense of consumers, as predicted by the theory of regulations (Stigler 1971, Pelzman 1976).[8]

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[6] For a general discussion of political influence of economic actors with "exit" options, see Bates and Lien (1985).

[7] The trend reversed to some extent in the new century. The share of investment restricting measures increased almost steadily in the first ten years of the new century. In 2010, approximately 32 percent of the policy changes affecting foreign investment were new restrictions or regulations for foreign investors (UNCTAD 2012: 76).

[8] The theory of regulation predicts that the regulatory system often serves the interest of the regulated industries more than the consumers, since the former are better organized and closer to the regulators.

Global market integration has made it easier for consumers, who have suffered from socially inefficient regulation, to look for foreign products with fairer prices. To retain their customers, producers would give up the rent from state-created cartels. On the other hand, competitive deregulation may also lead to the abolition of a socially desirable regulation, because regulation aimed at protecting social safety is often costly for producers. The concern for negative effects of competitive deregulation has been high in areas such as environmental and labor regulations.[9]

Despite those powerful claims, arguments against convergence abound. Many works in political economy have highlighted the continuing idiosyncrasies of economic systems, including macroeconomic policies, regulatory practices, and government institutions (Berger and Dore 1996, Kitschelt et al. 1999, Vogel 1996).

There are several plausible reasons for countries to maintain their diverse systems in today's world. First, the idea of "tightness of fit" offers a convincing theoretical foundation for such arguments (Berger and Dore1996). Because individual economic rules and regulation are embedded in a larger economic system, which, in turn, is a part of an even larger social system, it is difficult to change the rules

[9] This concern, however, is not supported by empirical evidence. In fact, economic openness is often linked to improvements in labor and environmental standards. This "trading-up" effect, a notion originally proposed by David Vogel (1995), means that market integration can create incentives for states to adopt more stringent product standards of a dominant regional economy (the "California Effect"), at least under certain conditions. See also Vogel and Kegan 2004.

individually. A rule that works well in one type of economic and social system does not produce expected outcomes in a different system. Incremental changes, therefore, are neither viable nor desirable.

Second, in clear contrast with the "retreat of state" argument that views the role of state shrinking, others maintain that states' role has become even more important to maintain their competitiveness in global markets. To take advantage of the opportunities offered by economic integration, a government should provide high quality public goods, such as property rights, economic infrastructure, and basic education. There is thus a greater need for a capable government (Garret 1998, Garret and Lange 1996, Weiss 2003).

Third, countries can also maintain policies not favorable to holders of mobile capital, either through unilateral standard setting or careful coordination among national governments. Especially when a country has a sufficiently big economy and can effectively shut firms or products out of its market when they do not meet its own standard, it can maintain a high tax rate or costly regulatory requirements. Besides, countries with stricter regulation would continue to attract business when meeting higher environmental and labor standards result in a stronger brand image, especially for producers of consumer products. Furthermore, a country without enough market

power to make such unilateral measures effective can still keep high standards if other countries also maintain a similarly high level of regulatory standard. In other words, governments can overcome the pressure to "race to the bottom" through international regulatory coordination (Drezner 2000, Vogel and Kegan 2004).

Last but not least, the option of adhering to outdated policies and institutions is still available for countries. Even if adhering to the old system is costly for a country, it does not necessarily mean that reform occurs. Despite the enormous pressure, globalized markets pose on countries toward a certain policy direction, domestic forces often work against reform. Once introduced, institutions create vested interests (Pierson 2000), making it difficult to change them. As North (1990) argues, some countries have maintained institutions that led to a low level of economic performance for a long period. In a globalized world, where firms compete fiercely at the international level, states with inefficient economic institutions lag behind, but rarely deteriorate.

Financial Deregulation, Re-regulation, and Globalization

In this subsection, I discuss the impacts of globalization on the area of financial regulation. As Bryant (1987: 67) notes, if their home country has constraining regulatory, tax, and supervisory systems, financial institutions have "incentives to locate affiliated offices outside of their home country and to book transactions through those offices to

take advantage of the less constrained operating environments abroad." The constraints include high reserve requirements against deposit liabilities, binding interest rate ceilings on deposits, high ratios of required capital to assets, high effective tax rates on domestic profits, and unusually strict examination procedures. According to Bryant (1987: 139), competitive pressure is especially intense in the financial sector because "financial intermediation is more 'footloose' than most other economic activities. It can shift locations with less difficulty and without incurring prohibitively large cost." The expected outcome is the relaxation of regulation in the financial sector. "Even more than for industry in general, therefore, the scope exists for an individual locality or nation to try to lure financial activity within its borders by imposing less stringent regulation, taxation, and supervision than that prevailing elsewhere" (Bryant 1987: 139). The dynamics of such "competition in laxity" in the financial sector is evident from the prominence of "offshore centers" for financial institutions.

As Perez (1998: 760–761) argues, uncoordinated exit and evasion by financial market players is one of the causal mechanisms through which market drives financial liberalization. Without raising their voice, they can influence policymakers through actual "exit" or threat of "exit," as policymakers know the cost of losing financial business (Laurence 1996, 2001). Even when governments try to prevent capital flight by

banning the international movement of capital, mobile capital can easily find loopholes in the era of financial globalization. When holders of capital can enjoy less costly financial services in other countries, governments have no choice but to ease domestic regulations.

As discussed above, in terms of economic regulation in general, such pressure for deregulation can sometimes be welfare enhancing. Financial regulation can be set not to serve the public interests but to create rents for the regulated, which have captured the state apparatus (Rosenbluth 1989). In this case, competitive dynamics caused by globalization eliminates unnecessary regulation and enhances efficiency in the economy. However, the "race to the bottom" in the financial sector can also cause severe problems. To keep smooth and stable functioning of financial systems, certain types of regulation, namely those called "prudential regulation," are indispensable. Prudential regulation aims at maintaining stability in the financial system and includes, among others, capital adequacy requirement, portfolio restrictions, and disclosure requirements. Nonetheless, these socially desirable regulations impose immediate costs on individual economic players, both providers and users of financial services. A greater flow of international capital is therefore considered to be a factor to destabilize the financial system, based on the assumption that investors are short-sighted.

Yet, global pressure does not only work to produce laxer regulation. It can also facilitate a type of stricter regulation that protects investors. Such opposite dynamics, called the “race to the top,” can occur because the holders of mobile asset sometimes prefer strict, not lax, regulation in general. This line of argument is supported by ample evidence in the field of finance (Cerny 1993, Vogal 1996, Laurence 2001). Tighter regulation is not necessarily a bad thing for firms, the users of financial services. Listing on a stock exchange that requires strictest disclosure increases the credibility of the company with investors. Bank customers also enhance confidence if the bank is established in a country with higher capital requirement.

Since the market pressure is far from being conclusive, economic interests do not entirely explain the regulatory dynamics. To have a deeper understanding of the regulatory policy outcomes, political factors should also be considered. Political factors work through several different mechanisms. Below, I discuss these mechanisms and how they can work in the field of financial regulation.[10]

First, coercive pressure on governments at the international level can play a key

[10] Simmons, Dobbin, and Garret (2008) raise four mechanisms through which liberal economic policies spread globally: coercion, competition, learning, and emulation. While the second mechanism based on the notion of competition fits squarely to the economic explanations, the remaining three are all political. The categorization below roughly corresponds with theirs. However, it should be noted that Simmons et al. (2008) do not specify the details of those different mechanisms.

role in determining both the direction and details of financial regulation. Here, Realists' view of power relations may factor in. The fact that the U.S., either a "hegemon" or at least the most powerful country in the capitalist world in the post-World War era, was always in a position to pry open domestic financial markets of other countries through various bilateral and multilateral negotiations suggest that the superpower used its overwhelming power, either military or economic, to make others open doors to promote the interests of politically powerful financial institutions. Especially in the aftermath of the Asian Financial Crisis of the late 1990s, such line of argument gained popularity, as some observers recognized the causes of the crisis as premature liberalization. The "Wall-Street-Treasury Complex" (Bhagwati 1998) was regarded as the driver for liberalization in many less developed economies. The Wall Street financial institutions, which had been highly internationally oriented and profitable, aimed at promising markets in the emerging world. They successfully urged the U.S. government to exert influence on policies in developing countries (Wade 1998).

The fact that the demand for greater openness comes more from those who want to expand their business oversees than from the potential users of their services also points to the role of power in international political economy. This is more so because in the field of finance, the country with the greatest competitiveness has been

the U.S. As opposed to the economic explanation, which mainly focuses on the interest of users of financial services, a power-based view can be applied to explain the outcomes of intergovernmental negotiations, mainly with demands from players who hope to break in a new market.

Second, a school of thought that emphasizes the role of ideas offers a plausible explanation for financial liberalization (Hall 1989, Goldstein and Keohane 1993, McNamara 1998). The spread of neoliberal ideas explains the global trend for financial liberalization (Pauly 1988, Yergin and Stanislaw 1998).[11] In the early post-war years, the prevailing idea concerning financial regulation is that of "embedded liberalism" (Ruggie 1982). While international trade in goods was rapidly liberalized after the end of the Second World War, most countries kept capital control to shield their national economies from external shocks (Simmons 1999). A different set of ideas, often dubbed as neoliberalism, started to take hold first in the U.S. in the 1970s and then spread to other parts of the world. The newly accepted ideas call for minimizing the role of governments. In the financial sector, the trend toward deregulation that started in the U.S. in mid-1975 spread to other advanced economies in the 1980s and to less

[11] In the categorization by Simmons, Dobbin, and Garret (2008), the ideational explanation falls in the third and fourth categories, learning and emulation, where the former mainly views ideas as somewhat established, causal beliefs, and the latter emphasizes the socially constructed meanings attached to ideas.

developed ones in the 1990s.

Third, domestic politics is another important explanatory factor. To explain the process of financial liberalization in general, the society-centered approach focuses on the role interests of various societal groups. Organized groups exert political pressure on decision makers in search for reform (Perez 1998: 760-761). Their interests vary, and it is crucially important to know what determines the balance of power of conflicting interests. One may emphasize shifting power within a society as a result of changing economic environment. As global financial integration empowers holders of mobile capital, policies favorable to those actors are expected to prevail (Keohane and Milner 1996). In this sense, this approach is likely to produce a similar conclusion to the "market forces" approach. On the other hand, the institutionalist approach focuses on the effects of political institutions. Even if holders of mobile capital increased their influence, the less efficient "losers" in the global competition can be better organized or have a better connection with policymakers, including elected politicians and administrative officials. They are often desperate to keep existing protections from competition, because their vested interests are at stake. Under certain institutional conditions, those who are at a disadvantage in the market competition can be political winners, preventing expected market-oriented reform in the face of globalized financial

markets.

In sum, the literature of international political economy gives several distinct explanations for the trend toward financial liberalization in general. The widely held idea is the argument that emphasizes the consequences of economic globalization. Renewed strength of mobile capital has forced governments to adopt economic policies based on neoliberal ideas. Opening doors to foreign financial institutions is considered to be among such market-oriented policy reform. Yet, it is not the only mechanism, as discussed above. Ideas or domestic politics also matter.

We cannot simply discuss the effects of economic and political factors on regulatory policies in general, as financial regulation includes a wide set of policy measures. In the next section, I discuss the various aspects of financial liberalization.

2.2 Banking Sector Opening

Types of Financial Liberalization

Financial liberalization has many aspects. Liberalization transpires both domestically and internationally. Domestic, or internal, liberalization refers to the relaxation of financial regulations, such as removal of restrictions on interest rates, credit allocations, and range of products. Its main purpose is to allow market forces to work within the

domestic financial markets. On the other hand, external liberalization consists of the liberalization of international capital flows and internationalization of financial services. The former means removal of barriers set by government regulations to limit the transnational flow of capital and restrictions on the convertibility of the currency. The last couple of decades have witnessed globally a steady trend toward freer flow of capital. Simmons (1999: 42, Figure 2.1) points to the almost constant decline of the average number of capital controls in fifteen OECD countries from 1967 to 1993. Of the total of nine measures, such as restrictions on capital account, deposit restrictions, and restrictions on current transactions, the average went down from about 2.5 in 1967 to almost zero in 1993. Similarly, Ito and Chinn (2012: 12, Figure 1) demonstrate that industrial countries as a group opened their capital account steadily in the 1980s and achieved almost full openness by the mid-1990s, using their own index of capital account openness. On the other hand, in less developed countries and emerging markets, openness increased in most of the years during the 1990s and 2000s, although openness decreased during some years when countries faced the global financial downturn in the late 1990s and again in the late 2000s.

Many political economists have argued that the greater flow of capital is a result of the increased internationalization of financial activities in the 1980s and 1990s,

as globalization made it difficult for national governments to sustain controls on cross-border capital transactions (Goodman and Pauly 1993, Andrews 1994). The liberalization measures conducted by respective national governments, in turn, further increased flow of capital. The trends reinforce each other.

Domestic liberalization of financial regulation is also closely interrelated to freer international flow of capital. Basically, financial liberalization at the domestic level is accelerated by global competition. In the 1980s, many advanced countries, including the U.S., United Kingdom, Japan, and France conducted financial liberalization, though to varying degrees, at least in part because of the deregulatory pressure they felt in global competition (Reid 1988, Cerny 1989, Rosenbluth 1989, Laurence 1996, 2001).[12] Financial authority can even use external financial liberalization as a leverage to organize regulatory reform at the domestic level, which is otherwise difficult due to the resistance from vested interests. The Japanese version of the Big Bang financial liberalization program, which was announced in November 1996, started with the revision of the Foreign Exchange Control Law to ease restriction on cross-border capital transactions. It was meant by reform-minded bureaucrats of the

[12] It is important to note, however, that earlier cases of deregulation in the U.S. and U.K., which set the global trend toward deregulation, started with domestic reasons. In the U.S., the "May Day" abolition of fixed fees for trading stocks in 1975 was directly a result of judicial decisions. See Jarrel (1984).

MOF to spur domestic-level financial liberalization necessary for the survival of the Japanese financial system in international competition (Suginohara 2004: 206-209).

Internationalization of financial services is yet another type of external liberalization of finance. It "eliminates discrimination in treatment between foreign and domestic financial services providers and removes barriers to the cross-border provision of financial services" (Claessens 2002: 299). In this study, I mainly focus on the opening of domestic financial markets to foreign players—a type of financial liberalization that falls in the category of internationalization of financial services. It involves trade in services, which is a relatively newly developed concept in the history of international economy.[13] While opening doors to foreign financial institutions can be considered as a part of the increased internationalization of financial business, it is different from removing barriers to the international inflows and outflows of capital. Different dynamics are at work.

Internationalization and Banking Sector Opening

Following the general trend toward financial globalization, the banking sector has been internationalized relatively lately. International lending, or provision of credit from foreign-headquartered banks to local non-bank borrowers, can be conducted from the

[13] Services were not considered to be "traded" before the early 1970s. See Chapter 6 for more details.

home office (cross-border) or through local offices. For banks, the share of international lending, including both lending from the home office and local affiliates in foreign countries, has increased over the last decades. More than one-third of the total lending to non-banks by European banks goes to foreign borrowers in 2009. The figure remains less than 15 percent for the Japanese and U.S. banks (BIS 2010: 77). The internationalization of lending started with greater cross-border provision of financial services but, more recently, banks have increasingly established their direct presence in foreign countries (Marchetti 2008: 312, BIS 2010: 77). The methods for foreign expansion include joint ventures, subsidiaries, and branches.

On the borrowers' side, according to Claessens and van Horen (2012: 5, 22, Table 1), who composed a comprehensive database of foreign banks in 137 host countries, foreign banks substantially increased their presence in most countries between 1995 and 2009. However, the degree of reliance on foreign banks varies from economy to economy. In 2007, foreign bank loans account for 10 percent of total bank loans in OECD countries as a group, 17 percent in emerging markets, and 24 percent in developing countries (Claessens and van Horen 2012: 24, Table 4). Among the advanced countries, "foreign banks account for roughly one quarter of overall bank credit in the U.S. and EU countries," while the figure remains about 5 percent in Japan.

In emerging markets and developing countries, the operation of foreign banks significantly expanded since the mid-1990s, but there is a wide regional variation. More than 80 percent of borrowing in emerging Europe comes from foreign-headquartered banks, and about 50 percent in Latin America, while emerging Asian economies obtain less than 20 percent of their total bank borrowing from foreign banks (BIS 2010: 78).

The historical development in the U.S. is impressive. U.S. banking operations of foreign banks accounted for 18.2 percent of total commercial and industrial loans in the country in 1980. The share expanded steadily since then, culminated in 39.4 percent in 1993, and remained high throughout the remainder of the 1990s (IIB 1997: 30). The share dropped since then, but the figure was still 27.2 percent in 2006 (IIB 2008: 13). The beneficiaries of the increased availability of credit are not limited to economic players from the same home country, even though many financial institutions initially start foreign operation to serve their internationally oriented customers in their home markets. In 1984, loans to Japanese-owned firms accounted for more than three-quarters of Japanese branch lending in the U.S., but in 1989, it was no more than two-fifths. While they came to the U.S. following Japanese customers, Japanese banks increasingly serviced U.S. firms as they expanded their operation in the country (Seth and Quijano 1991). In 1997, according to a survey conducted by the Institute of International

Bankers, about half of the commercial and industrial loans by U.S. banking operations of foreign banks went to customers which were subsidiaries or affiliates of the banks' customers in the home countries (IIB 1997: 38).

What has driven governments to open their financial markets, which made the globalization of the banking business possible? As with other types of financial liberalization, the greater flow of capital across national borders is a natural candidate for the cause of the opening. Under pressure from the global financial markets, governments have no choice but to open their domestic markets to foreign financial institutions that offer superior financial services. Otherwise, domestic holders of capital exit the country to take advantage of opportunities offered in other countries.

The most fundamental problem of this line of argument is that the link between pressure from global markets and greater access for foreign financial institutions is not firmly established. There are clearer causal links between globalization on the one hand, and less regulation of domestic financial markets and less control of capital account on the other, even though the evidence to support such links is mixed. The greater ease with which capital is moved across national borders empowers holders of mobile capital, who often prefer laxer regulation. However, allowing more foreign banks into their markets is not an obvious consequence of globalization. In theory, under perfect (or

near perfect) integration of national economies, holders of mobile capital have little need to have subsidiaries and branches of foreign financial institutions established in their home countries, as they can move themselves in search of greater returns. This is especially true for large-scale users of financial services, such as multinational corporations and professional investors, who are footloose in global finance. If economic considerations motivate the opening of financial markets, then the driving force should be more a demand from service providers to have greater access to foreign financial markets, rather than the apolitical pressure exerted by mobile capital with the threat of exit. As such, we should turn to the political processes of financial opening. Without an effective exit option, the demand from providers should be filtered through politics.

Benefits and Costs of Opening Doors

Generally, increased competition caused by the entry of foreign players enhances efficiency in the financial sector. Opening domestic financial markets to foreign financial institutions reduces the distorting effects of protectionist measures that weaken discipline on policymakers, give unhealthy discretionary power to bureaucrats, and invite rent-seeking behavior by privileged interest groups (OECD 2002: 9). Besides, there are more direct benefits of having more foreign financial institutions in the

domestic markets. Foreign banks can be an important source of capital to the domestic economy. As seen above, foreign-headquartered banks are now substantial sources of credits in many countries, both advanced and developing. The entry of foreign financial institutions also provides jobs. For example, in the U.S., the total number of people directly employed by foreign banks was 118,291 in 1996 and 249,579 in 2006 (IIB 1997, 2008). In addition, accepting the entry of foreign financial institutions also protects the opportunities of domestic banks operating abroad, as it curtails the possibility of reciprocal protectionism in other countries.

On the other hand, several factors are given to explain and justify restrictions of foreign ownership in domestic financial markets (Graham 2001). While most of them are often economically unfounded, the logic has provided policymakers with grounds for restrictions.

First, from the economic perspective, the increased presence of foreign financial institutions can cause capital flight away from the country at the time of economic distress, even though economists also argue that much of the problem derives from information asymmetries, and not from foreign ownership. The true solution for the problem is to enhance the capability of financial players, both domestic and international, of risk-assessment and monitoring, to reduce uninformed capital inflows,

which easily disappear at times of crisis. One way of achieving this goal is to import foreign know-how of risk-assessment (Graham 2001). Another concern is that greater foreign ownership in the financial sector causes “contagion” by transmitting financial crisis from one financial system to another. Banks in a country that faces financial problems may cut lending in other countries and, in effect, export their own trouble. According to a recent analysis (Claessens and van Horen 2012: 17), in 2009, foreign banks reduced lending more than domestic banks as a response to the global financial crisis. Since the degree of reduction depended on factors such as the market share of foreign banks, the situation of home countries, and access to local deposits; however, we cannot easily conclude whether the greater presence of foreign banks and other types of financial institutions spread the financial crisis. The penetration of foreign financial institutions can decrease the risk of systemic financial crisis through diversification.

Second, there are also regulatory concerns. Foreign banks could circumvent more easily than domestic banks regulations of a monetary and/or prudential nature (Pecchioli 1983: 71).

Third, an infant industry argument is often employed to make a case for restricting the entry of foreign financial institutions. In less developed economies, some period of protection can be justified to let the domestic banking industry grow and

become competitive. The protection, however, in effect taxes the users of financial services. Moreover, the protection is more likely to hinder maturation of the domestic players than to foster them, as the protected financial institutions become dependent on the implicit subsidies.

In addition, political factors also influence the decisions concerning whether to accept foreign financial institutions into the domestic financial markets. First, nationalism plays a role. A sovereign state should not give up control of its financial sector, which is considered to be the lifeblood of the national economy, to foreign firms. In the discussion of foreign banks' entry in the late 1970s, for example, the Reserve Bank of Australia notes, "Banking is a key sector of the economy providing the community with money balances and payments' arrangements. Control of ownership of banks should therefore be maintained in Australian hands to ensure concern for the national interest. Foreign banks may be more inclined to give prior place to commercial advantage or to another country's national interest."[14] One may contend that a nation must have the best-functioning banking system possible even from a nationalist perspective, because the performance of the banking sector is crucial to the performance of its economy. Still, the nationality of important economic players often causes

[14] Reserve Bank of Australia, "Submission to the Committee of Inquiry into the Australian Financial System," Occasional Paper, No. 7, December 1979, p. 12.6, cited in Pecchioli (1983: 71).

concerns in many economies.

There is additional difficulty peculiar to opening domestic markets to foreign companies. As mentioned above, opening doors to foreign financial institutions is different from removing barriers to the international inflows and outflows of capital, even though it can be considered as a part of increased internationalization of financial business. In many cases, it is more an issue of FDI than international trade in the traditional sense of the term.[15] Letting foreigners invest freely in national territory and do business involves more complex problems than liberalizing international trade in goods. Unlike barriers to trade in goods, barriers to trade in services do not "take the form of transparent barriers imposed at the border," most typically tariffs and quotas. Instead, they are generally embedded in domestic regulations (Feketekuty 1999, Cooper 2010). Often, domestic regulations that do not explicitly discriminate against foreign providers curtail access to service suppliers from outside the country, regardless of whether the consequence was intended. Consequently, the liberalization of access for foreign firms inevitably entails changes in domestic regulation. Yet, individual regulation is often embedded in a certain economic and political structure, making it

[15] It is also possible to provide financial services across national borders without establishing subsidiaries or other entities in foreign countries. As in the case of consulting, such cross-border transactions of services became possible because of innovation in information technology. Yet, they also involve regulatory changes in the countries where the customers reside.

difficult to change. Amending existing regulation in line with international need is most often in conflict with certain vested interests at the domestic level. Besides, it infringes the authority of national governments to set their own regulation.

These problems have made international negotiations on trade in services more complicated than those on trade in goods. Nonetheless, efforts have been made after the 1980s to promote liberalization through international negotiations at the bilateral, regional, and multilateral levels. The next section discusses approaches to explain such negotiations.

2.3 Intergovernmental Negotiations and Banking Sector Opening

Intergovernmental negotiations on issues concerning trade in service and FDIs have a much shorter history than those concerning trade in goods. Throughout the post-Second World War period, international negotiations had been conducted under the GATT framework to eliminate barriers to the cross-national flow of goods. Setting the rules for international trade in services lagged behind. The inclusion of trade in services in the multilateral framework of trade liberalization became a serious subject only after the mid-1980s, and actual negotiations on liberalization began only after the late 1980s. The process through which trade in services rose to a multilateral agenda is discussed in

detail in Chapter 6. Preceding the formal inclusion of the subject in the multilateral framework were bilateral financial negotiations. The U.S.–Japan financial negotiations were the first of that type. After the successful conclusion of their initial round in the mid-1980s, there were more bilateral talks aimed at opening domestic financial markets.

Explaining Intergovernmental Financial Negotiations

Here, I consider three different perspectives in the study of international politics and examine their insights and shortcomings in understanding the process of intergovernmental negotiations over financial regulation.

First, the Realist perspective, which focuses on the rivalry and competition among states, emphasizes the role of power in determining outcomes of negotiations. All the polite diplomatic exchanges notwithstanding, it is the crude power relationship among participants that defines the outcomes. In the case of bilateral negotiation, the relative power balance matters. A second set of approaches is based on neoliberal institutionalism, which was developed in response to the Realist approach.[16] While it accepts the assumption of anarchy, it emphasizes the role of international institutions that facilitate cooperation among states. International institutions, such as the World Trade Organization (WTO) or the IMF, influence negotiation outcomes by reducing

[16] More precisely, it was developed in response to neorealism led by Kenneth Waltz (Baldwin 1993).

uncertainty, providing forums for negotiations, disseminating information, and creating shared norms (Keohane 1984).

These views see a country basically as a unitary actor. In international negotiations among countries with different sets of interests, the government tries to maximize the interest of the country. In reality, however, the process of intergovernmental negotiations is more complex than multiple unitary countries facing each other. There are diverse interests within a single country, and domestic battles for influence affect negotiation outcomes. The relationships among various interest groups and governmental agencies with conflicting interests are crucial in defining international agreements. The third theoretical perspective, the two-level game approach, thus looks at domestic political dynamics as well as the intergovernmental exchanges (Putnum 1988). Essentially, it conceives the politics of international negotiation as a two-level game, in which political leaders simultaneously negotiate at both the domestic and international levels. The final agreement they work out with their negotiating partners has to satisfy domestic constituencies. While such double-edged diplomacy imposes great constraints on negotiators, they can use strong domestic opposition as a leverage to win more concessions from their negotiating partners. The two-level approach challenges the traditional billiard ball image of international politics by introducing

domestic factors into the model of international negotiations. Yet, this sophisticated approach falls short of capturing an important aspect of intergovernmental relations. It basically deals with a national negotiating team as a neutral, unitary player.

Network of Financial Officials and Intergovernmental Financial Negotiations

This study sheds light on an understudied aspect of intergovernmental negotiations: the institutional setting in which intergovernmental interactions occur. The institutional conditions determine those involved in negotiations. Moving away from models that view intergovernmental negotiations as being conducted in a neutral arena, it analyzes how the arena for intergovernmental interactions is shaped and how the shape affects the policy outcomes. In doing so, it stresses the dynamics among officials and agencies within a government, and the role played by experts in the bureaucracy, as well as the significance of the transnational policy networks. Theoretically, it is based on institutionalism, but it takes a nuanced, case-specific approach to contribute to the more general theorization that highlights the importance of understudied factors.

The argument is that the structure of international financial negotiations affects the policy outcomes. An important institutional feature of financial negotiations is the extent to which they were exclusively held among specialists in the respective government. Contrary to the case in trade, the negotiators in financial talks have been

limited to a relatively small number of specialists within governments. In the U.S.–Japan cases in the 1980s and 1990s, which are the subject of this study, the talks were conducted mostly by officials in the sections of international finance of the U.S. Treasury and Japanese MOF. This exclusiveness distinguishes financial negotiations from other trade talks. Moreover, while the start of the talks involved decisions by the highest-level political officials, there was little political interference regarding the substances except for the very early days of the decade-long negotiations. Simply put, the negotiation process was mostly insulated from political intervention.

This exclusiveness is usually attributed to the highly technical nature of finance. A senior official of Japanese MOF who belonged to the International Finance Bureau and had engaged in a series of international financial negotiations in the 1990s wrote that "because the financial services sector is highly technical and requires expertise, it is essential to have negotiations among experts with seasoned knowledge" (Hosomi 1995: 46).

This line of argument, in general, appears often in the discussion of international monetary coordination. As Krasner (1978: 64–66, 80) argues with the case of the U.S., the policymaking of international monetary policy was more insulated from societal pressure than trade policy. In contrast to trade policy, which involves a large

number of institutions, authority concerning international monetary policy in the U.S. is concentrated in the hands of the White House, Treasury Department, and Federal Reserve Board. All these institutions were well insulated from particular social interests. The scarcity of interest groups in the international monetary policy process has often been attributed to the nature of monetary policy (Gowa 1988: 19). Odell (1982: 347) notes that "the esoteric nature of the subject of international monetary policy and ignorance on the part of group leaders" can explain the relative inactivity of interest groups in the field of finance. This intellectual barrier to monetary policy is often compared to trade policymaking (Gowa 1983: 134).

However, interest groups routinely engage on other issues as seemingly arcane as international monetary issues (Gowa 1988: 19). For example, highly politicized agricultural trade involves technical issues, such as health standards and a complicated system of taxes and subsidies, which are no less esoteric than monetary issues.

This study takes a different view by emphasizing the impact of pre-existing institutions on the shape of the forum where a new set of issues are discussed. With the specific case of intergovernmental negotiations on the opening of domestic financial markets, the existing network of financial experts that was developed to address international monetary issues mattered.

Global financial governance has been organized by a small number of countries, reflecting the overwhelming importance of large economies to the stability of the international financial system. After the 1960s, when the international financial system became increasingly unstable, a club made of a small number of rich countries primarily assumed responsibility for the management of the system. The increasing prominence of international financial issues has provided many formal and informal opportunities for government officials specializing in international finance to gather and discuss, such as the Group of Ten and Group of Five, as well as meetings at more formal international institutions, such as the Bank for International Settlements (BIS). The same individuals, mainly at the deputy level, often represented their countries in each of these international monetary forums for years (Russel 1973: 435). As a consequence, those officials fostered long-term relationships and developed mutual understanding. All these relationships tackle the problems of international payments imbalances and exchange rates, which remain important well into the new century. However, the existence of the network of financial officials explains the way another, but related, issue of financial opening was dealt with.

The Group of Ten was formed in 1961 to address the problem of international payments imbalances. Overrepresentation of Europe in these forums later led the U.S. to

form the Group of Five, an informal group of financial ministers from the U.S., France, Germany, the U.K., and Japan, accompanied by senior officials or deputies. It started as the Group of Four when the U.S. Treasury Secretary George Schultz informally invited finance ministers from France, Germany, and the U.K. in the Library of the White House, together with high ranking officials, to discuss the problems of the exchange rate regime in the spring of 1973. The officials from bureaucracy who were present in the first Library Group were Paul Volcker of the U.S., Claude Pierre Brossolette of France, Karl Otto Pohl of Germany, and Derek Mitchell of the U.K. (Baker 2006: 24). Japan joined several months later. Central bank governors began participating in the meeting in the fall of the same year (Volcker and Gyohten 1992: 134-135).[17] Since then, officials from the five countries frequently held meetings about international financial problems.[18] The 1986 Tokyo Summit of G7 established the G7 finance ministers' group as a separate entity from the summit meeting, making it a more visible gathering.[19]

[17] For an account by participants in these early events, see Volcker and Gyohten 1992: 101–135.

[18] The G5 remained as an informal meeting hidden from the public until September 1985, when the G5 issued the first formal statement on the international currency issue, which was called the "Plaza Accord." The end of the secrecy led to mounting pressure from Italy and Canada to expand the membership so that they could also join just as they did in the G7 summit meetings, which started in 1975 (Baker 2006: 24–26). For the origin and significance of the G7 summit meetings, see Putnam and Bayne 1984.

[19] Another predecessor of the international financial policy network was the Bellagio group, which was a private study group constituting economists and government officials responsible for international financial issues, established in 1963 (Cooper 1999). Japan first joined the group in 1968 when Vice Minister of Finance for International Affairs Yusuke Kashiwagi was invited. See

In history, central bankers have been at the center of the international network of financial officials, which began developing among them in the 1920s in an effort to reestablish the global gold standard system (Helleiner 2013). Yet, finance and treasury officials became active as the postwar monetary regime of the Bretton Woods System faltered. Furthermore, the role of financial regulators and supervisors in the international network of financial officials expanded over time, as the importance of the coordination of financial regulation and supervision increased beginning in the 1970s (Kapstein 1994).

In such meetings, the same individuals often represented their countries in each of these international monetary forums for years (Russel 1973: 435). This tendency is the clearest at the deputy level of government agencies, as officials at the deputy level both of finance ministries and central banks often stay longer at their positions than ministers and central bank governors.[20] Regular meetings among officials from financial ministries and central banks at this level fostered enduring friendships among them and increased mutual understandings not only of the questions at stake but also of

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Kashiwagi's memoir, "*Watashi no rirekisho*" [My personal history], in *Nihon Keizai Shimbun* September 27, 1986.

[20] For a comparison of rates of turnover at the top and deputy levels in the early years of international financial governance by the "club," see Russel (1973: 440).

each other's intentions (Russel 1973: 439).[21]

Therefore, the personal relationships among financial officials from major economies in some sense resemble what Haas (1992: 3) called the "epistemic community." It is a network of professionals who share a set of normative and causal beliefs as well as have common policy enterprises "presumably out of the conviction that human welfare will be enhanced as a consequence."

Helleiner (2013) stresses that financial officials shared a certain set of ideas concerning the goals of international financial governance. These shared ideas changed over time. In the interwar period of the 1920s, the shared goal was the reestablishment of the gold standard system, which was based on the liberal economic ideas. In the Bretton Woods era after the mid-1940s, the common idea shifted to that of "embedded liberalism" (Ruggie 1982). Then after the 1980s, more liberal norms reappeared. Nevertheless, it is important to note that international monetary negotiations occurred on the ground of shared understandings.[22]

As Kapstein (1992: 266–267) argues, however, government officials and

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[21] In the more private Bellagio group, government officials were exposed to academic arguments on exchange rate issues and developed a common understanding (Cooper 1999).

[22] On central bankers, Paul Volcker states that they "are almost uniquely able to deal with each other on a basis of close understanding and frankness" because of their common "experience, tenure, and training" (Volcker and Gyohten 1992: 99, 201).

central bankers are not neutral experts who provide purely scientific knowledge. They represent the interests of their respective countries. Moreover, their proposals and decisions are based not only on what economic theories suggest to be the best choice but also on the judgment about what is politically acceptable. In this sense, the group of financial experts from governmental agencies should not be regarded as an epistemic community. Similarly, Helleiner (2013) notes that the shared ideas and purposes should not be overstated, because financial diplomats nevertheless represent their respective countries' interests. They ultimately have to serve the interest of their home countries.

Consequences of the International Network of Financial Officials

What differences does this structure of intergovernmental negotiations make? When negotiators share knowledge of the issues in question and have developed long-term personal relationships with each other, these relationships have a profound impact on policy outcomes.

On the positive side, mutual understanding and trust facilitate mutually beneficial negotiations. With a deep knowledge of the financial markets in the counterparts' country, the negotiators can come up with realistic proposals that both sides can accept. Long-lasting relationships also make it possible for policymakers to negotiate with a long time horizon. When he made the following comments after a

series of bilateral financial negotiations of the first half of the 1990s with the U.S. ended, one of the Japanese senior officials had such positive effects in his mind: “An important feature of the negotiations was that they were held on the basis of mutual trust. It was because of the close relationship between the Japanese MOF and U.S. Treasury, which had been developed since the start of the Yen-Dollar Talks in 1983. The chairs and participants in the working group from both Japan and the U.S. not only had a thorough knowledge of the situation in the partners’ country but also knew each other personally well before the series of negotiations” (Hosomi 1995: 46).

On the other hand, the closed nature of such a policy network can have a negative impact for the society at large. The participants may prioritize protecting their own interests, such as their jurisdiction in the case of the government officials at the expense of the public interest, for example, by ignoring the economically most efficient policy. Since financial officials tend to have close ties with the private financial industry, the officials may also protect the commercial interests of those within the existing financial system. Moreover, officials might not recognize their previous policy failures and try to avoid blame, leading to mere incremental policy changes even when changing circumstances require drastic reform.

Tsingou’s analysis (2010) of the informal transnational policy community in

global financial governance resonates with this study in its interest in the role of the transnational network of financial experts. In discussing the global financial crisis since 2007, Tsingou (2010: 22, 34) highlights the surprising resilience of a network constituting governmental regulators and supervisors, as well as private sector actors after the crippling crisis. The consequence of such a network is incremental reform rather than wholesale change even at a time of an acute crisis, and policies that serve the interest of the members of the policy community rather than the public.

Politicization of Financial Negotiations

However, the institution at the international level is not static. It changes as its environment changes, and such changes affect negotiation outcomes.

As the salience of financial issues increased during the 1980s and 1990s, the exclusiveness of intergovernmental financial negotiations became lost. More and more political actors, including other economic agencies within the governments and legislative bodies backed by the private interest groups and the general public, came to be involved in the process. Moreover, as the GATT talks on service issues evolved, the issue was set in the multilateral framework, reducing the exclusive nature of finance.

First, at the domestic level, issues in the financial sector attracted more attention from the society at large since the 1980s. The relative economic importance of

the financial sector has increased in the last couple of decades in developed economies as a result of deindustrialization. As Figures 2.4 and 2.5 illustrate, the share of the financial sector in GDP surpassed that of the manufacturing sector in 1998 in the U.S. Even though Japan still has a bigger manufacturing sector than the financial sector in 2007, the gap has become steadily smaller since 1970.[23]

Alongside this "financialization" of economies, there has been a trend that finance penetrated into the societies of advanced economies since the 1980s. Ordinary people became investors, shifting their money from bank deposits to financial markets by purchasing various financial products, such as the money market funds (MMF). The trend has been especially noticeable in Anglo-American societies (Langley 2008). It was observed in Japan as well, where ordinary people began engaging in more speculative investment, such as investment trusts and foreign exchange markets. The term "Mrs. Watanabe" was widely used in the late 2000s to refer to ordinary Japanese housewives who engage in foreign currency speculation. As a wider segment of the society becomes involved in financial activities, we can expect that their interest in financial issues increases. In his analysis of exchange rate policies, Frieden (1994) argues that the

[23] Since the 1980s, the share of the manufacturing sector in the national economy declined not only in the U.S. and U.K., countries with the world's major financial centers, but also in Japan and Germany, whereas the share of the financial sector increased steadily. See Bermeo and Pontusson 2012: 25.

distributional impact of exchange rates increases as the world becomes more financially and commercially integrated. As a result, the salience of international monetary issues has grown in the arena of domestic politics.

Second, the increased activities of foreign institutions in the financial sector caused by globalization began invoking economic nationalism and became a politically sensitive issue. Generally, the expansion of inward FDI can invoke nationalism, as people sometimes feel that their territory is invaded by outsiders when foreigners take control of important economic sectors. Even worse, local companies that are exposed to foreign competition may attempt to appeal to nationalism to preempt foreign takeover and protect their own self-interests (Suginohara 2008).

In the U.S. in the 1980s, a sense of insecurity spread as competition with the rising East became visible (Spero and Hart 2003: 136–138). In the financial sector, Japanese financial institutions significantly expanded their presence, as I discuss more in detail in Chapter 4. In hindsight, this was in large part due to the economic bubble of Japan in the latter half of the 1980s. At that time, however, there was a widespread fear of being intruded upon in the U.S., leading to mounting political pressure on Japan. Combined with the swelling bilateral trade imbalances, matters in the arcane financial world became the subject of domestic political debate.

Third, at the international level, the issue of financial sector openness became a subject of multilateral negotiations under the framework of the GATT.[24] The financial sector remained to be discussed mainly among government officials specialized in the field of finance, even within the GATT. Yet, the incorporation of the sector into the larger framework of international trade negotiations entailed some involvement of actors outside the network of financial administrators.

Consequently, the nature of international financial negotiations defined by the cozy relationships among a relatively small number of well-informed specialists changed over time. More political concerns were reflected in the demands. Requests became more short-sighted. Financial issues were also linked to other issues more frequently.

On this point, this argument relates to the literature of issue linkage. The existing studies often place a high value on issue linkage, since combining issues that are valued differently by each party can yield mutually beneficial solutions to otherwise insolvable issues. Each side can benefit on the issue it values highly by making concessions on issues less important to it (See Sebenius 1983: 293-94). Similarly, unrelated issues can be used as side payment to overcome distributional obstacles to

[24] The process through which the issue was included in the multilateral framework in the 1980s is discussed in Chapter 6.

international cooperation (Tollison and Willett 1979). In a more abstract term, linking unrelated issues is the equivalent of making one-shot games to repeated ones, thus facilitating international cooperation (Keohane 1984).

In the study of international trade negotiations, issue linkage is often considered to be an effective strategy to overcome obstacles to a successful conclusion. One of the strengths of multilateral trade negotiations under the umbrella of the GATT and WTO in the post-war years lies in their encompassing nature. If negotiated sector by sector, fundamental and unresolved conflicts of interests between the North and South, as well as between food exporters and importers would have blocked any meaningful trade liberalization. Linking such issues in a package of liberalization agreement has enhanced trade liberalization (Davis 2004). On financial services, Dobson (2002) points to the division of the WTO negotiations along sectoral lines as one of the weaknesses of the GATS framework. Separating services from goods and individual services from each other makes the use of reciprocity more difficult. "Reserving financial services negotiations for finance ministers makes such linkages even more difficult" (Dobson 2002: 5).

Yet, the other side of the same coin is that the relatively "easy" issues may be sacrificed for accomplishments in "difficult" issues. In the case of financial negotiations,

for example, financial officials in Japan were deeply worried that their government might unduly sacrifice the financial sector by opening it up excessively to foreign players—at least against their standard—to protect the agricultural sector because of the political importance of rice farmers in Japan. For them, separating financial issues from others and keeping them for a relatively small number of specialists on finance produced reasonable and acceptable requests that would result in successful conclusion of negotiations.

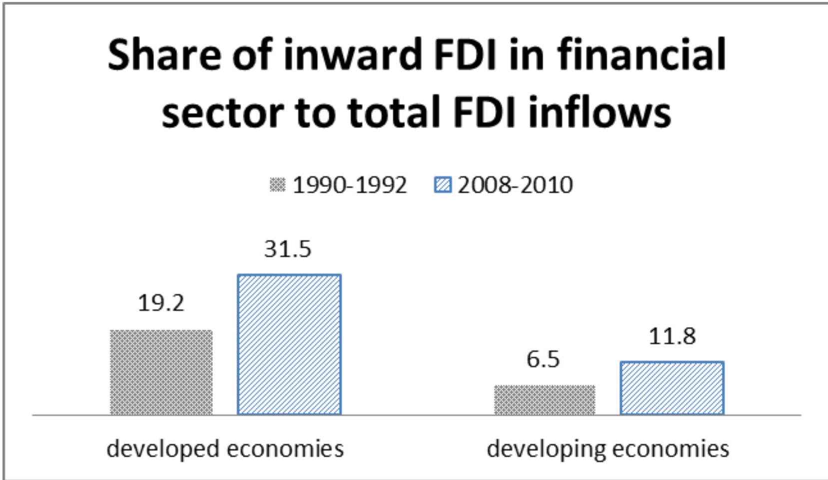
Figure 2.1 Foreign Exchange Turnover (Average Daily Turnover in April)

Global foreign exchange transactions per day

1983	$60 billion
1992	$820 billion
1998	$1.5 trillion
2001	$1.2 trillion
2004	$1.9 trillion
2007	$3.3 trillion
2010	$4.0 trillion

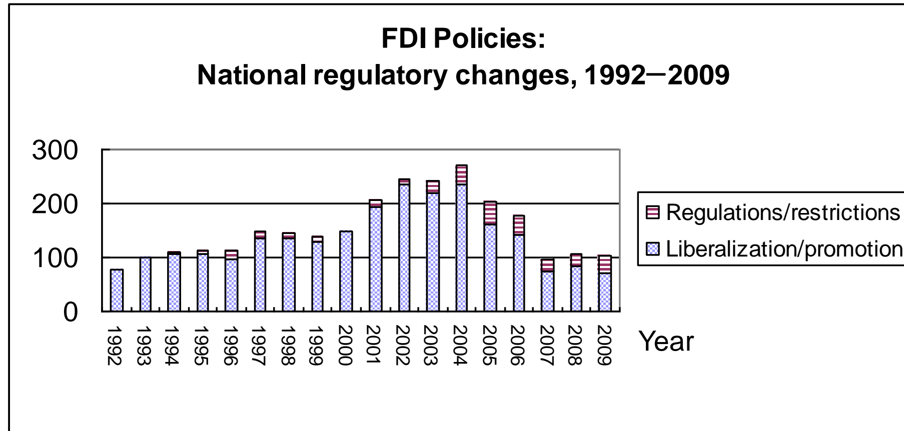
Source: Bank for International Settlement (BIS)

Figure 2.2 Share of Inward FDI in Financial Sector to Total FDI Inflows



Source: Complied from data taken from UNCTAD's *World Investment Report 2012*, table 26.

Figure 2.3 FDI Policies: National Regulatory Changes, 1992-2009



Source: UNCTAD, *World Investment Report 2010,* p.77.

Figure 2.4 Growing Importance of Financial Sector in GDP in Japan

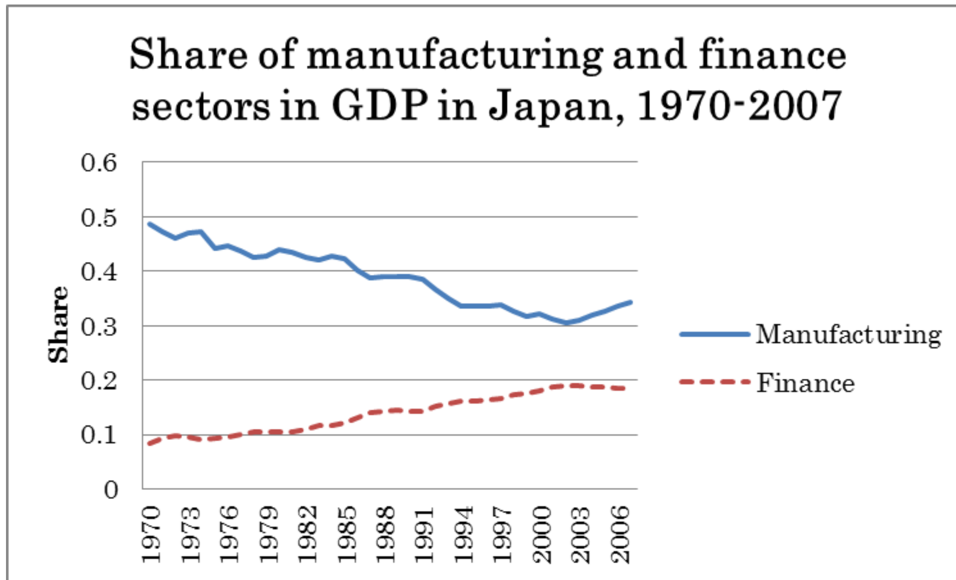
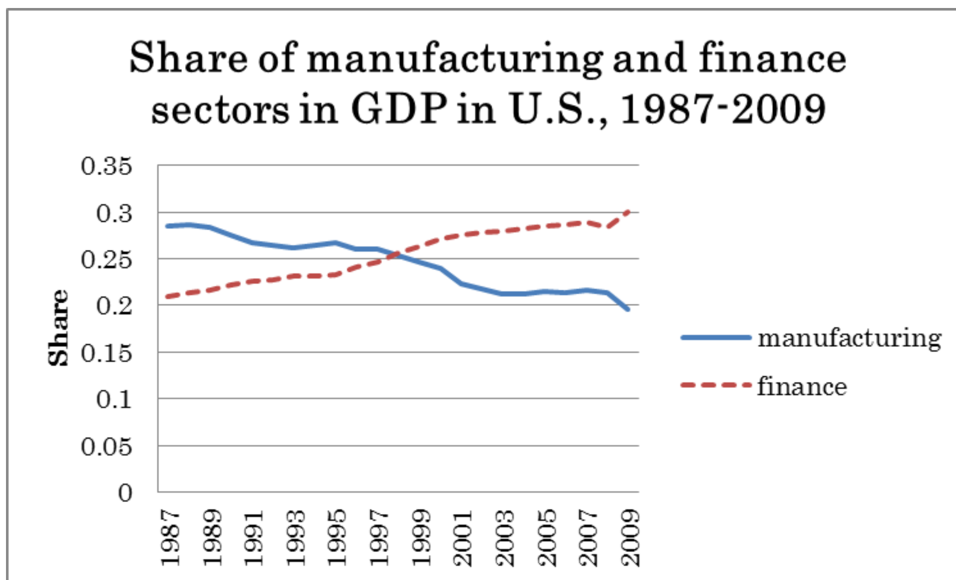


Figure 2.5 Growing Importance of Financial Sector in GDP in the U.S.



The periods covered by two charts differ due to different availability of data. The financial sector includes finance, insurance, real estate and business services.

Source: Author's conpilation based on OECD STAN Databanses.

Chapter 3 World's First Bilateral Financial Negotiation: The Yen-Dollar Talks

In 1983 and 1984, the governments of the United States and Japan held a series of negotiations over liberalization of the Japanese capital markets. The event, called the Yen-Dollar Talks, was the world's first bilateral negotiations aimed at opening the domestic financial markets (Frankel 1984: ix), paving the way for a more extensive US efforts to pry open financial markets in many less developed economies, especially those in the Asian region, in the 1990s. Another significance of the talks is that it was considered to be one of the exceptional successes in a series of frustrating U.S.-Japan trade negotiations in the 1980s. It resulted not in market-distorting voluntary export restraints (VERs) or an all-out trade war, but in some opening of Japan's previously closed financial markets to foreign players. It also triggered, or at least accelerated, the broad financial liberalization in Japan in the following decade.

It has been argued that the main reason for this success lies in the existence of groups that support the financial liberalization within Japan. While most domestic financial institutions resisted the opening as they had enjoyed the protection from competition through heavy_regulation, the users of the financial services, most notably large firms, supported the liberalization. As Schoppa (1997) demonstrated in his study

of the outcomes of US-Japan trade negotiations, domestic interests matter considerably in explaining the outcomes of intergovernmental negotiations.[1] However, this explanation is insufficient to explain the difference between the outcomes of the Yen-Dollar Talks and more contentious U.S.-Japan trade frictions of the time in general.

This chapter explains the Talks focusing on the institutional features of the financial issue area, and discusses the implication of the international negotiations. It argues that the unique institutional characteristic of financial negotiations between two countries is the key factor to understand the outcomes.

3.1 Agenda Setting: Why did Financial Liberalization Become a Bilateral Issue?

The framework for the series of negotiations was officially launched at the summit meeting between U.S. President Ronald Reagan and Japan's Prime Minister Yasuhiro Nakasone held in Tokyo in November 1983. The official name given to the framework was the Joint Japan-U.S. Ad Hoc Group on Yen/ Dollar Exchange Rate and Financial and Capital Market Issues, but it was known as the Yen-Dollar Committee. In the subsequent meetings under the framework, the government officials from the two countries discussed financial market issues, with the focus on internationalization of yen

[1] For a similar argument applied specifically to the Yen-Dollar talks, see Tadokoro 1988 and Rosenbluth 1989.

and liberalization of Japan's domestic financial markets. While trade conflicts had been common for the two countries and other part of the world, it was the first time that the opening of domestic financial markets became the subject of formal intergovernmental negotiations. Why was the issue put on the negotiation table precisely at that time?

As the official name suggests, the initial focus of discussion by the government officials from the two countries was the exchange rate. Financial liberalization was taken up as a means to address the problem of exchange rate, but later became the core subject. The exchange rate between the US dollar and the Japanese yen became a political issue because it was considered to be the main cause of the ballooning trade imbalances between the two countries. After the FRB under Paul Volcker raised interest rate to a historical high since 1979, the value of the US dollar jumped despite the already huge trade deficit the country had run. The trade deficit continued to grow, with Japan running the biggest trade surplus against the US in the 1980s.

[Figure 3.1]

Besides the overall trade imbalance, the imbalances in financial markets had become a source of concern in U.S.-Japan economic relationship since the 1970s. The

successful inroads of Japanese financial institutions in American markets contrasted sharply with the problems they had in penetrating Japanese markets. The US financial institutions started to complain in the late 1970s to their government about policies taken by the Japanese government. It should be noted, however, that the failure of US banks in making profits in the Japanese markets was not directly linked to trade imbalances at that time.

Japan's position in international financial markets had changed drastically over the post-war period. For two decades after the Second World War, the Japanese government's greatest concern regarding the control of international capital flow had been the lack of capital to finance domestic investment. The MOF placed restriction on capital outflows in order to alleviate the balance-of-payment problem. However, Japan had overcome its chronic balance-of-payment problem by the middle of 1960s and became a net creditor by 1969. Since the early 1970s, the MOF had gradually relaxed the restriction on capital flows in and out of Japan.[2] As Japan's balance-of-payment position improved and barriers to international financial transactions became lower, Japanese financial institutions expanded their international operations. They were especially successful in the American market where they rapidly expanded their

[2] The new Foreign Exchange and Trade Control Law of 1980 changed Japan's policy toward capital control into "free in principle" (Rosenbluth 1989, Chapter 4).

presence, in part taking advantage of the lax regulation there on foreign banks.[3]

On the other side of the Pacific Ocean, foreign banks had hard time in Japan since the mid-1970s. Right after the end of the Second World War, Citibank returned to Japan, together with Bank of America and Chase (Brown 1994: 16). Throughout the post-war period, foreign banks in Japan operated rather inconspicuously, enjoying the niche market in the Japanese financial market as they could mostly monopolize the business of connecting international capital markets and the Japanese economy. They faced increased difficulty since the mid-1970s, however. It was a result of gradual opening and liberalization rather than the closed nature of the Japanese market. In the past, even though it had been difficult for foreign financial institutions to enter Japan, it was a lucrative market for those who had established a sure footing. They were allowed to engage in a limited scope of business reserved for them. In the absence of many rivals, they could enjoy high earnings. After 1968, however, the MOF began to let a substantial number of major foreign banks into Japan.[4] The number of foreign banks operating in Japan grew from mere 18 in 1970 to 41 in March 1974 to as much as 61 in

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[3] See next chapter for more details.

[4] After giving license to J.P. Morgan in 1968, the MOF permitted the entrance of foreign banks into the Japanese banks in an orderly fashion. The permission was based on strict reciprocity. Moreover, the MOF did not allow banks already entered Japan to expand branch networks. See Brown 1994.

1978 (Brown 1994: 58). As a result, competition had turned increasingly fierce and the profits thin.

At the same time, changes in Japan's economy had diminished the advantages foreign financial institutions used to have. For example, as Japan accumulated foreign reserves and Japanese banks established their creditworthiness in international capital markets, the role of foreign banks as conduit to the international capital markets was no longer needed (Brown 1994: 51).[5] Foreign banks in Japan used to have exclusive right to make foreign currency loans, which was called "impact loan." However, the introduction of the new Foreign Exchange and Trade Control Law (Foreign Exchange Act) of 1980, which allowed Japanese banks to engage in foreign currency lending, deprived the foreign banks of the lucrative and stable business and introduced intense competition. They tried to find new sources of profit, such as leasing and consumer financing, but those business proved to be risky and unprofitable. As their earnings declined sharply, they began asking their home government for assistance (Brown 1994:68–9).

In that sense, gradual liberalization especially of international business, combined with remaining regulations on the banking sector in general, had actually

[5] In 1951, Japanese banks raised 16 percent of lending funds from foreign sources, and even in 1970, 12 percent of all lending were financed from abroad (Brown 1994: 62).

worked against foreign banks in Japan, as the profitable niche markets they have dominated were being eroded. Foreign banks in Japan were at a competitive disadvantage to Japanese banks, because they lacked the network of branches that would provide the low-cost deposits, as well as the close relationships with Japanese corporations. Without further deregulation, these banks would not be able to overcome these problems by, for example, having more branches or offering attractive interest rates.

By 1978, foreign banks began complaining publicly about the difficulty of raising yen funds. Led by Citibank, they demanded the right to issue certificates of deposits (CDs). In November 1978, four foreign banks testified in the Financial System Research Council, an advisory body for the MOF's Banking Bureau. The council's final report, however, described their complaints to be unfounded. Moreover, some observers viewed the permission for the Japanese banks to make "impact loans," which was granted in 1979, as a penalty imposed on foreign banks for having been outspoken (Brown 1994: 69–70). At that time, Japanese banks raised dollar funds by issuing CDs in New York, while issuing CDs was not permitted to Japanese banks in Japan as well as foreign banks there.

As their banks faced trouble in Japan, some sections of foreign governments,

including that of the US, started to pay attention to the plight of foreign banks in Japan, even though the US Treasury was slow to move. In May 1978, John J. Balles, then President of the Federal Reserve Bank of San Francisco, and Christopher Tugendhat, member of the European Commission, visited Japan respectively to discuss the issue with the Japanese government. Tugendhat asked for the permission to issue CDs and to establish branch networks (Tatewaki 2002: 217–18, Brown 1994: 68–70). The Japanese government responded that it would let foreign banks to issue CDs at the same time their Japanese counterparts would enter the business. Also in the US, a Congressional report, called the Jones Report and published in January 1979 to examine the problems in the U.S.-Japan trade relations, pointed to five discriminatory measures against U.S. banks in Japan. It included the restriction on establishing more than one branches and the issuance of CDs and bonds.[6] As for the CDs, Japanese banks, too, had long desired to obtain the permission to issue CDs in the Japanese markets. It was in May 1979 when the MOF allowed both Japanese and foreign banks to engage in that business.[7]

The U.S. Treasury held an intergovernmental negotiation on Japan's financial

[6] U.S. Congress, *Task Force Report on United States-Japan Trade*, Subcommittee on Trade of the Committee on Ways and Means, U.S. House of Representatives, January 1979.

[7] The MOF started deliberation on the issuance of CDs in 1978 in part in response to the request from the EC. *Nihon Keizai Shimbun*, May 11, 1978, p.3, July 7, 1978, p.1 and May 17, 1979, p.3.

regulation for the first time in 1979. In top-level talks of the officials from the two countries, the U.S. side asked Japan to ease restrictions on foreign banks operating in Japan, based on the idea of reciprocal treatment for U.S. bank branches. On the U.S. side, the private financial sector was not monolithic, however. Big banks (Citibank, Chase Manhattan, and Bank of America) hoped sweeping structural changes in the Japanese financial regulations. There requests included the elimination of barriers between short-term and long-term lenders and the diminution of the deposit-taking power of the Japanese Postal Saving System. Middle-sized ones, however, did not want such changes, as they feared that those changes would benefit big ones at the expense of the weaker.[8] This negotiation did not produce any significant policy change in Japan.

In the early 1980s, the U.S. efforts to open up Japan's financial markets became more systematic and government-wide. Here, the sense of unfairness played a role. The concern for the penetration of foreign banks into the U.S. markets started to grow in the 1960s. It began to attract political attention in the next decade, and in the 1980s, the rapid expansion of foreign banks, especially Japanese ones, became an important political issue, as I will discuss more closely in the next chapter. The unease came from the "invasion" by foreign players in an important sector in the U.S. economy.

[8] "US is said to be making efforts to ease restrictions on foreign banks in Japan," *Wall Street Journal* February 2, 1979, p.6.

In the bilateral negotiations, however, the liberalization of Japan's financial market became a highest-level agenda only when it was combined with the issue of yen-dollar exchange rates, and was regarded as one of the potential solutions of the huge trade deficit of the U.S. It was in the context of the overall U.S.-Japan trade imbalances that financial regulation was elevated to the highest-level of intergovernmental relations.

Even though bilateral trade imbalance itself is not a serious economic problem in multilateral trade, the surge of Japanese products into the American market caused severe tension as it translated into job losses. Frustrated observers often thought that Japanese protectionism, not the cost or the quality of products nor the macroeconomic policies of the two countries, caused such a trade imbalance. In addition, it was also argued that undervalued yen gave Japanese producers an unfair advantage. C. Fred Bernstein, a well-known economist who served as Assistant Secretary of the Treasury for International Affairs during the Carter administration, insisted that the misalignment between dollar and yen was the most important cause of the periodic outbursts of U.S.-Japanese economic conflict between 1970 and 1982 (Bergsten 1982). As Bergsten pointed out, the misalignment was mainly caused by macroeconomic policies of the two countries. To correct the undervalued Japanese yen, therefore, both countries had to

change their macroeconomic policies.

However, those frustrated with Japan accused the country of artificially holding down the value of the yen in order to discourage imports and encourage exports. It was Lee L. Morgan, chairman of Caterpillar, who seized on the issue of exchange rate and brought it into the political arena. Morgan's company had faced intense worldwide competition with Japan's Komatsu in selling construction equipment (Frankel 1984:1). In his testimony before the House Ways and Means Trade Subcommittee held on November 30, 1982, Morgan regarded the undervaluation of yen as the single most important cause of the trade imbalance with Japan.[9] To make his point stronger, he then commissioned Ezra Solomon, Professor of Stanford University, and David Murchison, a Washington lawyer, to draft a report on the issue. The Solomon-Murchison Report, released in September 1983, argued that the Japanese should contribute to a stronger yen by removing all artificial obstacles on the demands for yen, such as interest rate controls, and by making the yen a more attractive investment currency.

The assumption that overvaluation of the dollar was caused by Japan's microeconomic policies was obviously flawed, however. Computing the value of each currency in terms of a weighted average of trading partners, Frankel (1984: 13)

[9] Hearing before the Subcommittee on Trade of House Ways and Means Committee on"Current Exchange Rate Relationship of the U.S. Dollar and the Japanese Yen," November 30, 1982.

concludes “the primary problem is with the strong appreciation of the dollar and the root of that appreciation within U.S. economic policy, not with the yen or Japanese economic policy.” Moreover, economic theories suggest that the net effect of financial liberalization on the value of yen was ambiguous in direction and in any case likely to be small. Bernstein (1982: 1069–73) recommended reduction of U.S. budget deficit and more public spending in Japan, while he also suggested that Japan should actually restrict capital outflow. He noted that Japan’s significant liberalization of foreign access to Japanese capital market since 1980 was “a desirable step from the long-run point of view, but one which adds to capital outflow from Japan and thus weakens the yen in the short run.” Curiously, the Japanese MOF officially reported that no official in the U.S. administration truly believed the positive relationship between the liberalization of the Japanese capital markets and the value of yen.[10]

Still, the Solomon paper caught attention of the Reagan administration. The argument made by Morgan appealed to the people in the Reagan administration, who had strong belief in freer markets (Brown 1994: 92). It also fit the aggressive orientation of Treasury Secretary Donald L. Regan. Moreover, Morgan’s recommendation could be traded off domestically against strong election-year pressure for protection of U.S.

[10] Ministry of Finance, *Okurasho Kokusai Kinyukyoku Nempo* [International Finance Bureau Annual Report], 1985: 50.

business from Japanese imports (Frankel 1984: 2).[11]

Turf Battle and the Establishment of the Yen/Dollar Committee

Importantly, the Yen-Dollar Committee was also a byproduct of turf battle within the executive branch of the government. In 1983, the trade imbalance and the exchange rate became an important political issue in the U.S. in the year preceding the presidential election. Even though the exchange rate was a matter under the exclusive jurisdiction of the Treasury, frustrated members of the Reagan administration started to show signs that they would intervene in the matter of exchange rate.

On September 28, 1983, in the meeting between U.S. Secretary of State George P. Shultz and Japan's Minister of Foreign Affairs Shintaro Abe, Schulz pointed out that the issue of the Yen-Dollar exchange rate should be examined from various points of views and stated that if the Treasury and the MOF would not work on the issue, it could be handled by the Secretary of State and Minister of Foreign Affairs. Abe replied that he would inform the MOF and the Bank of Japan.[12] Earlier that month, Schulz called for efforts by the US and Japanese governments to address the problem of strong dollar and

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[11] In the official annual report of the Bureau of International Finance of the MOF, another story is told. According to the report, President Reagan cancelled his planned visit to the Philippines after the assassination of Benigno Aquino. As a result, the U.S. government needed to find a new issue that would highlight Reagan's trip to Asia. It was how the issue of exchange rate was taken up in the summit meeting. Ibid, pp. 49-50.

[12] *Asahi Shimbun*, September 29, 1983, p.9.

weak yen together with taking other policy measures to expand access of American products in Japan and to reduce the bilateral trade imbalance.[13] Yet, his comments in the foreign ministerial meeting shocked the Treasury and the MOF. They feared that diplomats would interfere in a crucially important issue under their jurisdiction. As the summit meeting between Reagan and Nakasone was planned in November, R. T. McNamar, Deputy Secretary of the Treasury, and Tomomitsu Oba, Vice Minister for International Affairs of the MOF, met secretly in Honolulu, Hawaii, on October 10 in preparation for the summit meeting.

According to a former senior official of the Japanese MOF, there was a move within the US Reagan administration in the fall of 1983 to create an interdepartmental forum to deal with the issue of foreign exchange. The State Department, the Commerce Department, and the United States Trade Representative (USTR) wanted to establish such a forum, which would also include their Japanese counterparts such as the Ministry of Foreign Affairs and the Ministry of International Trade and Industry (MITI).[14]

[13] Stuart Auerbach, "Japan Pressed by Shultz to Open Markets," The *Washington Post,* September 3, 1983, p. E9.

[14] Interview with Makoto Utsumi, November 29, 2002. Utsumi worked for the Ministry of Finance from 1957 to 1991. At the time the Yen Dollar Committee was established, he was Minister Extraordinary and Plenipotentiary at the Embassy of Japan in Washington, DC. He was also the head of the International Organizations Division, International Finance Bureau, in the mid-1970s. In the 1980s, he served as Director General of the International Finance Bureau and then Vice Minister of Finance for International Affairs. He represented the Japanese government in various international economic negotiations such as group of seven meetings, the preparation of the Plaza Accord, and the US-Japan Structural Impediment Initiative.

Within the US administration at that time, the Treasury was at a vulnerable position as it could not take effective measures to solve the problem of the exchange rate especially with Japan. Frustrated with the lack of solutions proposed by the Treasury, the White House, the Commerce and the USTR all severely criticized the Treasury. However, the involvement of other governmental agencies would be a nightmare both for the Treasury and the Japanese MOF. They did not want to have others interfere into the issue of exchange rate, which had been handled quite exclusively by a small number of financial officials at the international level.

At that time, the Commerce and the USTR also considered new steps to establish new international rules on trade in services, a new concept to deal with international investment and other types of transactions in the services sector, including the financial business.[15] For that purpose, too, they had an incentive to intervene in the financial negotiations.

To counter such moves, the officials in the international sections of the Treasury and the MOF, who had worked together before that point and known each other well, started to develop a new framework to deal with the currency problems combined with the problem of foreign banks' operation in the Japanese financial market.

[15] For more details on the U.S. moves on trade in services, see Chapter 6.

This is how the Yen-Dollar Committee came into existence.

3.2 Setting up the Yen-Dollar Committee

As discussed above, the U.S. government intensified pressure on Japan to raise the value of the yen and to reduce bilateral trade surplus as the summit meeting planned in November was approaching. In an effort to placate the U.S. government, the Japanese government incorporated the goals of reducing trade surplus and making the Japanese yen stronger into the Comprehensive Economic Plan announced in the end of October. Originally, the plan was prepared to fulfill Prime Minister Nakasone's pledge to expand domestic demand made at the Williamsburg summit in May 1983 and included measures such as expansion of public investments and tax cuts,. To address the issue of the exchange rate, "internationalization of yen" was added as one of the pillars of the plan. More specifically, the plan said that the Japanese government would consider significant changes in the real demand rule in forward exchange transactions and it would examine the possibility of creating a yen-denominated banker's acceptance (BA) market, among other things.[16] The plan fell short of offering concrete schedule for reform and was far from enough to satisfy the U.S. side, however. More concrete

[16] *Yomiuri Shimbun*, October 21, 1983, evening edition, p.2, and *Asahi Shimbun*, October 21, 1983, p.1.

proposals should be made.

The Treasury and the MOF continued to negotiate, and agreed to make more specific promises at the summit meeting and to set up a committee to further discuss the issue between the two agencies. Right after the summit meeting between Reagan and Nakasone, on November 10, 1983, U.S. Treasury Secretary Donald Regan and Japan's Finance Minister Noboru Takeshita announced an agreement in which the Japanese side agreed to eight specific measures on financial market liberalization.[17] The eight measures are:

(1) Real demand rule in forward exchange transactions would abolished on April 1, 1984.

(2) A bill to eliminate the designated company system would be submitted to the next Diet session in order to abolish the rule barring Japanese from foreign exchange speculation in the yen. It opened some Japanese industries, such as mining, to U.S. and other foreign investment.

(3) The bill to allow the issuance of foreign currency denominated national bonds abroad would be submitted to the next Diet session.

(4) The creation of Yen-denominated banker's acceptance (BA) market would be

[17] Since Regan did not visit Japan that time, McNamar met Takeshita on behalf of Regan (Takita 2006: 43).

studied seriously.

(5) The minimum denomination of CDs would be lowered to 300 million yen from 500 million yen on Jan 1, 1984.

(6) The ceiling on each bank's CD issues would be enlarged on April 1, 1984.

(7) The guidelines on the issue of Euroyen bonds by residents would be eased on April 1, 1984.

(8) The abolishment of the withholding tax on non-residents' interest earnings on investment in Euroyen bonds issued by Japanese residents would be studied.

To monitor the implementation of the measures and to discuss additional measures, they also agreed to set up an ad hoc working group. Under the Committee co-chaired by Regan and Takeshita, a working group was established. The co-chairmen of the Ad Hoc Working Group were Beryl W. Sprinkel, Undersecretary for Monetary Affairs, U.S. Treasury, and Japan's Tomomitsu Oba (Frankel 1984: 2).

Negotiators

On Japan's side, two officials in the MOF played a crucial role in establishing the Committee. The first was Tomomitsu Oba, who became Vice Minister for Foreign Affairs in June 1983. After his entry into the MOF in 1953, he mostly worked in

international sections of the ministry. Oba was Senior Deputy Director General of the International Financial Bureau since 1979, then appointed to be Director General in June 1982, and was elevated to Vice Minister for Foreign Affairs next year. Measured against the routine personnel practice of the MOF, Oba was relatively young when he became the vice minister.[18] The appointment of Oba, a man with a distinguished career in the international sections of the MOF and tactical skills to deal with conflicts of interests within the ministry, reflected the awareness within the ministry of the increasing importance of international relations to the Japanese financial system in the early 1980s, just before the US linked the exchange rate issue to the reform of the Japanese financial system. Before Oba's appointment, the position of Vice Minister for International Affairs, or *Zaimukan*, was considered to be an outsider to the mainstream MOF and often went to the runner-up to the administrative vice minister. Oba was sometimes called the first true *Zaimukan* (Brown 1994: 95–96).[19]

The second key person was Makoto Utsumi, who was at the Embassy of Japan in Washington, D.C.[20] Before moving to Washington, Utsumi's had a successful career

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[18] *Nihon Keizai Shimbun*, June 3, 1983, p.3.

[19] See also *Kinyu Zaisei Jijo,* June 13, 1983, pp. 18–19.

[20] His title was Minister Extraordinary and Plenipotentiary at the Embassy of Japan.

in the Tax Bureau of the MOF, but it hit a wall when the MOF's attempt to introduce a new system to reduce tax evasion failed in 1982. Oba sent him to the U.S. in June 1983, however, as his right arm in the expected interaction with the U.S. on financial issues. Fluent in English and French, Utsumi began to serve as a critical pipeline between Washington and Tokyo. In addition to meeting Treasury officials to exchange information, he also developed personal relationship with them by, for example, organizing *karaoke* parties. Later, he continued to advance in the international section of the MOF, returned to Japan in 1986 as the Director General of the International Finance Bureau, and eventually became a *zaimukan* (Brown 1994: pp.97-98)[21]

On the U.S. side, because of the government change from Democrat Jimmy Carter to Ronald Reagan in January 1981, all top-ranking officials of the Treasury changed. Consequently, we cannot expect much continuity of US officials from the 1970s. And yet, the new leaders of the Office of International Affairs worked together with the Japanese MOF officials before the establishment of the Yen-Dollar Committee, especially on the issue of the Mexican debt crisis (Brown 1994: 93). The US negotiating team was led by Undersecretary of the Treasury for Monetary Affairs Beryl W.

[21] Utsumi had an experience of international negotiation as the head of the International Organizations Division of the MOF in the mid-1970s.

Sprinkel.[22] He received his Ph.D. in economics from University of Chicago. Before entering in the government, he had worked for the Harris Trust and Saving Bank in Chicago from 1952 to 1981.[23] His personal policy position affected the negotiation outcomes, as I will discuss later. Those who set up the Committee with their Japanese counterparts were Deputy Secretary of the Treasury McNamar and Assistant Secretary for International Affairs Marc E. Leland.[24] Both were lawyers, and appointed by President Reagan to the Treasury positions at the beginning of 1981.[25]

On the Japanese side, in addition to these officials from the international section of the MOF, Director Generals of domestic bureaus became members of the international negotiation team. The internationally oriented officials within the Japanese

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[22] The responsibility of Under Secretary for Monetary Affairs included that of international affairs. The position was abolished when Sprinkel left the Treasury in 1985 and replaced by a new position, Under Secretary for International Affairs. Clyde H. Farnsworth, "Washington Watch: Treasury Realignment" *Washington Post,* March 25, 1985, p. D2.

[23] Later, he became chairman of the Council of Economic Advisers in February 1985, and became known for his handling of the 1987 stock market crash.

[24] Interview with Makoto Utsumi, November 29, 2002.

[25] From 1973 to 1977, McNamar was Executive Director of the Federal Trade Commission. Ronald Reagan, “Nomination of R. T. McNamar To Be Deputy Secretary of the Treasury,” January 23, 1981. (http://www.presidency.ucsb.edu/ws/?pid=43701). In February 1984, in the midst of the Yen/Dollar talks, Assistant Secretary Leland was replaced by David Mulford. Some of the lower rank participants had worked in the international office of the Treasury since the 1970s. Robert Fauver, Director of Office of Industraial Nations and Global Analysis, had been International Economist in the Treasury since 1970. Fauver moved to the State Department in 1989 and played a key role in the SSI talk with Japan (Schoppa 1997: 337). William McCamey, who attended the Committee as the Treasury’s attaché to the US Embassy in Tokyo, had served as an international economist of the Treasury. Erik Floyd, another Treasury’s attaché in Tokyo, also started his career in the Treasury and continued to serve there before he moved to the private sector in 1986.

MOF perceived the establishment of the framework as an opportunity to expose domestically-minded financial industries and their regulators in the Japan to a rapidly internationalizing world of finance.[26] After the establishment of the working group was agreed on in November 1983, the Japanese MOF established intra-ministry committees to identify problems and collect their ideas through discussions (Kuribayashi 1988: 79–81). As these committees cut across the bureaus, they included director generals of domestic sections, such as the Banking Bureau and Securities Bureau, together with officials from the International Finance Bureau. The talks thus directly involved officials who usually deal mainly with domestic matters, working closely with domestic financial institutions they regulate. This domestic group remained by the sideline in the course of the negotiations, however, being pushed by the U.S. team into liberalization, while negotiations on terms of liberalization were mostly carried out by Oba, Utsumi, and other officials from the International Finance Bureau.

By contrast, the U.S. side was consisted of officials from the Office of International Affairs, reflecting the asymmetrical nature of the talks. However, the American side surprised the Japanese side with its detailed knowledge on Japan's financial system, including informal practices and tax systems. The Japanese negotiators,

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[26] At that time, the word "internationalization" was more common than the word "globalization." The latter gained currency in the 1990s.

many of whom were generalist career bureaucrats and not specialists of financial issues, were no matches for their U.S. counterparts in the negotiations. The U.S. negotiators were very well-informed of the complaints from the Japanese industry on Japan's inefficient financial regulations.[27] That was the result of the International Banking Act of 1978. Based on the law, Congress ordered the Treasury to draft a report examining the treatment of U.S. banks in other countries. Since the drafting of the first National Treatment Study in 1979, the department sent a fact-finding mission to Japan. The Treasury also had an attaché in the U.S. Embassy in Japan. The increased contact between the Treasury attaché and the foreign banking community in Japan developed information on foreign banking problems within the department (Brown 1994: 70, 85, 92).

Such commitment of the Treasury to the situation of US banks in Japan was another important factor that contributed to connecting the exchange rate problems and the reform of the Japanese domestic financial markets.

Negotiation Process

The working group had six meetings before the two countries agreed on the final accord. The first three were held once a month from February to April. In the first meeting, the

[27] *Toyo Keizai Kinyu to Ginko* June 15, 1984, 52-54.

two sides exchanged their views. The main topics for the second and the third meetings were liberalization of Japan's financial markets and the internationalization of yen, respectively. Then in the following three meetings held in May, negotiators drafted the final accord (Oba 1984).

The relationship between liberalization of financial markets and the exchange rate remained unclear. The aim of the series of talks, therefore, eventually became the opening up of Japan's markets to U.S. financial institutions rather than the correction of the exchange rate (Kojima 1985: 35). In the early stage of negotiations, the U.S. negotiators directly demanded to improve the access to the Japanese markets. They shifted to more indirect strategy of focusing on liberalization of Euroyen markets by mid-March. The shift in focus was at least in part caused by the appointment of David Mulford in February 1984 as Assistant Treasury Secretary for International Affairs in the Treasury to succeed Marc Leland.[28] Mulford had been the head of the investment advisers group for the Saudi Arabian Monetary Agency before that appointment, and had over nine years of experience at Merrill Lynch Capital Markets.[29] As an expert on the Euromarket, Mulford aimed to achieve U.S. objectives by promoting the

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[28] *Kinyu Zaisei Jijo,* June 11, 1984, p. 24–27.

[29] "Capital People, "*The American Banker*, January 3, 1984, p.3, and March 5, 1984, p. 3.

development of an international yen market, based on the expectation that the growth of a relatively unrestricted Euroyen market would break the restrictions in Japan's financial markets.

The U.S. team thus placed special emphasis on the development of the Euroyen as a measure to enhance overall financial liberalization. And it was particularly difficult to overcome the differences on the issue. In early May, the two parties attempted to prepare a draft of the final accord but failed, mostly because they could not agree on the specifics of liberalization of the Euroyen market.[30] The Japanese government feared that a free Euroyen market would seriously disturb the established order of the heavily regulated financial markets of that country. It also had concern that the internationalization of yen would result in loss of control over the domestic money supply. The U.S. side insisted the liberalization of medium- and long-term Euroyen loans to residents, swift relaxation of the guidelines for issuance of Euroyen bonds by non-residents, and the abolishment of the withholding taxes on Euroyen bonds issued by residents, while the Japanese side proposed gradual liberalization.

Interestingly, it was not exactly the U.S. financial institutions operating in Japan hoped for. The U.S. banks in Japan did not welcome their home government's

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[30] *Asahi Shimbun*, May 12, 1984, p.9.

effort for internationalization of yen, because increased use of yen in international trade and investment would possibly erode their global advantage obtained through their ready access to dollar sourcing and investment (Rosenbluth 1989: 75). Nevertheless, the idea of securing interests of the American companies by promoting Japan's liberalization appealed to the market ideology of the Regan administration and of the Treasury, and the strategy was adopted.

In addition to help American financial institutions that were already operating in Japan, there laid an increased concern for trade in services, which was becoming an important part in the world trade system. Unlike the trade in goods, the rules for the trade in services were almost nonexistent in the GATT system at that time, and the U.S. began working to establish a new regime for the sector. The U.S.-Japan negotiations over the exchange rates thus served as a test for the establishment of a new global framework for trade in services.[31]

On domestic liberalization, there was also a major disagreement. The Japanese side insisted on step-by-step, incremental reform of interest rates and other financial regulation. The U.S. team was frustrated and demanded "step-by-step with long stride"(Takita 2006: 77–78).

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[31] See Royama 1986:80–81. For more details about international negotiations over trade in services, see Chapter 6.

3.3 The Outcome

The Committee issued a report in the end of May 1984. The Yen/ Dollar Accord was a comprehensive agreement committing the Japanese government to substantial reform of the financial markets. The issues were divided in four issue areas: (1) domestic capital market liberalization, (2) access of foreign financial institutions to Japanese money and capital market, (3) the "internationalization" of yen, or the development of a Euroyen market, and (4) the enhancement of cross-border direct investments. To make the talks two-way at least on paper, the Japanese concerns on the U.S. financial issues were also listed in the Accord. Yet, it was obvious that at the center of the Accord was the liberalization of the Japanese financial markets. The Accord set direction toward liberalization of the domestic financial markets of Japan. While it pointed to detailed issues, it did not set specific schedule for the implementation on most of them. The pace was mostly left to the MOF. The bilateral committee was to examine the progress in the subsequent follow-up sessions.

The specific promises made in the May agreement were as follows.[32]

[32] Report by the Working Group of Joint Japan-U.S. Ad Hoc Group on Yen/Dollar Exchange Rate, Financial and Capital Market Issues, to Japanese Minister of Finance Noboru Takeshita, U.S. Secretary of the Treasury Donald T. Regan, May 1984.

(1) Domestic capital market liberalization

- Liberalization of interest rates

The MOF offered a specific time schedule on the liberalization of large denomination deposits (mostly CDs), and stated that it would move on to interest rates on smaller deposits.

(2) Access of foreign financial institutions to Japanese money and capital market

- The management of investment funds in Japan by foreign firms

The MOF would license qualified foreign banks to participate in trust banking activities. A concrete scheme would be announced by the end of 1984.

- Membership of foreign securities firms in the Tokyo Stock Exchange

The MOF "requested the TSE to study ways of providing opportunities of membership to foreign and domestic non-member firms."

- Dealing in Japanese government securities by non-Japanese banks

Qualified Japanese branches of non-Japanese banks would be allowed to trade government securities soon.

(3) "Internationalization" of yen and the development of a Euroyen market

- To enlarge the Euro-yen markets, the following measures were carried out.

First, Euro-yen CDs were introduced in December 1984. Second, short term

Euro-yen lending by banks outside of Japan to Japanese residents was permitted in June 1984.[33] Liberalization of long-term lending was more difficult because the lending by foreign affiliates of Japanese banks to Japanese residents could be a violation of the Long Term Credit Bank Act, which separated the long-term and short-term bank lending. Nevertheless, the ban on long-term Euro-yen lending to non-residents was lifted in April 1985 and that to residents in May 1989. Third, external yen lending by banks in Japan to non-residents was also liberalized.

- International bond issues

The liberalization of euro-yen issues from 1984 to 1986 led to the liberalization of yen-dominated bonds issues in Japan by non-residents. The Japanese government also deregulated Euro-yen bond issues by residents, which in turn enhanced the liberalization of non-collateralized bond issues in Japan. Responding to the U.S. demand, the Ministry of Finance also granted equal treatment of domestic and foreign underwriters of Euro-yen bond issues.

- Relaxation of restrictions on foreign exchange transactions

The "real demand principle" was abolished in April 1984. The MOF announced that it would remove the "swap limit rule" on the conversion of foreign currency

[33] The loans to non-residents was already permitted.

into yen both for foreign banks and Japanese banks, effective June 1, 1984.

(4) Enhancement of cross-border direct investments.

- Designated company system

A bill to eliminate the designated company system was passed by the Diet on May 18, 1983.

Domestic Liberalization and U.S.-Japan Talks

On the same day, the Ministry of Finance issued a separate document titled "Current Status and Prospects for Financial Liberalization and Internationalization of the Yen," which outlined specific measures to deregulating financial markets and promoting internationalization of the yen. The Financial System Research Council (*Kinyu Seido Chosakai*), an advisory body to the Minister of Finance, began discussions on how to handle financial liberalization in the fall of 1982. The final report was originally scheduled to be issued in April. In response to the establishment of the Yen-Dollar Committee, the issuance was delayed so that the report would also cover the issue of liberalization of the yen including recommendation to establish the Japan Offshore Market (Kuribayashi 1988: 91–92). The report covered some domestic issues that were

not subject to the Yen-Dollar Accord, such as the scope of business allowed to each type of financial institutions and the maintenance of stability of financial systems.

As these developments demonstrated, the U.S. pressure was not the only factor that caused the liberalization of financial markets in Japan. It was working in tandem with internal demands for decontrolling the compartmentalized structure of the financial system and the regulations over interest rates.

Three changes in the Japanese economic system facilitated financial liberalization in the 1970s. The first is the massive issuance of government debt since 1975. The introduction of public auction system in 1978 brought market-based interest rates in a heavily regulated financial system. The second was the accumulation of funds in big corporations. Major companies became less dependent on bank lending. Thirdly, at the international level, deepening integration of national financial markets and innovations in financial technologies, the tight regulations in Japan became increasingly outdated. Major companies started to raise funds in Euromarket rather than in the heavily restricted domestic markets since 1975 (Kaizuka 1986).

Gradual liberalization of interest rates and relaxation on foreign exchange transactions began in the late 1970s. Japan's MOF had recognized the need to make the Japanese financial sector more efficient by the 1970s. Until the end of the 1970s,

however, its efforts were mostly directed at guiding mergers of financial institutions to make them stronger and more competitive rather than enhance efficiency by removing excessive regulation and introducing more competition. In response to the demand for financial liberalization, the MOF started to deliberate the strategy in 1975. At the end of the 1970s, call market rates and interests on bills were liberalized. The establishment of CDs in 1979 was also an important step toward further liberalization of deposit interest rates. As for the external liberalization, the Foreign Exchange Law was amended in 1979 and the new law became effective in December 1980. Under the new law, all external capital transactions became free unless explicitly prohibited. The revision was a reaction to overseas criticism mounted against Japanese controls on most international financial transactions (Nishimura 2003, Rosenbluth 1989).

Yet, the reform dynamics within consensus-prone Japan is known for its time-consuming and incremental nature. The use of an advisory council, the MOF's Financial System Research Committee, was a typical way with which financial regulatory changes were discussed in Japan. Advisory councils have played important roles in Japanese policymaking. Usually consisted mainly of scholars, representatives of various interest groups, retired bureaucrats, and journalists, their most straightforward function has been to provide outsiders' advice and to pluralize governmental

decision-making, but in reality, a more important function of the councils is adjusting all kinds of conflicting interests (Schwartz 1993). In the case of financial liberalization, severe conflicts of interest among different types of financial institutions, such as various types of banks and securities companies, often constitute the main obstacle to substantial reform. Rather than excreting strong leadership, nor having the issue discussed in the parliament, it has been customary for the MOF to take time to coordinate in the advisory council and outside of it to hammer out a compromise. As a consequence, reform is always extremely slow and only gradual. In the history of liberalization of financial markets in Japan, therefore, the accord with the U.S. crucially accelerated the process. Even though the liberalization process dated back to the 1970s, it was this 1984 agreement that made the Japanese government commit itself to a specific time schedule for deregulation (Frankel 1984, Osugi 1990:7-9).

Follow-up Sessions, 1984–1988

After the Yen/Dollar Accord was concluded, the officials of the two countries had a series of meetings to follow-up the agreement. The main task was to see whether Japan would abide by the agreement. Starting from the first follow-up session in November 1984, six sessions were held until April 1988. The liberalization measures pledged by the Japanese side were mainly examined, while the U.S. promises, including the efforts

to reduce budget deficits, were not seriously scrutinized.

During this period, the MOF presented the progress in liberalization of interest rates on wholesale transactions. More importantly, the MOF also tried to give preferential treatments to some foreign financial institutions by allowing some of them to enter into the Japanese financial markets, or letting some existing firms engage in some new types of business. In June 1985, the MOF announced that it would allow all of the nine foreign banks that had applied for the license of trust banking. Since the MOF did not permit Japanese commercial banks to engage in trust banking, it was "more-than-national treatment." At that time, the management of ballooning pool of retirement savings in Japan attracted attention of Japanese and foreign financial institutions alike. In the summer of 1983, Morgan Guaranty Trust Company and the Nomura Securities surprised the financial regulators by announcing their intention to form a joint venture to enter the investment management business. The MOF officials declined to accept it, but they felt that it would not satisfy the U.S. government (Pauly 1988: 87).

Furthermore, in November 1985, six foreign securities firms were given membership of the Tokyo Stock Exchange. In December 1985, the MOF permitted some European commercial banks to open securities subsidiaries in Japan on the basis

of reciprocity. Furthermore, in June 1987, the MOF gave securities licenses to ten American and European securities companies. Four of them were securities subsidiaries of American commercial banks. The same was not allowed to Japanese banks until 1993.

In the course of the follow-up sessions, the U.S. brought up new issues, such as the liberalization of the interest rates on small denomination deposits, claiming that the remaining regulations on those interest rates had depressed domestic consumption in Japan.[34] However, both sides were generally satisfied with the results, as the terms of agreement were generally met and the Japanese capital markets were gradually liberalized.

In the last of the follow-up sessions, held in April 1988, the mood was primary positive and buoyant. Even though the issue of foreign institutions' access to the Japanese government bond market, which became the main issue in the bilateral talks remained to be unsolved, Mulford noted after the meeting that "important achievements" were made since the talks began in 1984. The two countries agreed to reorganize the framework to go beyond the Yen-Dollar Accord, and renamed it the "U.S.-Japan Working Group on Financial Markets". The new group would take a more

[34] *Asahi Shimbun*, May 28, 1987, evening edition, p.1.

global perspective and discuss the function and regulation of global and domestic markets among other topics.[35]

Evaluating the Outcome

How should the negotiation outcome be evaluated? In almost all negotiations, the outcome falls somewhere in between the competing interests, and it is hard to say which side wins. Overall, however, the U.S. side won a series of liberalization measures both in international use of the yen and of domestic regulation. Even though financial liberalization was already under way in Japan, the scope and speed of liberalization of Japan's financial markets were unthinkable without the pressure from the U.S. government. Measures to liberalize Euroyen transactions were taken, liberalization of interest rates was launched, and U.S. financial institutions were given access to the Japanese market. Of course, the Japanese negotiators did not concede to every American demand. Most notably, the MOF did not offer specific time table for the liberalization of interest rates of small-denomination deposits, and did not allow medium- and long-term Euroyen lending (Rosenbluth 1989: 82). Those are the measures that could rock the foundation of the tightly regulated and compartmentalized

[35] Carla Rapoport, "US Pleased With Latest Japanese Deregulation," *Financial Times*, April 21, 1988, p.35. At that time, the introduction of new bank capital rules was discussed in the Basel Committee on Banking Supervision. In the bilateral financial talks, the U.S., as well as the U.K., demanded Japan to introduce strict regulations. *Nihon Keizai Shimbun*, May 24, 1987, p.1.

Japanese financial system of the time. The system had been under pressure for reform, even without the pressure from the U.S. government. However, the MOF carefully guided the reform process throughout the 1980s to carry it out in an incremental matter. The medium- and long-term Euro yen lending was liberalized only in May 1989, and the liberalization of interest rates of small-denomination deposits was completed in 1994.

Importantly, the MOF also made concessions of a different kind. Especially in the follow-up sessions of the Yen-Dollar Talks, the MOF granted preferential treatment to certain foreign, chiefly American, financial institutions. Some of them are allowed into the business that was not permitted to their Japanese counterpart. A significant example is trust banking.

This policy caused concern among other countries. Out of the fear that U.S. banks and financial institutions would take all the best opportunities preserved for foreigners as a result of tough negotiations, the British Treasury also started a series of negotiations with Japan in October 1984. Germany, France and Italy followed suit. Geoffrey Littler, then second permanent secretary in the U.K. Treasury, led the British negotiating team, which met twice a year with the Japanese team (Cortazzi 2001: 439–448). His list of key demands included licenses for securities firms, and

liberalization of rules for professional investment management. Over time, the British team echoed the U.S. team to demand liberalization of interest rates on savings and other rigidly controlled financial regime in general. Membership of the Tokyo Stock Exchange was also on the table. Littler noted that “changes seemed to have been limited to small incremental steps” in Japan, referring the situation with the term “notorious line of ‘step-by-step’ changes.” The two sides also started to exchange views on a number of international financial problems toward the end of the negotiations (Cortazzi 2001:445–6).

3.4 Explaining the Outcome

There are a couple of different perspectives to explain this outcome. Here, I discuss three approaches. The first is based on the realist view of international politics, the second the ideational explanation, and the third interest based approach. Then I proceed to use my own explanation, which rest on institutional conditions.

Power-based Explanation

First, the Realist camp would see the results as the product of power relationship between the two countries. More specifically, the result should reflect the superior power of the US. In reality, the impact of military power on the economic negotiations

is hard to observe, but there were two instances in which the US side resorted to coercive measures in some sense. The first was the effort to link the issue to Japan's contribution to the World Bank. During the negotiations, the US government blocked the enlargement of Japan's role in the World Bank, asserting that the Japanese should open up their capital markets more than they had offered if it would hold enhanced status in the World Bank. Japan was to be moved in shareholder strength in the bank from fifth place to second in recognition of its contribution to the $9 billion aid program for poor countries. The strategy did not work in favor of the U.S, since not only Japan but also most other countries criticized the US for linking the bilateral issue to the issue of international aid, which was urgently needed in the international society.[36]

The second was the more general use of reciprocity by the U.S. Congress. At the time the bilateral talks were held, efforts were being made there to introduce reciprocity in dealing with applications by foreign banks to open a Federal branch or agency. In early 1984, Jake Garn, Republican senator and Senate Banking Committee chairman, introduced an amendment to the International Banking Act of 1978.

At that time, the *Business Week* argued that the reciprocity bill was effective in

[36] Max Wilkinson, "Ministers deadlocked over $9bn IMF aid for Third World," *Financial Times*, April 14, 1984, p.1,Milt Freudenheim and Henry Ginger, "The World," *New York Times*, April 15, 1984, p.4.

making Japanese concessions even though it did not pass.[37] However, the effect was very limited at best, since the administration and the private financial sector of the U.S. did not want to use it as leverage. At the hearing on the bill, S. 1293, held on September 26, 1984, Treasury Secretary Regan opposed the bill. He stated that countries such as Japan, South Korea, Canada, Australia and Portugal made progress in liberalizing their financial markets. He also noted that reciprocity requirements could be counterproductive. On Japan, he said that the Yen-Dollar Accord was being implemented smoothly. Witnesses from the private financial sector also cautioned the committee against the reciprocity bill. Robert P. Williamson, president of the Bankers' Association for Foreign Trade (BAFT) and senior vice president of Security Pacific National Bank in Los Angeles, told the committee that the "informal policies or administrative practices" in each country should be dealt with through negotiations. Peter Howell, vice president of Citibank, gave similar testimony. No U.S. banks pushed for the bill earnestly.

At the same time, Regan added to his caution to reciprocity that the administration would not "hesitate to take vigorous actions to promote or protect our interests." Senator Garn asserted that Congress would monitor the situation and his

[37] "A Bill That's Packing a Punch before it Passes" *Business Week*, May 14, 1984, p. 44. The Japanese side denied the effects of the bill. Interview with Makoto Utsumi, November 29, 2002.

pending bill or stronger legislation “will remain a threat.” He promised to introduce his bill again next January so that it would be available for action.[38] The development since then will be discussed in the next two chapters.

Interest-based Approach

The second explanation of economic negotiations focuses on interests of important economic groups. Schoppa (1997) argues that, in intergovernmental economic negotiations, outside pressure to open a market works only when such pressure resonates with domestic demands. Rosenbluth (1989: 53) also puts, “[f]oreign diplomatic pressure is effective only when market forces have already altered domestic costs and benefits or when there is a perceived threat of retaliation.” We can argue that the talks bore fruits because the U.S. entered where there was already an ongoing debate on liberalization.[39]

The opinion expressed by big business in Japan have been in powerful concert with the pressure from the U.S. Ryoichi Kawai, then chairman of Komatsu and the head of Keidanren’s panel for discussing industry and finance, told *Nihon Keizai Shimbun* in

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[38] Jay Rosenstein, “Better Deal for US Banks Abroad Aim of Administration, Congress,” *The American Banker*, September 27, 1984, p.2, Dennis W. Holden, “The National Treatment Debate Continues,” *United States Banker,* October 1984, p.42, “Regan Opposes Banking Reciprocity Bill,” *Jiji Press Ticker Service* September 27, 1984.

[39] See Brown 1994, Chap. 6.

May 1984 that the Japanese industrial circle mostly agreed to what the U.S. government demanded. Kawai said that Japan should have liberalized its financial markets on its own initiative. Interestingly, he stressed in the interview that he did not have technical knowledge of financial matters and avoid discussing the details, apparently not to irritating the banks too much. Kawai nevertheless emphasized that the MOF should allow issuance of convertible bonds without collateral. The leaders of Keidanren, including Chairman Yoshihiro Inayama, met Treasury Secretary Regan in March to discuss the issue[40]

On the other hand, the main opponents of liberalization within Japan were two types of specialized banks: the long term credit banks and trust banks. As they engage in a narrow range of banking business protected by regulation, it was very crucial for them whether regulation on scope of business would be lifted or not.

On the demand side, the financial negotiations took place in the first place because of the intense pressure from a wide-range of import-competing industries in the U.S., which called for the immediate correction of the exchange rate. On more specific issues, certain private companies were associated with certain demands. For example, big U.S. banks operating in Japan, such as Citicorp, hoped for liberalization of

[40] *Nihon Keizai Shimbun*, April 3, 1984, p.3, and May 8, 1984, p.3

international use of the yen. Merrill Lynch, the investment bank where Treasury Secretary Regan had served as its head before he came to the government, was often associated with the American demand for the membership of the TSE.

However, the changes achieved in the negotiations were not necessarily promising for U.S. banks operating in Japan. It was likely that only a couple of big foreign banks, such as Morgan and Citicorp, that would benefit from the outcomes. Indeed, it was likely that the greatest beneficiaries were Japanese big business, which would be able to raise money with better terms as a result of the liberalization of bond markets.[41]

Generally, the requests from major American banks influenced the negotiation outcomes as they provided information to U.S. negotiators. However, their lobbying was not directly reflected in the negotiation outcomes mainly because of the lack of unity among them. Their trade organization, the Institute of Foreign Bankers in Japan, was established only in November 1984, after the issuance of the Yen/Dollar Accord. The MOF strongly hoped to have an organization of foreign banks in order to simplify the process of hearings from foreign bankers.[42] Finally in 1984, some European banks

[41] *Toyo Keizai Kinyu to Ginko* June 15, 1984, pp.52-54.

[42] The first of that kind was established earlier, but did not take off and was eventually dissolved as the most powerful of foreign banks in Japan, such as Citibank, Chase Manhattan and Bank of America, did not join.

decided to establish a new association with 31 member banks. Since then, the institute played a key role in communicating with the MOF and realized some of their requests. For example, it successfully requested the MOF to ease some tax exemption procedures (Tatewaki 2002: 297).[43] Many leading U.S. banks remained outside, however. Citicorp, which had been the most influential foreign bank in Japan, was not a member even in 1988. The bank saw that it would be more effective to lobby the MOF independently[44]

The interest-based approach is insufficient in explaining the *outcome* if it is useful in understanding *demands*. Most importantly, there are always conflicting interests over almost any economic policies. In order to explain policy outcomes, some other variables should be factored in.

Ideational Explanation

The third line of argument is an ideational explanation. The policy orientation of two top negotiators in the U.S. team contributed greatly to the negotiation strategy and outcome. The head of the U.S. team, Beryl Sprinkel, was a well-known monetarist. He

[43] The Institute was renamed to the International Bankers Association in 1998. The Japanese Bankers Associations started to accept foreign banks as its members in 1999 and some foreign banks jointed (Tatewaki 2002: 299).

[44] David Lake, “Institute of Foreign Bankers blazing tough trail in Japan,” *The American Banker* July 10, 1986, and Tatewaki 2002: 296-299. The number of members was 40 out of 76 foreign banks in 1986, and it increased to 61 out of 81 in 1988. In contrast to banks, foreign securities companies in Japan chose to join Japanese trade associations. “Foreign firms in Japan: Turning Japanese,” *Economist*, February 27, 1988, p. 71.

was heavily influenced by Milton Friedman when he was at University of Chicago. Before entering in the government, he had worked for the Harris Trust and Saving Bank in Chicago from 1952 to 1981.[45] His commitment to monetarist ideal had substantial impact on the outcome of the negotiation. Rather than forcing Japan to accept measures to give direct access to U.S. financial institutions, the U.S. head believed that by removing regulatory barriers, the competitive U.S. financial sector would prosper in the Japanese markets.[46]

Another key person on the U.S. side that gave an ideational base to U.S. demands was David Mulford, Assistant Secretary of Treasury for International Affairs and the substantial leader of the U.S. team at the working level. As a former private banker, he had more experience in the Euromarket than anybody else in the bilateral committee. The appointment of Mulford just when the bilateral talks started had a significant influence on the negotiation. As the specialist of the Euro market, he led the strategy of liberalizing Japan's market rather indirectly through the expansion of the

[45] Later, he became chairman of the Council of Economic Advisers in February 1985, and became known for his handling of the 1987 stock market crash.

[46] His market-oriented view also produced the U.S. policy of "benign neglect" in the face of the excessively strong dollar against all other major currencies in the early 1980s, which was caused most importantly by a tight monetary policy. Only when Sprinkel moved out of the Treasury to lead the Council of Economic Advisers in February 1985, the U.S. government changed its attitude and became inclined toward more intervention in the foreign exchange markets, resulting in the Plaza Accord of 1985.

Euroyen market.

Less significant but not negligible was the policy orientation of Prime Minister Nakasone. As a political leader who carried out a series of economic reform, such as privatization of Japan Railway and Nippon Telecom, Nakasone was sometimes compared to Reagan and Margaret Thatcher as the champions of neoliberal reform. The idea of liberalizing Japan's financial markets appealed to Nakasone. With the tacit support from the prime minister, deregulation worked more smoothly (Takita 2006: 108–9).

The significance of the ideational factor notwithstanding, it does not wholly account for the final negotiation outcome. In addition to liberalization of the Euroyen markets, the May Accord also included some measures to directly increase access of U.S. financial institutions to the Japanese markets, causing concern among other countries, which worried that American financial institutions would unfairly obtain all the best opportunities in the Japanese markets. This strategy went clearly against the market oriented views of the financial markets. Moreover, the Japanese side was reluctant to carry out drastic reform despite the policy orientation of the prime minister.

Institutional Setting

As discussed earlier in this chapter, the existing network of international financial

officials played a pivotal role in defining the format of the world's first bilateral negotiations over the financial regulation. Even though the leading members in the U.S. Treasury and the Japanese MOF were not long-time friends due to the government change and the mechanism of political appointment of top administrative officials in the U.S., they worked together since 1982 over international financial issues, especially the debt crisis of the early 1980s. When mounting pressure in the U.S. made it inevitable to work out certain framework to address the issue of exchange rate, the two government agencies cooperate with each other to exclude other government agencies from the framework.

As a result, the focus shifted from the exchange rate to overall liberalization of the Japanese market, especially the creation of a more active Euroyen market. It was also combined with some direct demands to give preferential treatments to the U.S. financial institutions operating in Japan, since the Treasury had obtained detailed information from them. The idea of correcting of the exchange rate through microeconomic policy changes, which was politically popular but technically not plausible, was mostly shelved.

In establishing the negotiation framework of the U.K.-Japan financial talks, the head of the British team, Geoffrey Littler, proposed to include staff members from the

Bank of England and the Department of Trade, two agencies that shared responsibilities for the matters under discussion, but the Japanese MOF refused to include people of the Bank of Japan and the MITI as the official members of the negotiating team. Littler noted the "problems of inter-departmental jealousy in Tokyo" which he found much more acute than the British one (Cortazzi 2001: 442).[47]

3.5 Summary

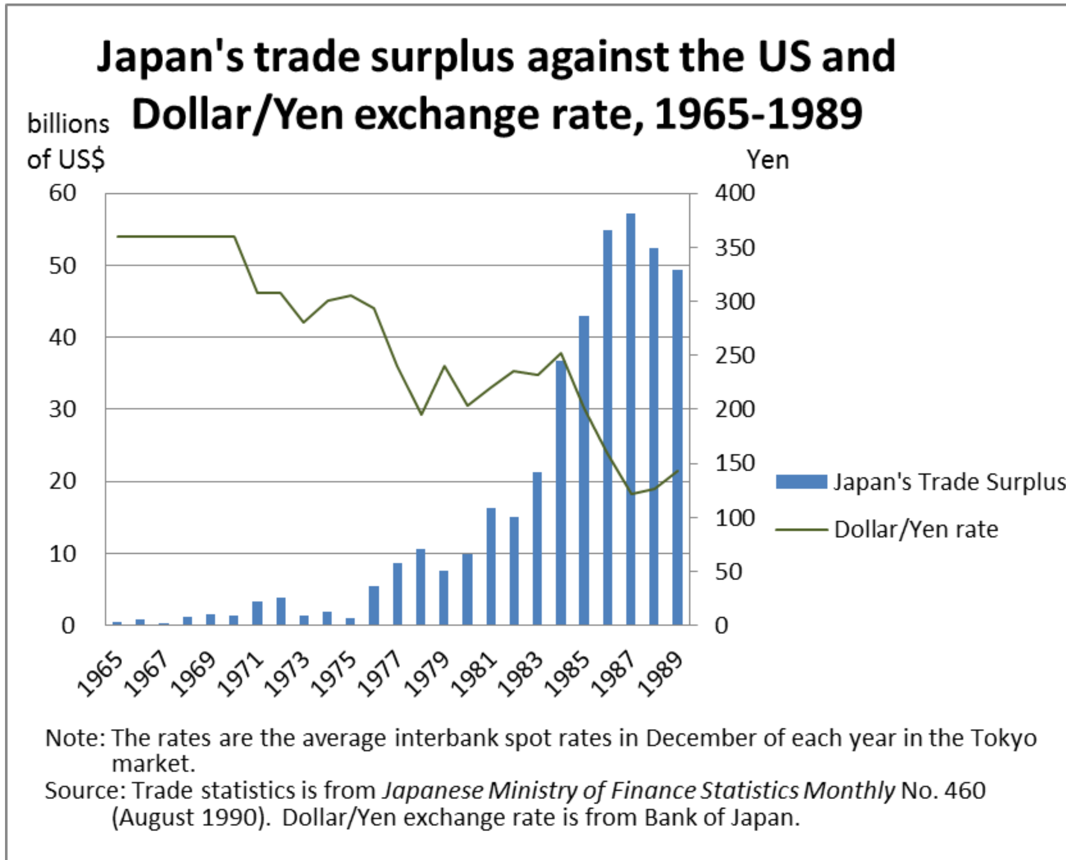
The main feature of the bilateral negotiations between the US and Japan in the mid-1980s was the institutional setting in which participants were mostly limited to financial officials who had been involved in international negotiations over the matters of international finance. The financial talks, which started with the keen interests in the misalignment of dollar-yen exchange rates, attracted the interests of a wide range of governments and political actors on the US side. However, the financial officials succeeded to set up a Treasury-MOF committee and to exclude participation of other governmental agencies.

The result of such institutional arrangement was a successful conclusion based on deep understanding of the issues. Through a series of tough negotiations, the

[47] Littler's lecture to the Japan Society, recorded in Cortazzi 2001:439–448.

negotiators also developed a sense of friendship and shared political commitment (Takita 2006: 146-47). In the end, the negotiations led to gradual liberalization of the Japanese financial markets, combined with the grant of "more-than-national treatment" to some American financial institutions in terms of access to certain business that were not allowed to the Japanese financial institutions.

Figure 3.1 Japan's Trade Surplus against the U.S. and Dollar/Yen Exchange Rate, 1965–1989



Chapter 4 Call for Reciprocity: Congress and the Bilateral Financial Negotiations

By the mid-1980s, the expansion of the Japanese economy brought the foreign concerns over financial issues in general and domestic regulation in particular into sharper focus. Indeed, the issue of domestic financial regulation closely relates to international financial relations, the details were discussed only within the closed network of specialists of finance by that time. However, as the influx of Japanese companies on the U.S. soil became visible, the number of people who were interested in the behavior of Japanese financial institutions increased. The result was the bigger voice that claimed reciprocity rather than the principle of nondiscrimination to deal with the bilateral financial relations.

This chapter examines the process through which the call for reciprocity produced a new policy on the side of the U.S., and the effect of such policy on the bilateral financial relationship.

4.1 The Background: Foreign Financial Institutions in the US before the IBA of 1979

The history of foreign banking in the U.S. dates back to the 19th century. In the early days, foreign banks were established mainly to facilitate trade and international

investments. The number of foreign banks in the U.S. increased first in the post-World War I era, and then after the WW II. However, they remained only a marginal part of U.S. banking industry until the late 1960s and the 1970s, when their presence increased dramatically.[1] Before then, the expansion of U.S. banks overseas was far more visible in the post-war era, in tandem with the expansion of the U.S. international trade.

The main characteristic of the U.S. regulation toward foreign-owned financial institutions had been the lack thereof, as the "laws regulating foreign-owned banks were written when there were not enough foreign banks in the U.S. to bother about.[2]" Consequently, the regulatory system did not have an adequate mechanism to regulate and oversee non-American financial institutions. There was no federal regulation and supervision. Foreign banks were usually regulated and supervised by states. Such a system had given foreign banks operating in the U.S. significant advantages over domestic ones, as the former were not subject to costly regulations. Most notably, foreign-owned banks could set up interstate branches or agencies, while their domestic counterparts were not allowed to establish interstate branch networks by the McFadden Act.[3] Moreover, foreign banks could engage in some types of non-bank business, such as stock brokerage, while U.S. banks were strictly kept from securities business by the

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[1] For the early history of foreign banking in the U.S., see Damanpour 1990: 10–19.

[2] "Chasing the U.S. Dollar—at home," *Time,* April 3, 1978, p.36.

[3] Interstate banking was allowed only in 1994. See Mulloy and Lasker 1995.

Glass-Steagall Act. They were also able to purchase banks in the U.S. in a manner that the antitrust laws prohibited to U.S. banks. Foreign banks were also exempted from some types of mandatory payment. They usually need not pay the non-interest bearing reserve to the Federal Reserve System, as they were not required to be members of the system. Similarly, their deposits were usually not covered by the Federal Deposit Insurance Corporation. In sum, the laxity of U.S. regulations of foreign banks had given advantages to them over their domestic competitors. Moreover, they also posed problems for stability of the American financial system.

Their access to cheaper capital and lower capital requirement at their home offices were also considered to be the sources of unfair advantages, while they were more a problem of international coordination than that of domestic regulation.[4]

Regulatory Development

As the presence of foreign banks in the U.S. became salient in the 1960s, those problems came to attract attention of some policymakers. In 1966, the Congressional Joint Economic Committee published a report on foreign banking activities, titled "Foreign Banking in the United States."[5] The report recommended the inclusion of foreign banks' activities under the supervision of national banking authorities, the

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[4] See David C. Cates, "Foreign banks are cracking the facade of U.S. banking," *Fortune*, August 28, 1978, pp.94-99,"Unequal opportunity lenders," *Forbes*, August 21, 1981, p.34, "Chasing the U.S. Dollar—at home," op. cit.

[5] U.S. Congress, Joint Economic Committee, *Foreign Banking in the United States*, Economic policies and practices, Paper No. 9, by Jack Zwick, Washington, D.C. 1966.

Comptroller of the Currency and the Federal Reserve System. The report was especially significant in that it called for the principle of national treatment, which later became the basis for U.S. policy development toward foreign banks (Damanpour 1990: 47, Pauly 1988: 30–31).

Shortly after the publication of the report, some bills were introduced in Congress to address the problem of oversight of foreign banks in the U.S. Some of them were based on the principle of reciprocity, not national treatment. In 1966, Senator Jacob Javits of New York introduced a bill, which called for the expansion of federal authority over foreign banks. The bill also insisted on a reciprocity test for federal license (S. 3767). Next year, Wright Patman, chairman of the House Banking Committee, introduced a similar bill in the House. Neither the Javits bill nor the Patman bill reached to the hearing, however, reflecting the indifference of Congress to the issue at that time (Pauly 1988: 31–33).

In 1969, Patman again targeted foreign banking activities in the U.S. by introducing provisions that would affect some types of foreign banks operating in the U.S. into the revision of the Bank Holding Company Act, which primary aimed at reforming regulation of domestic bank holding companies. The bill passed in 1970, but the ambiguous wording of the law allowed the Fed to interpret it flexibly with regard to distinctly foreign operations. Foreign banks operating domestically as branches and agencies, as opposed to subsidiaries, remained unaffected and outside the federal

jurisdiction (Pauly 1988:32–33).

4.2 Foreign banks in the US in the 1970s and the International Banking Act of 1978

The concern over lax regulation of foreign banks in the U.S. grew as a result of the dramatic increase of foreign presence in the U.S. banking industry. By 1980, foreigners owned approximately 12 percent of American banking assets.[6] Most foreign banks clustered in and around New York City, Los Angeles, and Chicago but some also appeared in Houston, Atlanta, Miami and Boston.

As they increased their presence, the nature of operation of foreign banks had changed. In early years, foreign banks established subsidiaries mainly to meet the U.S. banking needs of their own home customers. Later, they started to engage in U.S. corporate business.[7] For example, many of the offices of Japanese banks were set up in the U.S. in the 1970s to help the expansion of Japanese exports and to court the retail business of Asian people in California. Then, the banks began attracting medium-sized American companies.[8] The primary method of U.S. entry also changed. In the 1970s, the purchase of the U.S. banks came to outnumber new subsidiaries of foreign banks

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[6] Caroline Atkinson, "Foreign investment in U.S. banking," *Washington Post*, September 14, 1980, F1.

[7] "Unequal opportunity lenders," op.cit.

[8] Thomas C. Hayes, "Growing Japanese role in California banking," *New York Times*, August 25, 1983.

established in the U.S. The wave of acquisition in the 1970s was the consequence of the lower value of the U.S. dollar and the depressed U.S. stock market values (Damanpour 1990: 61).

[Figure 4.1]

[Figure 4.2]

[Figure 4.3]

In response to the growing importance of foreign banks in the U.S., two Congressmen, Wright Patman and Thomas Rees, introduced their respective bills in 1973, which would limit foreign banks to the subsidiary form, restrict their operations to one state, and impose Federal Reserve requirements. Moreover, they attempted to establish "a ceiling on aggregate foreign participation in the U.S. market and prohibiting foreign acquisition of American banks." Federal Reserve Chairman Arthur Burns opposed to those restrictive bills, for they could lead to limiting activities of American banks abroad (Pauly 1988: 33–34).[9]

The Federal Reserve itself initiated a data collection program in 1972. It also set up a committee to review the regulatory aspects of international banking. A bill

[9] In the same year, in California state legislature, a bill to restrict further penetration of foreign actors in the California banking market was narrowly defeated after Bank of America, out of concern for foreign reprisals against its overseas network, lobbied intensely against it.

based on the study was sent to Congress during the closing days of the 93rd Congress in 1974 in an attempt to preempt the introduction of more restrictive bills such as those proposed by Patman and Rees. With some revisions, the bill was reintroduced in 1975, titled the International Bank Act (IBA) (Damanpour 1990: 47–48, Pauly 1988: 33–36). It took three more years that the IBA was finally passed in August 1978, and enacted on September 17.[10] Together with the Federal Reserve, the Comptroller of the Currency had also "been urging Congress to bring the foreign banks under tighter control."[11]

In essence, the IBA established the principle of national treatment. Under the law, the operation of international banks was subject to the same regulatory requirements as U.S. domestic banks. Interstate activities of foreign banks were restricted, foreign branches and agencies were subject to the Federal Reserve requirements and interest rate regulation, and branches engaged in retail banking were required to have deposit insurance. Non-bank financial activities were subject to the Bank Holding Company Act of 1956. The IBA permitted foreign banks to own Edge corporations. It also allows agencies and branches access to the discount window and payment services provided by Federal Reserve banks (Damanpour 1990: 51, Hultman and McGee 1989: 386).

Interestingly, the attitude of various types of American banks toward regulation

[10] For details about the deliberation and passage of the IBA, see Pauly 1988: 37-56.

[11] "Unequal opportunity lenders," op.cit.

of foreign banks was determined mainly by their concern for competition with their domestic rivals rather than the foreign ones. The main opposition of tighter regulation came from large, internationally oriented American banks, even though they did compete with foreign-owned banks for large multinational customers. Rather than asking protection from foreign competition, they would rather use foreign "invasion" to remove the restriction on interstate banking imposed on them.[12] They also feared foreign retaliation against their own operation overseas.[13] When the deliberation on the IAB was carried out in Congress in 1978, however, they remained silent. According to Pauly (1988: 54), the "growing scope of competitive pressure from foreign bank activity could no longer be treated as a peripheral matter even for major banks." On the other hand, large regional banks, such as Philadelphia National and Wachovia in Winston-Salem, which felt the foreign competitive pressure less immediately than the money-center banks, were among the staunchest advocates of tighter rules on foreign banks. They believed that "if the foreigners continue to be given free rein to roam the American landscape…, the New York banks will one day obtain a similar privilege."[14] Investment bankers, such as Goldman Sachs, Morgan Stanley, and Solomon Brothers

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[12] Ibid, and Cates,op.cit.

[13] "Chasing the U.S. Dollar—at home," op. cit.

[14] Cates, op.cit., pp.96–97.

have been active on behalf of foreign clients with the cases of foreign acquisitions.[15] For the moment the prospect of introduction of some restrictions in the near future made the U.S. markets more attractive, as a new regulatory bill would contain a "grandfather" clause.[16]

When the IBA established the principle of national treatment, as opposed to reciprocity advocated by some politicians, importance of foreign investment was well taken into consideration in the process of creating regulation of foreign banks.

Aftermath of the IBA

One of the ramifications of the passage of the IBA was the subsequence issuance of the National Treatment Study by the Treasury, which assessed whether U.S. financial firms received national treatment abroad. The first National Treatment Study was published in September 1979, as the IBA mandated the Treasury to issue one. The report recommended that diplomatic efforts continue to press for further progress toward national treatment abroad (Pauly 1988: 63). Since then, Congress had requested periodic updates of the study. The updates took place in 1984 and 1986 at the request of Senator Jake Garn, the-chairman of the Senate Banking Committee. The fourth national treatment study, issued in December 1990, was a reaction to the requirement of the Omnibus Trade and Competitiveness Act of 1988. The legislation required updates of

[15] Ibid, p. 95.

[16] "Chasing the U.S. Dollar—at Home," op. cit.

the study in every four years (Bayard and Elliot 1994: 269). Importantly, the requirement had an unintended side effect that influenced intergovernmental financial negotiations. In order to analyze financial barriers, the Treasury attaché started to have constant contact with the foreign banking community in Japan. As a result, the Treasury became familiar with problems confronted by U.S. banks in Japan. The detailed knowledge helped the Treasury to make concrete demands to Japan in bilateral negotiations (Brown 1994: 92, 122).[17]

Toward the end of the 1970s, foreign acquisition of large U.S. banks attracted further attention to the operation of foreign banks in the U.S. Especially in 1978, the acquisition of Marine Midland, then the 13th largest bank in the U.S., by Hongkong and Shanghai Banking Corp (HSBC), a British-owned Asian bank, brought the issue of foreign banks into public notice. The acquisition, one of the largest takeovers in the American banking history, was carried out despite the opposition from New York State banking superintendent.[18] The caveat is that "[t]hey are paying premium prices for what must at present be considered very weak banks."[19] From economic point of view, new investment from abroad in the banking sector should benefit the American

[17] See also the hearing before the Subcommittee on Trade of the Committee on Ways and Means, House of Representatives, July 29, 1991, p.5.

[18] Atkinson, op. cit. For the issue of foreign acquisition during this period, see Pauly 1988: 57–62. The policy debate on the acquisition of Marine Midland took place during final congressional deliberation on the IBA.

[19] Cates, op. cit., p. 96.

economy. Yet, the acquisition spurred concern. In response, the Depository Institutes Deregulation and Monetary Control Act of 1980, whose main aim was to increase competition through deregulation, imposed a six-month moratorium on the purchase of U.S. banks by foreign bank holding companies until July 1, 1980 (Damanpour 1990: 60–62).

4.3 The Issue of Primary Dealers

In the early 1980s, foreign bank expansion in the U.S. slowed due to global recession, the international debt crisis, appreciation of the dollar, and intensification of competition within the American market (Pauly 1988: 61–2). However, the presence of foreign banks, especially the Japanese ones, started to bring policy concerns again by the mid-1980s. In the international ranking of banks in terms of assets, Japanese banks started to dominate the top ten of the list. Moreover, in the latter half of the 1980s, Japanese companies took over many U.S. firms, some of which with symbolic importance in the U.S. economy and culture.

[Table 4.1]

To address the rising concern, in the 100th Congress (1987–1988), the Senate

passed two reciprocity bills related to the field of finance, which failed to clear the House. The first was Title XV of S1407 and sections 909-910 of the Proximire Financial Modernization Act of 1988. Subsequently, the issue of financial market reciprocity surfaced again in the drafting of the Omnibus Trade and Competitiveness Act of 1988. In the end, one such provision, the Primary Dealers Act or the Schumer amendment, was included in the legislation. As the name shows, the provision focuses on the endowment of the status of primary dealers to financial institutions that would handle the U.S. treasury bonds.

The issue surfaced in response to the Federal Reserve's December 1986 decision. That month, the Federal Reserve Bank of New York announced the addition of five new primary dealers. Among them were the U.S. units of Nomura Securities and Daiwa Securities. Moreover, in the same month, the New York Fed approved two foreign acquisitions of existing primary dealers, one of which was the acquisition of Aubrey G. Lanston by the U.S. unit of the Industrial Bank of Japan.[20]

The decision provoked resentment from Congress because the share of foreign financial institutions in Japanese government bond market was very limited. In fact, foreign participation in the dealings in government bonds was one of the subjects in the

[20] Primary dealers can deal directly with the New York Fed when it buys and sells U.S. government securities as part of its open-market operations. Since some large institutional investors will do business only with firms that are primary dealers, the status is more than just permission to engage in one type of business.

Yen-Dollar Talks. The Japanese MOF granted foreign banks membership of the government bond syndicate for the first time in April 1984. Moreover, as a part of efforts to fulfill the promise to enhance the functioning of the secondary market in Japanese government securities, the Japanese government allowed qualified Japanese banks to buy and sell government securities in the secondary market starting in June 1984. At that time, the MOF began informal discussions with interested non-Japanese banks and, in October, the ministry allowed them to deal in public bonds. Still, the share remained close to null at the time of the Fed's decision, as the closed nature of the syndicate underwriting system, which was sharply different from the American system of open bidding, contributed to limit the role of foreigners in Japan's government bond market. All Japanese government bonds were issued and underwritten through negotiations with a syndicate of banks and securities firms until 1984. The MOF and the syndicate members decide on coupon rates and allocation.[21] This arrangement was not always favorable for financial institutions that were members of an underwriting syndicate, because they had to accept unattractive, as well as attractive, primary issues. The *Wall Street Journal* cited comments by analysts who attributed the reluctance of the Japanese government to grant foreigners a sizable underwriting position to the fear that foreign firms would not "play by the same rules."[22]

[21] The system was introduced in 1966 in order to ensure full subscription of government bonds.

[22] Monica Langley, "Trade bill conferees agree on limits for foreign dealers in U.S. securities," *Wall Street Journal* March 31, 1988, p.1.

Nevertheless, from the perspective of Congress members, the efforts by the Japanese government to grant foreigners some share in its government bond markets after the Yen-Dollar Talks were far from enough as they witnessed more and more Japanese financial institutions obtaining the status of primary dealers. The problem of foreign participation in the Japanese government bond market took on symbolic importance.

In response to criticisms, the New York Fed released a letter from Corrigan to Congressman Schumer to explain its decision. Corrigan stressed the benefits of foreign participation in the U.S. government debt market "at a time when the enormous burden of our cumulative fiscal deficits makes this especially important." Moreover, he emphasized the importance of maintaining the soundness of global financial markets. At the same time, noting recent actions of the Japanese government to liberalize its financial markets, he warned an adverse Fed reaction if Japan would fail to further improve foreign access.[23]

The letter did not convince Schumer. In March next year, he introduced an amendment to HR 3, the House's version of the Omnibus Trade bill of 1988. The Schumer bill (HR1463), titled Primary Dealers' Fair Competition Act, would prohibit the Federal Reserve from designating, or continuing a prior designation of, foreign

[23] Letter from Corrigan to Congressman Schumer on December 11, 1986, cited in Bayard and Elliot (1994: 275–76).

firms as primary dealers of U.S. government securities if their home government denied U.S. firms "equal access" in their government securities market. It required foreign countries to "accord to United States companies the same competitive opportunities in the underwriting and distribution of government debt instruments issued by that country as it accords to domestic companies." In other words, the bill would prohibit the acquisition by a foreigner of a primary dealer in U.S. securities if the country involved did not grant U.S. securities dealers the same access to its markets that the foreign country's dealers were afforded in the United States. The bill thus "substituted reciprocal national treatment for mirror-image reciprocity or "equal access" to American institutions." The Fed would be required to act within one year of enactment.[24] According to a Japanese newspaper, the primary purpose of the bill was to use it as leverage in the U.S.-Japan bilateral trade negotiations over the liberalization of Orange imports in Japan.[25]

In the late April, Donald Riegle, Senate Banking Committee Chairman, also introduced a bill (S1101) that was virtually identical to the Schumer bill (Bayerd and Elliot 1994: 278). In the House, Schumer's measure was incorporated into the omnibus trade bill and approved on April 30 by a 290-137 margin.[26]

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[24] *CQ Weekly,* August 8, 1987, p.1822. See also Bayerd and Elliot 1994: 278.

[25] *Nihon Keizai Shimbun,* November 13, 1991, p.9.

[26] Robert M. Garsson, "Bill to curb Japanese banks offered in Senate," *American Banker* May 4, 1987, p.11.

The U.S. side was far from being united in the call for reciprocity on this issue, however. First of all, the financial authorities, mainly the Treasury Department and the Federal Reserve, made their objection clear.

The Treasury had strongly opposed to the notion of reciprocity in the area of financial services until the beginning of the 1990s. In his response to Senator Garn's request for a national treatment study, for example, Secretary James Baker stated, "the Treasury continues to believe that a policy of national treatment, seeking equality of competitive opportunity, is preferable to a policy based on reciprocity."[27] In addition to its conflict with the principle of free trade, the Treasury warned that U.S. firms would be particularly vulnerable to demand for mirror-image reciprocity from countries with universal banking systems, such as Germany and France (Bayard and Elliot 1994: 270). David Mulford, Assistant Treasury Secretary for International Affairs, expressed opposition to the mandatory nature of the provision when the bill was approved later.[28]

The Fed was also opposed to the use of reciprocity. For example, in May 1987, E. Gerald Corrigan, the president of the New York Fed, said before the Senate Budget Committee that he opposed to barring Japanese firms from primary dealer status, citing Japan's recent efforts and the possibility of limiting capital flows into the U.S.[29] It

[27] Letter from Baker to Garn, cited in Bayard and Elliot 1994: 270.

[28] Langley, op. cit.

[29] Michael R. Sesit, "New York Fed chief opposed to barring Japan firms from primary dealer status," *Wall Street Journal* May 7, 1987, p.1.

concerned that retaliatory measures would induce foreign counter-retaliation, impeding international financial flaws. Its main concern was to keep international financial markets open. The U.S. financial authorities' aversion to reciprocity was reinforced in the late 1980s and early 1990s by the growing importance of foreign purchases of U.S. government debt, as the U.S. budget deficit grew. The Treasury tried to respond to the pressures from Congress and private sector to secure access of U.S. financial firms to foreign markets through multilateral forums, the OECD and the Uruguay Round negotiations of the GATT, and bilateral negotiations (Bayard and Elliot 1994, Chapter 11). According to one estimate, Japanese-owned dealers do about 20 percent of their business with Japanese investors.[30] Up until the middle of 1990, Japanese institutional investors had bought about 30 percent of U.S. treasury bills.[31]

Even more noticeably, the opposition also came from U.S. private financial industries. Industrial Bank of Japan faced the possibility of losing the primary dealer status after its U.S. unit purchased primary dealer Aubrey G. Lanston. Citing this case, the opponents contend that the introduction of penalties retroactively could deter future foreign investment in the U.S. by signaling foreign investors that they risk losing their investment if the U.S. had a dispute with their government.[32]

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[30] Robert M. Garsson and Jed Horowitz, "Japan dealers in U.S. unfazed by trade bill," *American Banker*, August 26, 1988, p.2.

[31] *Asahi Shimbun,* August 8, 1990, evening edition, p.2.

[32] Michael R. Sesit, "Concern grows among investment firms that trade legislation could backfire,"

Actually, Schumer's move was in part a response to the complaints he heard from U.S. securities firms in Japan during his trip to Japan in April 1987, when he heard the complaints from U.S. securities firms operating in Japan about the Japanese 10-year government bond market.[33] However, U.S. financial companies changed their tone later, at least publicly. Commercial banks no longer saw access to the Japanese government bond market as a pressing issue.[34] Noting the reluctance of U.S. financial firms with substantial operation in Japan to support the Schumer amendment, Bayard and Elliot (1994: 279) stipulate that they avoided supporting the provision publicly for fear of retaliation by Japan's Ministry of Finance. Moreover, they also did not want to set the precedence of reciprocity legislation.

Despite these objections, Congress continued to move with reciprocity bills. On July 21, Senate passed the bill. While the administration signaled its intention to veto the legislation, the sweeping Senate's vote, 71-to-27 in favor of the bill meant it had sufficient support to override a veto.[35]

Wall Street Journal, May 6, 1987, p.1.

[33] In April 1987, shortly after the introduction of his amendment, Schumer, together with Jake Garn and other influential members of the Senate Banking Committee and House Banking and Budget Committees, visited Japan at the invitation of the Japanese Liberal Democratic Party. *Nihon Keizai Shimbun,* May 2, 1987, p.2.

[34] Kathryn Graves, "Trade bill's proposal on primary dealers causes concern at U.S. firms in Japan," *Wall Street Journal,* April 21, 1988, p.1.

[35] Robert M. Garsson, "Bill progresses to bar Japanese from acting as primary dealers," *American Banker* July 23, 1987, p.2.

Japan's Efforts to Give More Access

While the legislation was moving, Japan continued its efforts to placate foreign governments, especially the U.S., by giving new ability to foreign firms in Japan. As to the government bonds, in March 1987, the MOF decided to expand the auction system in the future issues of government bonds. In the same month, the MOF and Japanese banking and securities industries agreed to raise the share of foreign securities firms in the underwriting of 10-year bonds from about 0.3 percent to about 1.6 percent.[36]

Furthermore, a fundamental change in the underwriting of government bonds was announced in April. Starting in November 1987, the MOF would launch a new auction method for 10- year bonds, for which the market was the largest. Under the new modified-auction system, each syndicate member could bid for additional bonds.[37] In addition, in August, the government abolished the requirement that foreign banks had to operate in Japan for at least five years to become eligible for membership of the syndicates. In September of that year, the MOF also began auctioning of 20-year government bonds. First issued in October 1986, it was the second issuance of this long-term bond.

Besides, in December 1987, the Tokyo Stock Exchange announced that it

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[36] *Asahi Shimbun,* March 24, 1987, p.9.

[37] Later, the ministry had raised the auctioning share of 10-year bonds to 40 percent in 1989 and to 60 percent in 1990. The government started to expand the share again in 2002. Ministry of Finance, *Guide to Japanese Government Bond,* 2004.

would grant 16 of the new 22 TSE memberships to foreign companies. The new members began trading in May 1988. In addition to some American firms, the new members included four British, two French, two West Germany and two Swiss firms. The selection was apparently political.[38]

These developments seem to be a notable victory of U.S. Congress. Charles E. Schumer was reported to have said, "We've gotten the changes we have [in Japan's policies] because the Japanese realize our legislation is going to pass."[39] However, even without the American pressure, the system had been under stress since the late 1970s because of the development of the domestic government bond markets. By the mid-1980s, it would be no longer possible to issue government bond irrespective of market prices. Then-chairman of the Japan Securities Dealers Association stated that the auction system should be expanded regardless of foreign pressure.[40] The large Japanese securities firms, whose share in the 10-year bond syndicate was disproportionately small compared to banks and smaller securities houses, supported the liberalization of the 10-year bond market. Within the MOF, the Securities Bureau and some officials of the International Finance Bureau and the Government Debt Division Bureau supported

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[38] Elisabeth Rubinfienm "Tokyo Exchange's new foreign members begin trading, but with little fanfare," *Wall Street Journal*, May 23, 1988, p.1.

[39] Michael R. Sesit and Tom Herman, "New York Fed to admit Nikko Unit as primary U.S. dealer, sources say," *Wall Street Journal*, December 22, 1987, p.1.

[40] *Nihon Keizai Shimbun*, April 16, 1987, p.3.

the expansion of the auctions system, while the Banking Bureau opposed to it (Bayard and Elliot 1994:277).

Yet, the timing of the decision doubtlessly reflected the American influence. The April 1987 decision was made just before Prime Minister Nakasone's visit to the U.S. in the end of the month.[41] Some officials in U.S. securities firms complained that this was far from a true auction, though which they might be able to increase their participation.[42]

Primary Dealer Provision Became Law

Despite these efforts of the Japanese government further intrusion of Japanese firms in the U.S. government bond market irritated Congress, which further moved toward the introduction of the reciprocity legislation. As of December 1987, foreign institutions controlled eight of 40 primary dealers in the U.S.: three Japanese, two British and one each from Australia, Hong Kong and Canada.[43] In addition, a unit of Nikko Securities was allowed to become the forth Japanese primary dealer that month. Also added to the dealers list were a unit of Chicago Research & Trading Group and a subsidiary of Britain's Lloyds Bank. Schumer criticized the move of the New York Fed. In a letter to Schumer, Corrigan noted that in the future the bank would continue to weigh

[41] *Nihon Keizai Shimbun,* April 26, 1987, p.1

[42] Susan Chira, "Japanese bond plan disappoints firms," *New York Times*, June 6, 1987, p.39.

[43] Sesit and Herman, op.cit.

geographic concentration when awarding primary dealer status. [44]

That month, House-Senate conferees were trying to work out differences in the two bills. The Senate legislation would allow Lanston to retain its primary dealership. Christopher J. Dodd, a Democratic Senator from Connecticut, tried "to alter the provisions in such a way as to permit his constituent, primary dealer Greenwich Capital Markets Inc. to be acquired by Long Term Credit Bank of Japan Ltd. If allowed, the Dodd changes would also permit Japan's Sanwa Bank to buy another primary dealer, Brophy, Gestal, Knight & Co."[45]

In March 1988, the House-Senate conferees agreed on the securities dealer provision. While foreign firms would be barred from serving as dealers unless the government allowed U.S. firms to become primary dealers in the securities, the period before the decision was extended from six months in the original provision to one year.[46] In April, the House and Senate agreed to substitute reciprocal national treatment for mirror-image reciprocity. The final version of the Primary Dealers Act of 1988 would require the Federal Reserve to seek reciprocal national treatment only in the area of the underwriting and distribution of government bond. The act would grandfather

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[44] Sesit and Herman, op. cit., and Michael R. Sesit and Tom Herman, "New York Fed's action on dealer spurs criticism," *Wall Street Journal* December 23, 1987, p.1.

[45] Sesit and Herman, op.cit., December 22, 1987, p.1.

[46] Langley, op. cit.

firms that had acquired, or informed the Fed of their intention to acquire, a primary dealer before July 31, 1987. The cutoff date meant that bank-owned primary dealers (Sanwa's Brophy Gestal Knight, LTCB's Greenwich Capital Markets, IBJ's Aubrey G. Lanston) were exempted from the bill provisions. The main target would be Japanese securities firms, particularly Nomura Daiwa, and Nikko.[47] The provision also allowed an exception to such prohibition for countries having or negotiating bilateral agreements with the United States.

A senior executive at a major Japanese bank in New York was reported to have said that there was no way that Japan could have full reciprocity in one year.[48] U.S. financial companies operating in Japan also expressed concern that "Japanese investors might start to avoid the U.S. bond market. This would interrupt the flow of funds from Japan that has become crucial to financing the U.S. budget deficit."[49] Other provisions in the omnibus trade bill (HR3) also reflected the growing concern over foreign takeover of American assets, and the administration and multinational corporations opposed similarly, complaining that it would drive out needed foreign investment.[50]

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[47] Bayard and Elliot 1994: 280, Robert M. Garsson and Jed Horowitz, "Japan dealers in U.S. unfazed by trade bill," *American Banker,* August 26, 1988 p.2.

[48] Langley, op. cit.

[49] Kathryn Graven, "Trade bill's proposal on primary dealers causes concern at U.S. firms in Japan," *Wall Street Journal,* April 21, 1988, p.1.

50 John Cranford, "Alarm over foreign investment in the U.S." *CQ Weekly*, March 19, 1988.

While the bill was being discussed in Congress, the U.S. and Japan continued intergovernmental negotiations to address the issue, among with other issues. In the sixth follow-up session of the Yen Dollar Talks, held in April 1988, they discussed the handling of Japanese government bonds through syndicate. The U.S. side used the primary dealer provision to obtain greater leverage on Japan and urged that foreign firms be allocated larger shares within the syndicate and that an auction system be created to allow Japanese and foreign firms to compete in the important 10-year bond market (Brown 1994: 114–115).

In the meantime, Fuji Bank failed to acquire the entire outstanding shares of Kleinwort Benson Government Securities of Chicago, which held primary dealer status. The U.S. monetary authorities' inclination to limit geographic concentration seemed to have affected the failure. The British government delayed approving the London-based local affiliates of Nomura Securities and Daiwa Securities to engage in the British government bond market business. Apparently the British government took advantage of this approval to get the membership of Tokyo Stock Exchange for two securities houses from the country, Barclays de Zoete Wedd Securities and James Capel Pacific.[51] Still, in June 1988, the Fed approved the acquisition of two U.S. primary dealers by Japanese banks: Brophy, Gestal, Knight by Sanwa Bank and Greenwich Capital

[51] Sumio Kudo, "West builds walls to retard inroads by financial firms; friction centers on primary dealer designation," *Japan Economic Journal,* May 21, 1988, p.1.

Markets by the Long Term Credit Bank.[52]

On August 23, the Omnibus Trade Bill was signed into law (HR4848-PL100-418) by President Reagan. The first version of the bill (HR3) was vetoed May 24, for a reason unrelated to the primary dealer provision.[53]

After the passage of the bill, the Treasury continued to use it as leverage in bilateral negotiations. In July 1988, the Treasury demanded an auction system of 10-year government bonds. The move confused the MOF, because by then the MOF believed that it could deal with the problem by increasing the fixed share of foreign financial institutions in underwriting the bonds. However, the U.S. side decided that such a measure would not increase the fairness and called for a full-auction system.[54]

In response, the MOF announced the new system of issuing government bonds on September 6, 1988. Starting in April next year, the Japanese government would sell 40 per cent of the monthly issue of 10-year bonds by competitive bidding. The remaining 60 per cent would be allocated to the members of the syndicate at the average auction price. Of that amount, the share of foreign financial institutions would be raised from 2.5 per cent to almost 8 per cent. The Ministry also said that it would name four

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[52] "Two Japanese banks allowed to acquire U.S. primary dealers," *Wall Street Journal* June 7, 1988, p.1.

[53] It was largely because of a section requiring advance notice to workers of plant closing and lengthy layoffs. That provision was passed later as a separate bill (HR2527-PL100-379).

[54] *Nikkei Kinyu Shimbun*, July 22, 1988, p.1

foreign firms co-managers of the syndicate.[55] E. Gerald Corrigan, president of the Federal Reserve Bank of New York, and David C. Mulford both praised the moves.[56] Japanese securities companies, whose U.S. units had attempted to acquire the position of primary dealers, had also publicly lobbied for an auction system. They were "angry that three bank-owned primary dealers…were exempted from the trade bill provisions," since "the major share of Japanese 10-year notes goes to banks, and yet banks are the ones who are protected under the legislation."[57]

In early 1989, the Federal Reserve undertook a study of foreign bond markets in preparation for its ruling under the primary dealer provision. The focus of its report was to assess the de facto, not de jure, treatment of U.S. financial institutions abroad. The report assessed the government bond markets of Japan and the United Kingdom (Bayard and Elliot 1994: 281–282). In preparing its study, the Fed asked for comments from the public. Several U.S. securities houses send letters to the Fed. "The most vigorous criticism came from Morgan Stanley, which asserted that important Japanese government economic data was being leaked to Japanese competitors." Yet, the

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[55] *Asahi Shimbun,* September 7, 1988, p.9.

[56] "Japan Unveils New Measures to Widen Foreign Role in Government Bond Mart" *Wall Street Journal,* September 7, 1988, p.1.

[57] Robert M. Garsson and Jed Horowitz, "Japan dealers in U.S. unfazed by trade bill," *American Banker,* August 26, 1988 p.2.

company "did not recommend that the primary dealerships be denied to the Japanese."[58]

In August 21, 1989, the Fed eventually decided not to bar Japanese securities companies from primary dealer status. It voted 5 to 1 to accept a stuff report that acknowledged progress in the Japanese policies in opening their securities market.

4.4 Summary

During this period, the expanding presence of foreign players, especially those from Japan, invoked the sense of unfairness in the U.S., which spurred legislative actions. Consequently, the principle of reciprocity was advocated to deal with the issue of who could handle government bonds. While it was incorporated into a law, its final version gave considerable discretion to the regulatory agencies, and the measure was not invoked in the end. Yet, it did seem to enhance intended expansion of foreign access to the Japanese government bond market. It should be noted, however, that the reform of government bond system in Japan was already undergoing, and the rule would be changed sooner or later even without the American pressure.

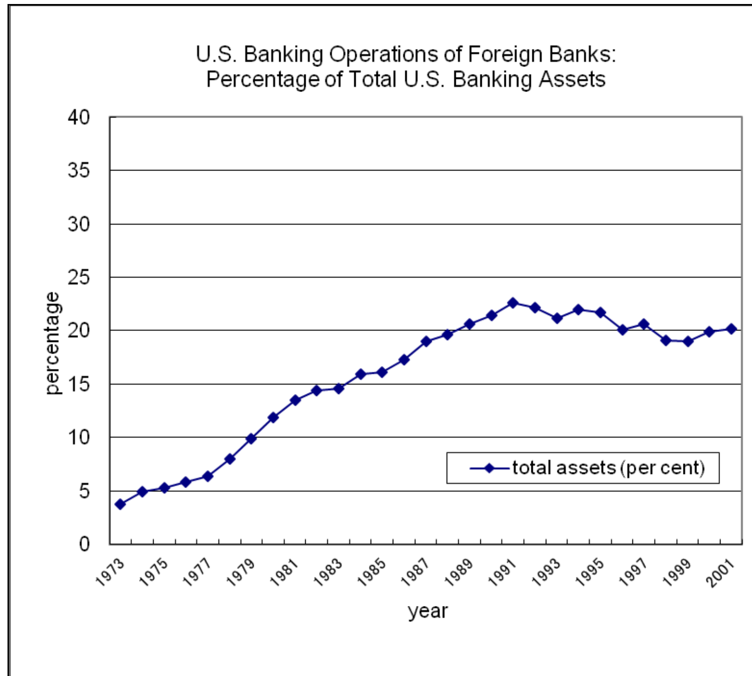
For the purpose of this analysis, what is important in this case was the limited use of retaliatory threat produced moderate negotiation outcomes between the two governments. The financial authorities tried to limit the involvement of outside players

[58] Stan Hinden, "Fed vote favors the Japanese; finding shows no U.S. discrimination," *Washington Post,* August 22, 1989, C1.

in the process, mainly for fear of disturbing flow of funds into the U.S., even though officials sometimes attempted to take advantage of the Congressional moves to gain greater concession from Japan. The Japanese side offered some placatory measures, and the U.S. side accepted them.

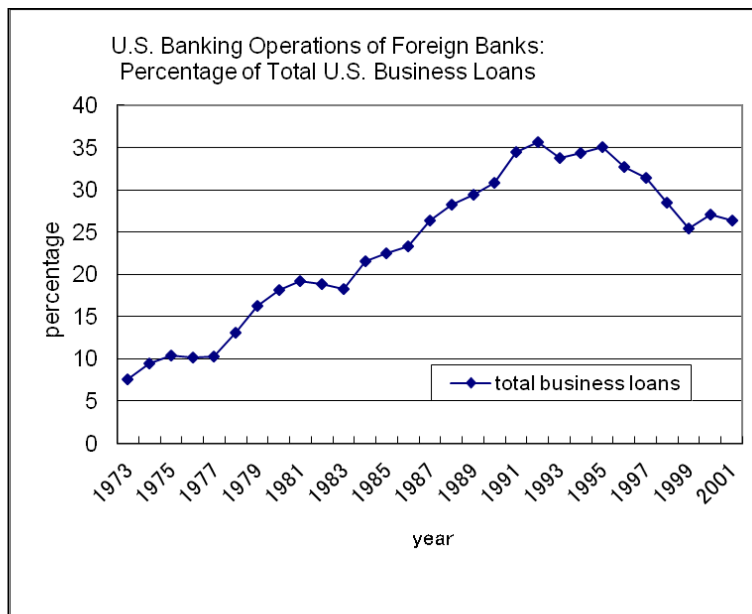
However, after this period, the demand from the American Congress escalated and, as a result, they changed the nature of the bilateral financial negotiations, which is the subject of the next chapter.

Figure 4.1 U.S. Banking Operations of Foreign Banks: Percentage of Total U.S. Banking Assets



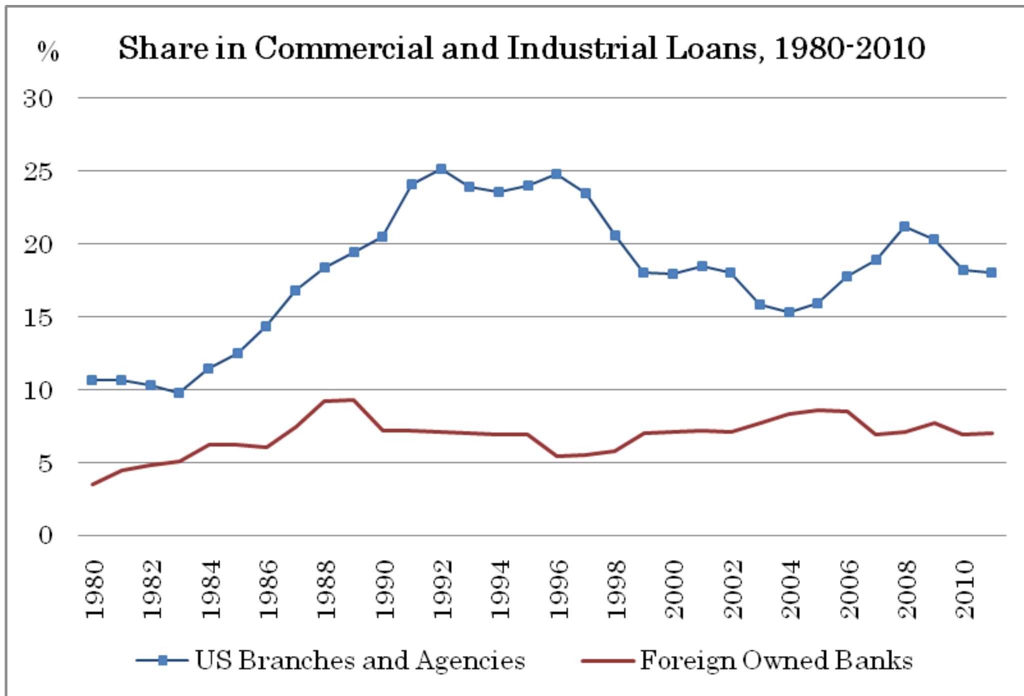
Source: Federal Reserve Board, "Share Data for U.S. Offices of Foreign Banks," June 2002.

Figure 4.2 U.S. Banking Operations of Foreign Banks: Percentage of Total U.S. Business Loans



Source: Federal Reserve Board, "Share Data for U.S. Offices of Foreign Banks," June 2002.

Figure 4.3 Foreign Banks in the U.S.:
Share in Commercial and Industrial Loans, 1980-2010



Source: FRB, Structure and Share Data for U.S. Banking Offices of Foreign Entities

Table 4.1 The *Banker's* Top World Banks in terms of Assets, 1989

1	Dai-Ichi Kangyo Bank	JPN
2	Sumitomo Bank	JPN
3	Fuji Bank	JPN
4	Mitsubishi Bank	JPN
5	Sanwa Bank	JPN
6	Industrial Bank of Japan	JPN
7	Norinchukin Bank	JPN
8	Credit Africole	FRA
9	Tokai Bank	JPN
10	Mitsubishi Trust	JPN

Source: The *Banker,* July 1989, "Top 1000."

Chapter 5 Out of Control? Tougher Demands for Openness

At the turn of the decade, there was a growing sense of insecurity among Americans concerning the international expansion of Japanese economic players. The fear of being taken over led Congress to be tougher on Japan. The U.S. demands against Japan during this period, especially those delivered by Congress, were characterized by the demand for reciprocity. Without Japan opening its markets to US players, the lucrative US markets should be also closed to Japan. The administration tried to contain the outrage so that it would not harm the overall U.S.-Japan relations. The trend spread to the area of finance, which had been politically less salient for the public and Congress as other trade issues including automobile and computer-related products. The U.S. side also became increasingly hawkish in its demands to open up Japanese financial markets to American players.

In this chapter, I examine how the changing climate affected the bilateral financial negotiations during this period. Specifically, I focus on how the structure of the negotiations, such as the arena and players involved in the process, changed and how such changes in turn affected the negotiation outcomes.

5.1 The U.S.-Japan Relationship around 1990

As the Communist threat had waned during the last years of the Cold War, economic competition among countries came to be seen as an issue of national security. In 1989, by a 3-1 margin, the American respondents of an opinion poll named Japan's economic challenge as a great threat to America's future than the Soviet military.[1]

Since the mid-1980s, there was a growing concern in the U.S. over the loss of control of sensitive industries, especially to the rapidly expanding Japanese. In 1987, a Japanese company, Fujitsu, tried to purchase an 80-percent share in Fairchild Semiconductor Corporation, a large supplier of computer chips for the U.S. military, from a French company. The proposed acquisition raised concern among U.S. government officials, and Fujitsu eventually withdraw its offer (Spero and Hart 2003:137). The Exon-Florio amendment of the Omnibus Trade Act of 1988, established in 1991, would prohibit mergers, acquisitions, or takeover of American firms by foreign interests when such actions are deemed injurious to the national security of the U.S. (Spero and Hart 2003: 149).

One of the consequences of the tough attitude of the American public toward Japan was the greater demands for reciprocity in dealing with the bilateral economic

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[1] Robert Neff, Paul Magnusson, and William J. Holstein, "Rethinking Japan," *Business Week*, August 7, 1989, p.44.

relationship. The post-war international trade regime under the GATT had developed liberal international economic order on the principle of nondiscrimination. However, the idea of reciprocity appealed because the notion not merely suggests sanctions for undesirable behaviors of other countries, but it was meant to introduce the sense of fairness. The tendency to resort to reciprocity was especially visible in Congress. On the other hand, the administration tended to be cautious out of the fear of retaliation and spillover effects on overall diplomatic relationship.

In the field of finance, the administration had been far more cautious than Congress in applying the principle of reciprocity to gain greater access to the Japanese financial markets. The importance of inward investment affected the attitude. Yet, over time, the Treasury came to take advantage of the Congressional calls for reciprocity to win more concessions from Japan, while it maintained its opposition to automatically applied reciprocity bills.

Ironically, in the hindsight, the era corresponds with the burst of the economic bubble in Japan. Japanese financial institutions started to lose its competitiveness in the world market toward the end of the 1990s. However, the perception in the early 1990s remained to be that of Japanese banks sailing abroad in the bubble era.

5.2 U.S. Fair Trade in Financial Services Act (FTFSA)

In the 100th Congress (1987–1988), in which the reciprocal treatment of American financial institutions in the Japanese market with respect to dealing of government bonds was demanded, the legislature also took up the issue of reciprocal access of American financial institutions in general to the Japanese market. The call for reciprocity in the financial sector dated back in 1983, when Senator Garn introduced legislation that would require regulators to use reciprocity as a criterion in considering foreign banks' application to establish branches in the U.S. (Bayard and Elliot 1994:270). In 1987, the Senate Banking Committee considered the so-called "Fair Trade in Financial Services" provision as part of the Omnibus Trade Bill. The Senate adopted the "national treatment" provision,[2] but it was "dropped in conference at the urging of House Banking on grounds that it would be better considered as part of comprehensive banking legislation.[3]" The Senate then added the language to the Proxmire Financial Modernization Act later in 1988,[4] which was passed by the Senate but was not

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[2] Title XV of S 1409.

[3] Testimony of Senator Jake Garn, (written statement), Subcommittee on Trade, Committee on Ways and Means, House of Representatives, July 29, 1991, p. 14.

[4] Section 909 and 910 of the Proxmire Financial Modernization Act of 1988.

considered by the House.[5]

In the 101st Congress (1989–90), the reciprocity bill was again introduced at the beginning of 1990. In January, Donald W. Riegle, Chairman of the Senate Banking Committee, introduced the Fair Trade in Financial Services Act to the Senate as S. 2028 for the first time. In a markup held in May, the Committee incorporated S. 2028 into the Defense Production Act Amendments of 1989 (S. 1379). The Senate passed the bill on October 3. While the House version of the Defense Production Act (DPA) Amendments (HR486) did not have the provision, the Conference Committee filed a DPA Conference Report that contained the Fair Trade in Financial Services provisions later that month, and the House agreed to the report. However, the Senate adjourned before considering the Conference Report.[6]

The main purpose of the Senate bill was to allow U.S. regulators to take action against banks in countries that did not grant U.S. banks "effective market access." The bill would give regulators, the FRB and the SEC, authority to deny applications from foreign banks and securities firms for new branches, or other changes in operations, if

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[5] Testimony of Senator Jake Garn, (written statement), Subcommittee on Trade, Committee on Ways and Means, House of Representatives, op.cit., p. 14. See also Bayard and Elliot 1994: 273.

[6] Senate Report 103-235, Conference Report to accompany S. 1527, February 22, 1994, legislative history.

Treasury Secretary determined that the home country did not extend national treatment to U.S. banks. It would not allow existing operations to be curtailed. It would not require true "reciprocity," where a foreign country would be required to allow U.S. firms to operate with the same freedom they enjoy in the U.S.

The Bush administration had been opposed to the bill, despite some indication by David C. Mulford, the Under Secretary for International Affairs, Treasury Department who was in charge of the U.S.-Japan bilateral negotiations, that it might shift to supporting it if Japan would not move forward with financial liberalization swiftly enough. The Head of House Banking Committee Henry B. Gonzalez expressed concern over the bill, as the retaliation provision could also affect banks from Latin American countries.[7] On the other hand, some pointed to the link between Riegle's home-state auto industry, which was ravaged in the early in the early 1980s as a result of fierce competition with Japanese companies, and the introduction of the reciprocity bill.[8]

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[7] *Nihon Keizai Shimbun*, May 23, 1990, p.3.

[8] Robert M. Garsson, "Senate bill would pressure Japan to open its financial markets," *American Banker*, May 25, 1990, p.1.

5.3 Bilateral Negotiations: U.S.-Japan Working Group on Financial Markets

In the field of finance, despite the reforms in Japan after the conclusion of the Yen-Dollar Accord in the middle of 1980s, the market shares of foreign banks did not improve. This situation irritated U.S. Congress (Brown 1994: Chap. 7). In such irritation, the new framework of bilateral negotiations, the U.S.-Japan Working Group on Financial Markets, was launched in November 1989. When the establishment of the new framework was agreed to replace the follow-up sessions of the Yen-Dollar Talks, it was intended to move away from issue of domestic liberalization to discuss those in international financial system more generally.[9] When it started, however, the focus shifted to even more domestic issues in Japan's financial markets. Moreover, the U.S. side started to stress more general liberalization, such as deregulation of interest rates, rather than measures that directly affected American financial institutions. The former could be a more difficult issue, as it touched directly on the structure of the whole financial system.

The first meeting of the new working group was held in Washington, D.C. in November 1989. The main subjects were the liberalization of interest rates, the complicated and opaque procedure for introducing new financial products, and the

[9] Carla Rapoport, "US pleased with latest Japanese deregulation," *Financial Times*, April 21, 1988, p.35.

difficulties for Japanese investors to access foreign markets. In this meeting, the two governments agreed to establish a working group to deal with technical issues.

Why did the U.S. begin to change its position despite the initial expectation that the working group would be a forum for discussing management of international financial markets? The personal relationship in the international network of financial officials continued. Even in Japan, where career-track bureaucrats routinely rotate posts, provoking criticism that they cannot accumulate sufficient expertise nor develop close relationship with their foreign counterparts, respective vice financial ministers for international affairs in the 1980s served for three years, which was longer than the normal two-year tenure. Moreover, all vice ministers since 1983 were promoted directly from the post of Director-General of the International Finance Bureau. As such, they had engaged in international negotiations over financial issues before they became the vice minister. In the U.S., David Mulford served first as assistant secretary for international affairs from 1984 and then as under-secretary for international affairs from May 1989. Until his resignation in 1992, Mulford played a key role in preparing for the annual summit meetings as "financial sherpa," addressing the Latin American debt crisis, and restructuring the foreign debt of the former Soviet Union.[10] Given his long

[10] Peter Norman, "Top Treasury official quits for First Boston," *Financial Times*, November 6, 1992, p.6, "Treasury's David Mulford Will Join CS First Boston," *Wall Street Journal*, November 6, 1992,

experience and deep knowledge in international financial affairs, the *Guardian* wrote upon his resignation that "there have been few G7 decisions outside Mulford's range.[11]"

One of the factors that triggered the change was the success of the U.S.-Japan Structural Impediments Initiative (SII) talks, which took place from July 1989 to June 1990.[12] As mentioned in the introductory section of this chapter, in the late 1980s, the American public came to regard Japan's economic "intrusion" as a national-security issue and, in reaction, politicians attempted to introduce bills to counter the Japanese expansion. The Bush administration tried to contain such moves for fear that the effects would spill over on the overall relationship with Japan, including the security relations. One of such efforts was the SII talks held between the two countries. In order to counter Congressional moves to introduce threat of retaliation, the Bush administration proposed the bilateral negotiation framework to discuss barriers to trade and investment in Japan outside of the shadow of the Super 301 of the Trade Act (Schoppa 1997:

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p.B8.

[11] Alex Brummer, "Mulford Secrets," *Guardian*, November 6, 1992, p.16. Mulford remained in the position of Assistant Secretary until he finally became the Under Secretary for International Affairs in May 1989. He could not get the post before then even though the post was open because of the tension with Deputy Secretary Richard G. Darman, who was a longtime aide of Treasury Secretary James A. Baker III and who wanted to handle the issues concerning international affairs on his own. Hobart Rowen, "Mulford left his imprint on world economic policy," *Washington Post*, November 15, 1992, and Funabashi 1988: 212-215.

[12] The SII talks were officially launched on July 14, 1989. The Interim Report was published in April next year, and the Final Report came out on June 28, 1990.

10–11).[13]

While liberalization of financial services in Japan were not among a wide range of issues covered by the SII, bilateral negotiations on the domestic financial deregulation continued as follow-up of the Yen-Dollar Talks. As the SII covered areas that had been considered domestic matters (Janow 1994), the bilateral financial negotiations also came to cover apparently purely domestic issues.

The SII also affected the nature of the composition of participants in the negotiations. Before the SII, negotiators in the area of finance were limited to Treasury officials on the U.S. side. In the SII talks, however, officials from other governmental agencies also played a role. This change pushed the Treasury to a tougher position against Japan. Before the talk, the negotiations over financial matters were left almost exclusively to the U.S. Treasury and the Japanese MOF. However, in the talk, legislatures and other governmental agencies began to intervene. Because of this change, the necessity of the information on wider range of political and administrative developments arose.[14]

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[13] The proposal of the SII talks was revealed on May 29, 1989 on the same day of the announcement of USTR's National Trade Estimate Report, which named Japan an "unfair trade" under the Super 301 provision of the 1988 Trade Act.

[14] *Nikkei Bijinesu*, February 11, 1991, pp.199-204. Related to the SII, another factor that was said to have contributed to the tough attitude of the U.S. was a personality clash between Mulford and his rival, Assistant Secretary for International Affairs of the U.S. Treasury Charles Dallara. Dallara's achievements in the SSI meetings attracted a lot of attention in the U.S. Yasuhiko Shibata,

Ironically, the introduction of the BIS capital adequacy requirement and the crash of the Japanese stock market, which brought the weakening of Japanese banks operating in the U.S. also contributed to the change. The resulting decline in the volume of lending by the Japanese banks in the U.S. deteriorated the already problematic credit crunch there. The U.S. officials aimed at reviving the Japanese economy through reform of the financial sector.[15] Soon after the first meeting, Mulford wrote in the *Financial Times* about Japan's financial liberalization. While he noted that some important progress had been made since the Yen-Dollar talk, he complained that the Japanese markets were still far from a truly market-based financial system. Although measures such as partial deregulation of interest rates, development of the money market, and the new membership of foreign financial institutions in the Tokyo stock exchange should be commended, overall, the remaining regulations, such as those on interest rates, and on new, innovative products and services, are regrettable. Mulford also complained that opaque informal practices limit the entry of foreign firms in the Japanese markets. He linked financial liberalization to the issue of trade imbalances by claiming that competitive interest rates would increase the personal income of depositors, thereby

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"Currently speaking: financial friction likely to emerge," *Daily Yomiuri*, May 26, 1990, p.9.

[15] Robert Neff, Paul Magnusson, and William J. Holstein, "Rethinking Japan," *Business Week*, August 7, 1989, p.44.

boosting consumption and imports. Moreover, development of efficient, liquid money market in Japan would encourage greater use of the yen in international transactions.[16]

FTFSA, the Government Agencies, and the Private Sector

Even though the first bilateral meeting was held before the submission of the FTFSA bill, the meeting also reflected the growing call for reciprocity in Congress. On February 28, Mulford signaled a potential shift toward a reciprocal policy at a House Banking Committee task force. Mulford told a House Banking Committee Task Force on International Competitiveness that negotiations with Japan to increase the access of U.S. banks to Japanese financial markets had not been wholly satisfactory. Mulford also said that the EC had decided in 1989 to adopt the principle of "reciprocal national treatment" by the end of 1992. He said that the European might gain leverage with the Japanese.[17]

Yet, the Treasury did not openly back the idea of reciprocity in the area of finance. In his testimony before the Senate Banking Committee in April 1990, Mulford said the administration preferred to push for more open market abroad for U.S. firms rather than impose retaliatory measures, noting that the risk that retaliations would

[16] David Mulford, "Needed; bolder steps towards freer access; Japan's financial markets," *Financial Times,* November 29, 1989, p.27.

[17] "Foreign bank rules are under review," *CQ Weekly*, March 3, 1990.

follow reciprocity once it would be used.[18] He also told that the U.S. was pressing for more rapid interest rate deregulation in Japan.[19] Alan Greenspan, Chairman of the Federal Reserve Board, also expressed his opposition to the reciprocity bill in his April testimony.[20]

U.S. bankers also expressed disdain. They say the legislation would serve no purpose and was a reckless Japan-bashing exercise for Congress.[21] New York bankers warned that U.S.-Japan relations could deteriorate if the bill passed. One of those bankers said that approving the bill could make Japan less willing to back U.S. administration efforts to provide financial assistance to Third World countries.[22] In his testimony before the Task Force on International Competitiveness of U.S. Financial Institutions, John S. Reed, Chairman of Citicorp, raised his concern that the Fair Trade in Financial Services Act "could be counter-productive if it plays to the tendency of the Europeans to talk of reciprocity." He said to negotiate open markets and transparency of

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[18] Robert Trigaux and James R. Kraus, "Treasury aide rejects plan to hit Japan," *American Banker*, April 6, 1990, p.1.

[19] James R. Kraus, "Senate bill spurs Japanese concern; measures would retaliate for unequal bank access," *American Banker*, March 1, 1990, p.2.

[20] *Nikkei Kinyu Shimbun*, April 9, 1990, p.6.

[21] James R. Kraus, "Senate Bill Spurs Japanese Concern" *American Banker*, March 28, 1990, p.10.

[22] Trigaux and Kraus, op.cit.

regulation should be the better approach.[23] He also stressed the importance of lifting the regulations that had rendered the U.S. financial industry highly fragmented and compartmentalized both by function and by geography. He especially emphasized how the Glass-Steagall Act made the U.S. banks disadvantaged against European banks.

Despite these oppositions, the reciprocity bill moved through the process. On May 24, the Senate Banking Committee approved the Fair Trade in Financial Services Act (S2028), which was attached by voice vote to a measure amending the Defense Production Act. President Bush opposed the Riegle bill and would veto it if it was send to him as a freestanding bill.[24] The committee defeated an amendment by Phil Gramm, which would have prohibited sanctions against foreign banks and securities firms unless it was shown that there would be no adverse effects for U.S. consumers. On the other hand, it accepted an amendment by Christopher J. Dodd, which called on regulators to exempt from future punitive actions financial institutions from counties that had extended national treatment to U.S. financial firms in the past. This amendment would

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[23] Hearing before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Task Force on International Competitiveness of U.S. Financial Institutions of the Committee of Banking, Finance and Urban Affairs, House of Representative. May 8, 1990. The citation is in page 23. Reed was Chairman of the U.S. Government-appointed "Service Policy Advisory Committee on Trade Negotiations (S-PAC)" and Chairman of the private sector Coalition of Service Industries (CSI) (pp.40-41).

[24] Robert M. Garsson "Senate Bill Would Pressure Japan to Open Up its Financial Markets," *American Banker*, May 25, 1990, p.1.

focus the bill even more sharply on Japan.[25]

5.4 Liberalization of Interest Rates in Japan

During this period, the Japanese Ministry of Finance (MOF) attempted to liberalize interest rates gradually. In the early March of 1990, the Japanese MOF asked various types of financial institutions to submit their proposals for interest rate liberalization.[26] By April, the MOF was reported to set a plan to complete the deregulation of time deposit interest rates by the fall of 1993. The Ministry began consultation with various types of banks, and by the end of April, they accepted the plan.[27] In the meantime, the MOF also decided to allow banks to introduce a new financial product in October 1990, a step toward liberalization of interest rates. The new instruments, with the minimum sales unit of 3 million yen, would have interest rates that would float with deregulated large-denomination time deposit rates.[28]

Besides these moves toward interest rate liberalization, just before the second

[25] "Bill seeks equal treatment for U.S. banks abroad," *CQ Weekly Report*, May 26, 1990.

[26] *Kinyu Zaisei Jijo* April 9, 1990, pp.12-13.

[27] *Asahi Shimbun,* April 21, 1990, p.1.

[28] *Asahi Shimbun*, April 14, 1990, p.3.

meeting of the Working Group, the MOF made some decisions that would give foreign banks more favorable treatment than the domestic ones. In April 1990, the Ministry announced that the restriction on new branched would not be applied to foreign banks. This decision would work especially favorably to Citibank, which tried to expand its retail network in Japan.[29] Japanese banks criticized the policy for being discriminatory against them. In doing so, however, major banks hoped to achieve complete removal of the restrictions on branching by using the American pressure.[30]

In the same month, the MOF also announced that it would permit foreign securities firms, such as Morgan Stanley, Merrill Lynch, Goldman Sachs, Solomon Brothers, to open bank subsidiaries in Japan and authorized the establishment of such branches in February 1991. Japanese banks were strictly prohibited from engaging in securities business by the Securities Exchange Law.

Yet, the U.S. negotiators continued to complain the slow pace of financial liberalization in Japan. In the second meeting of the working group was held in Tokyo in May 1990, the focus was on further deregulation of deposit rates in Japan. The meeting ended with both sides far apart on the question of how quickly Japan should

[29] *Nihon Keizai Shimbun*, April 19, 1990, p.1.

[30] *Nihon Keizai Shimbun*, April 26, 1996, evening edition, p.2.

deregulate interest rates on bank deposits. The U.S. side was adamant in insisting on the basic principle of market liberalization through the deregulation of interest rates.[31]

Behind the tough U.S. requests was the persistent expansion of Japanese banks' shares of U.S. and other overseas markets.[32] In the hindsight, Japanese financial institutions had already begun losing their strength by then. After the economic bubble of the latter half of the 1980s, stock and land prices started to fall in 1990 and 1991 respectively. They subsequently plunged by more than 50 percent in a few years. A direct result of the burst of the bubble was the plight of the financial sector, riddled with non-performing loans. At that time, however, most observers did not anticipate that consequence. Mulford aggressively pressed for further steps to liberalize Japan's financial markets. He demanded the immediate decontrol of interest rates.

When the talk was held, the MOF did not present a concrete schedule for interest rate deregulation. As mentioned above, the MOF had already begun negotiations with domestic banks over the timetable for further interest rate deregulation. However, the Ministry and the private sector could not reach an agreement on the concrete timetable due to the fierce opposition from small- and medium-sized banks,

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[31] *Asahi Shimbun*, April 20, 1990, p.9.

[32] Masaharu Usuki, "Tokyo economist says Japan should speed deregulation," *American Banker*, August 24, 1990, p.4.

which were strongly against quick deregulation of interest rates.[33] There was also the question of how to deal with the government-run postal saving system, which did not fall under the jurisdiction of the MOF.

The U.S., however, demanded complete liberalization of interest rates on all bank deposit within one year. The firm demand came from the belief that the remaining interest rate regulation in Japan had given Japanese banks a substantial advantage. According to the argument, the regulation kept interest rate in Japan artificially low, providing Japanese banks with an unfairly cheap source of funds.[34]

The proportion of deposits with liberalized interest rates in Japan's major banks was about 60 percent at that time. The figure varied across different types of financial institutions. As of the end of February 1990, that of city banks was 59.3 percent, regional banks 48.4 percent, second regional banks 45.5 percent, and credit associations 30.7 percent.[35] This meant that the liberalization would affect smaller financial

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[33] *Kinyu Zaise Jijo*, May 28, 1990, pp.6–7, and June 4, 1990, pp.14-15.

[34] Stefan Wagstyl, "Washington calls on Japan to speed up financial deregulation," *Financial Times*, May 23, 1990, p.1, A.E. Cullison, "US official warns Japan of sanctions," *Journal of Commerce*, May 23, 1990, p. 3A. Many U.S. managers had attributed the competitiveness of Japanese companies in manufacturing sector to the low cost of capital in Japan. The believed that the cost of capital had been significantly lower in Japan due to the historically high national saving rate and the government intervention in allocating the pool of savings. However, Kester and Luehrman (1992) found no evidence that the cost of capital had been systematically lower in Japan.

[35] Yamada Teizo, "Kinri jiyuka to sono eikyo" *Kinyu*, June 1990, p.5.

institutions more severely.

Other major demands were the deregulation of restrictions on foreign currency deposits and on new financial opportunities. The *Wall Street Journal* remarked that "this time around, the U.S. is seeking broad deregulation of deposit rates, widespread direct dealings in the currency markets and greater opportunity for foreign financial institutions to manage Japanese cash," while in the past, the U.S. had primary sought specific openings for U.S. banks and securities firms into Japan's financial markets on a case-by-case basis.[36] The IMF also urged Japan to liberalize interest rates in its meeting with Japan in July 1990.[37] In its Annual Report, the IMF especially noted the need for further liberalization of interest rates in Japan.[38]

The MOF briefed the U.S. officials on a schedule for liberalizing interest rates and promised to allow foreign securities firms to conduct foreign exchange business through their subsidiaries in Japan. Under the pressure, there were some signs that the Japanese government would accelerate the schedule for interest rate liberalization. In July, Finance Minister Ryutaro Hashimoto suggested to Treasury Secretary Brady that

[36] Christopher B. Wilcox, "Latest U.S. demands for market access in Japan may spur strong opposition," *Wall Street Journal*, May 18, 1990, A5C.

[37] *Asahi Shimbun*, September 13, p.2.

[38] *International Monetary Fund Annual Report 1990*, p.14–15.

Japan might move up its schedule for the liberalization of interest rates of time deposits.[39] Moreover, the MOF eased restrictions on Japanese residents' overseas deposit accounts in foreign-denominated currencies, as it promised to the U.S. in May. Permission was no longer necessary for amounts worth 30 million yen or less.[40]

The MOF and banks were also negotiating over the introduction of a new saving deposit in the spring of 1992. The new product would be a non-time saving deposit that would carry a higher interest rate than ordinary liquid deposits, with the withdrawal frequency limited. The introduction would be a step toward deregulation of interest rates on liquid bank deposits.[41]

5.5 Developments related to the Reciprocity Bill in the US. 1990 and 1991

Bill Close to Passage, Fall 1990

The efforts made by the Japanese government notwithstanding, in October, the Senate floor passed the financial services provision as a part of the Defense Production Act Amendments. In the previous month, the House approved a version of the Defense

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[39] *Asahi Shimbun*, July 9, 1990, p.2.

[40] *Asahi Shimbun*, July 18, 1990, p.8.

[41] *Jiji Press*, October 31, 1990, *Asahi Shimbun*, November 24, 1990, p.3, and March 11, 1991, p.2.

Production bill (HR486) that did not include the Japan provision. Some major Japanese banks applied for underwriting of debentures and CPs to the FRB in order to obtain approval before the passage of the Fair Trade in Financial Services Act.[42] The bills moved to a House-Senate conference committee, as the Senate and House versions must be reconciled. The administration continued to oppose the measure, arguing it ran counter to free-trade principle, and lobbied for a one-year extension of a Defense Production Act without the Riegle provision. The Treasury said the original measure would undermine U.S. efforts to stop the EC from including similar reciprocity requirements.[43]

Even though the Senate and House conferees agreed to incorporate the measure into the bill renewing the Defense Production Act, the Senate accepted the modification of the measure, which would give the Treasury greater discretion. The new version of the bill would not mandate the Treasury to shrink the U.S. services provided by foreign banks and brokerage. The bill directed the Treasury to conduct negotiations with any country that would be found to engage in "*significant*" discrimination against U.S.

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[42] *Nihon Keizai Shimbun*, September 20, 1990, evening edition, p.1.

[43] Robert M. Garsson, "Senate Clears Bill Aimed at Japan Markets," *American Banker*, October 5, 1990, p.1, "Conferees clear bill on trade barriers to financial firms," *Wall Street Journal*, October 23, 1990, A20.

financial institutions. If the negotiations would be unsuccessful, the U.S. regulatory agencies could deny applications of financial institutions from that country for entry, mergers, acquisitions, and other activities. Moreover, the new version of the bill reduced the requirement for the Treasury to report to Congress from once a year to once in two years. This effectively extended the deadline for the first report to the end of 1992. Although the Treasury withheld comment on the conference action, the press observed that the department no longer opposed the legislation in its new form.[44] One factor that contributed to the expansion of Treasury's discretion was the request of the House Energy and Commerce Committee, which had been concerned about the possible impact the bill would have on inflows of foreign investment.[45]

The Japanese MOF lobbied the Treasury, the FRB, and influential members of Congress to stop the passage of the fair trade bill at this stage.[46] Under these circumstances, however, the expectation was high that the bill would be enacted in the 101st Congress. Still resisting the bill, Japanese banks speeded up applying for new lines of business in the hope of obtaining approval before the passage of the bill and thereby

[44] Ibid, and "Conferees agree on fair trade bill to let agencies bar foreign banks," *American Banker*, October 24, 1990, p.2, "Restricting foreign banks," *CQ Weekly*, October 27, 1990, *Nikkei Kinyu Shimbun*, October 23, 1990, p.1.

[45] *Nikkei Kinyu Shimbun*, October 23, 1990, p.1.

[46] *Nihon Keizai Shimbun*, October 18, 1990, p.7.

gaining exemption from retaliatory measures.[47]

Yet, the bill died with adjournment. The House floor passed the provision on October 26. Ironically, the Senate, which passed the provision earlier that month, could not clear the bill by the end of the Congressional session on October 28, largely because of the Bush administration objection to some provisions concerning defense procurement.[48] The death of the legislation implies that passing the bill itself was not the high priority for the administration.

Changing Attitude of the U.S. Side, 1991

Yet, the Treasury Department's National Treatment Study of 1990, published in the early December, was especially critical of Japanese barriers of entry by U.S. banks and securities firms. Undersecretary Mulford hinted in a press briefing on the report that the Bush administration might support retaliatory legislation next year. He said Japan could well be the target of U.S. retaliation. The global negotiations on free trade had collapsed the week before.[49]

Since the start of the new year of 1991, the media pointed out that the Bush

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[47] *Nihon Keizai Shimbun,* October 24, 1990, p.1,

[48] *Banking Expansion Reporter,* November 19, 1990, p.1.

[49] Stuart Auerbach, "Treasury: Japan still restricts U.S. financial firms," *Washington Post*, December 12, 1990, A12.

administration began to toughen the U.S. trade policy against Japan. Recession in the U.S. helped stiffen the U.S. attitude toward the slow progress in reducing the huge U.S. trade deficit against Japan. Japan's passive role in the Gulf war and the Uruguay Round of the GATT also made the view on Japan severer. Furthermore, concerns for the possible shift in American public opinion at the 50th anniversary of the attack on Pearl Harbor might also affect the stance of the U.S. government.[50] The *New York Times* reported that some Congressional staff members suggested that the administration intended to head off an expected drive in the 102nd Congress to enact punitive legislation on foreign investment and trade.[51]

In the same period, the Interior Department tried to prevent Japan's Matsushita Electric Industrial Company from retaining the right to do business in Yosemite National Park by acquiring MCA Inc. The Justice Department was preparing to file a civil antitrust lawsuit to stop an attempt by Nippon Sanso KK of Japan to take over Semi-Gas System, a U.S. semiconductor company. The acquisition was sharply criticized in Congress. The Interior and Justice moves made a sharp contrast to

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[50] Clayton Jones, "Tough trade dispute, U.S. recession put Japan on spot," *Christian Science Monitor*, January 22, 1991, p.4.

[51] The *New York Times* also pointed out Japan's refusal to support the U.S. effort to force the European Community to end agricultural subsidies in global trade talks. Clyde H. Farnsworth, "US hardens trade stance with Japan," *New York Times*, January 7, 1991, p.D6.

previously expressed positions of the Reagan and Bush administrations, which had generally accepted any foreign acquisitions.[52]

In the field of finance, in January 1991, Treasury officials suggested that the administration was considering to shift their attitude and to support the Fair Trade in Financial Services Act. In the third meeting of the working group held in January 1991, the main subject was again the liberalization of interest rates in Japan. It was the meeting originally scheduled in March. The schedule was moved forward to January at the request of the U.S. side, as the U.S. negotiators wanted to start negotiations before the resumption of Congress.[53]

The U.S. negotiating team, led by Mulford, called for the liberalization of interest rates for time deposits within months, as well as further opening of the investment advisory business and the transparency of financial administration. Frustrated by the slow progress in the talks, the U.S. side warned Japan that Congress would pass retaliatory measures unless Tokyo would act rapidly to deregulate its financial markets and increase access for foreign businesses. The U.S. was "seeking

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[52] Ibid.

[53] *Nihon Keizai Shimbun*, January 25, 1991, p.5. Aside from the Congressional schedule, the U.S. administration might also wanted Japan make concessions in the context that Japan's contribution to the Gulf War was considered far from enough.

commitments from Japan for a much faster timetable for deregulating interest rates and freeing money markets and foreign exchange controls that the three-year period so far promised." It also wanted foreign concerns would be "allowed to act as lead managers and underwriters on corporate issues and to bring financial products to Japan." In addition, they also called for fairer and more transparent rules in general. The U.S. Treasury was deliberately ambiguous about the fair trade in financial services bill.[54]

In response, the Japanese side, led by Makoto Utsumi, the Vice Minister for Finance for International Affairs, only told that the MOF planned to complete liberalization of interest rates for time deposits in 1993.[55] Moreover, Utsumi cautioned that the reciprocity bill would backfire on the U.S. In an unusually blunt warning at a news conference with Mulford after the meeting, Utsumi stated that if the U.S. would apply sanction against Japan through the reciprocity bill, Japanese financial institutions would curb credit to the U.S., which would be "very harmful" for the US. He warned that the bill, if approved, could send a "very serious signal" to the Japanese banks and could worsen the existing credit crunch within the U.S.[56] The meeting did not produce

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[54] Peter Riddell, "Tokyo warned on foreign business access," *Financial Times*, January 28, 1991, p.16.

[55] *Asahi Shimbun*, January 30, 1991, p.9.

[56] Peter Riddell, "U.S. and Japan in deadlock over financial markets" *Financial Times* January 29,

any significant results.

As the tension between the two sides increased, the Fair Trade in Financial Services Act was introduced to the 102nd Congress in 1991 and 1992. In 1991, the sponsors of the Fair Trade in Financial Services Act in the Senate suggested that they would attach the provision to any bank-related bills introduced in the 102nd Congress.[57] It indeed became parts of various bills and passed the Senate during that Congress, and it was also introduced in the House. Compared to the previous Congress, the prospect for passage was brighter, because the stance of the Bush Administration had changed. While it was not enthusiastic about the bill, it aimed at more aggressive use of the bill as leverage for pushing Japan in the bilateral negotiations. However, due to disagreements between the two Chambers, the Conference Committee eventually dropped the provision in the end.

In February 1991, Chairman Riegle reintroduced the Fair Trade in Financial Services Act again as a part of the Defense Production Amendments Act of 1991 (S347), a bill to extend the expiration date of the Defense Production Act of 1950, which had expired in 1990. On February 22, the Senate passed it by voice vote despite opposition

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1991, p.6, Clyde H. Farnsworth, "Japan's stern warning on trade sanctions" *New York Times* January 29, 1991, D18.

[57] Thompson's International Banking Regulator, various issues, 1991.

from the Treasury as well as foreign countries including Japan.[58] Later, the provision was also attached to a separate bill for sweeping reform of the U.S. financial system.[59] When Riegle introduced the bill, he said the provision was aimed primary at Japan. Even though European banks were slow to oppose the bill, because the measures were not aimed at them, the EC send a letter of objection to the legislation.[60]

Also in the House, Representative Stark, Democrat from California, introduced the Fair Trade in Financial Services Act on January 29, 1991.[61] It was the first time that the provision was introduced in the House.[62] The provision did not proceed in the House, however, and the House version of the Defense Production Act Extension and Amendments (H.R 991) did not contain the Fair Trade in Financial Services Act.[63]

In the July testimony, Senator Riegle raised some points to explain the need of

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58 "Financial Briefs," *Journal of Commerce*, February 25, 1991, p.3A, *Nihon Keizai Shimbun,* February 22, 1991, evening edition, p.2 and February 23, 1991, p.7.

59 *Jiji Press*, October 17, 1991.

60 Kenneth H. Bacon, "Foreign banks seek help as Congress begins writing some checks on them," *Wall Street Journal*, June 6, 1991, A20, and Hearing before the Subcommittee on Trade of the Committee on Ways and Means, House of Representatives, July 29, 1991, P.29.

61 The title was "To amend the International Banking Act of 1978 and the Securities Exchange Act of 1934 to provide for fair trade in financial services (HR697)".

62 *Nihon Keizai Shimbun,* February 5, 1991, evening edition, p.2.

63 Hearing before the Subcommittee on Trade of the Committee on Ways and Means, House of Representatives, op.cit., p.2.

the legislation, which he said was aimed especially at Japan. First, he mentioned the asymmetry between the U.S. and Japan. While the European banks controlled 184 billion dollars' worth of banking assets in the U.S., U.S. bankers held 230 billion dollars of banking assets in Europe. On the other hand, while Japanese banks controlled $ 435 billion of banking assets in the U.S., the U.S. banks had merely $19 dollars of banking assets in Japan. He regarded this asymmetry as a result of Japan's strategy of protecting its home market from foreign competition and using higher profit at home to subsidize market advances abroad.[64] He also cited another comment made by Alex Sheshunoff in 1989 that allowing foreign banks to have a major share of the U.S. market asymmetrically created risk because control over a nation's financial institutions meant control over other businesses.[65]

On the other hand, in the same hearing, Richard Self, Deputy Assistant U.S. Trade Representative for Service, stated that the negotiations with countries should be discretionary, rather than mandatory. He also demanded that the authority to negotiate with other countries should reside "within the executive branch, rather than within regulatory agencies." He also raised concern for the bill's implication on policies of EC.

[64] Ibid, p.6.

[65] Ibid, p.11.

Riegle stressed the range of flexibility given to the Treasury Department and the role of the provisions as leverage in international negotiations.[66]

The turning point came in April, when the Treasury started to openly support the provision. Deputy Assistant Secretary Barry Newman told Carper's Subcommittee on Economic Stabilization at an April 24 hearing that the department now supported the measure. At the same time, the State Department and the USTR raised concerns over the details of the bill, while they expressed support for the overall intention of the bill.[67]

In the meantime, the Japanese MOF took some important steps toward liberalizing the country's financial markets. In May 1991, an advisory committee of the MOF issued a report to propose liberalization of interest rates on demand deposit, which would be started in the spring of 1992.[68] Next month, a subcommittee of the Financial Research Council released its final report on comprehensive deregulation of Japan's financial system. Its recommendations included the permission of cross-entry of banks and securities industries into each other's business through subsidiaries. Based on the report, the MOF submitted bills for comprehensive deregulation of the financial system

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[66] Ibid, pp.37-52. Citation is in p.38.

[67] "House conferees move toward support of 'fair trade' bill," *Congressional Quarterly Weekly Report*, April 27, 1991, p.1050.

[68] *Asahi Shimbun*, May 22, 1991, p.1

next year. The Diet approved them in June 1992 without substantial discussion. These moves were mostly driven by domestic dynamics, but the pressure from American Congress and the bilateral talks apparently had some impact (Suginohara 2004).

In October, the fourth meeting of the working group was held between the U.S. and Japanese financial officials. The main subject of the talk was the financial scandals that surfaced that year. In 1990 and 1991, a series of financial scandals hit Japan. The media uncovered illicit loans major banks had made. Securities firms were found to have made illegal compensation payments to major clients over several years for losses caused by stock market declines. The Ministry of Finance was accused of overlooking, and sometimes tacitly permitting, these activities.

At that time, financial scandals also took place in other industrial countries. The most notable was the scandal that involved the Bank of Credit and Commerce International (BCCI), a bank with worldwide network, whose offices were closed in July 1991 in a coordinated action of world financial regulators. It had committed a startlingly wide range of criminal activities, including illicit purchases of banks and real estate, money laundering, and support of terrorism. This BCCI affair highlighted the vulnerability of the financial regulatory system to international crimes.[69] In the U.S.,

[69] For more details, see Kapstein 1994.

Solomon Brothers was found to have engaged in illegal bidding in the Treasury securities market. The trades of the firm bought far more than legal limit during the government sale of Treasury securities. In the communiqué issued on October 12, the Group of Seven took an unusual step of commenting on recent financial scandals. It called for "effective measures to avoid the recurrence" of the "irregularities that were revealed in some financial markets."

Even though the scandals were not limited to Japan, U.S. chief negotiator Mulford ascribed those in Japan to the lack of transparency in its financial system. In the bilateral talks, Mulford denounced Japan's Ministry of Finance for permitting anticompetitive practices in the financial markets. He was not satisfied with the explanation of the measures the MOF had deployed to prevent further misconducts.[70]

The strategy of focusing on financial scandals rather than interest rate liberalization reflected the U.S. concern over Japan's sluggish stock prices. After it peaked at 38,915 yen at the end of 1989, the Nikkei Stock Average started its long slide. If stock prices would continue to decline, foreign securities firms, whose main revenue came from commission revenue, would be seriously damaged. Moreover, since the stock market slump began at the same time as the introduction of the new BIS capital

[70] James Sternglod, "Treasury Official Rebukes Japan," *New York Times*, October 18, 1991, D1, *Asahi Shimbun,* October 18, 1991, p.1.

accord, the Japanese banks were forced to reduce the amount of loans. Whereas it spread to the domestic market through the 1990s, the reduction started in overseas markets, where the banks did not have longstanding relationship with the borrowers. It led to the further credit crunch in the U.S. For these reasons, the U.S. government shifted its focus to the issue of structural reform of the Japanese financial markets.[71]

However, this does not mean that the U.S. softened its position. On the eve of the meetings with Japanese officials, Mulford said that the steps the MOF had taken thus far did not address the root cause of the financial scandals. He demanded the ministry to stop the practice of informal administrative guidance and to issue clear, written policies to manage Japan's financial markets. He said that the Bush administration might become more favorably disposed to congressional action threatening sanctions if Japan will not introduce "real" reforms.[72] Besides, the demands for further liberalization of the Japanese financial markets continued. In the negotiation, Mulford also demanded further liberalization of interest rates and the opening of Japan's pension fund management business to foreign firms. In response, Tadao Chino, Japanese new Vice Minister of Finance for International Affairs, said that Japan had a

[71] *Nihon Keizai Shimbun*, November 27, 1991, p.9.

[72] "U.S. Treasury aide asks Japan to alter financial policies," *Wall Street Journal*, October 17, 1991.

plan to phase out fixed brokerage commissions but that the timetable had not been established.

The U.S. also called for the opening of the corporate pension market, citing that the share of foreigners in pension fund management in Japan was only 0.25 percent. The MOF explained its recent decision to give favorable treatment to foreign companies. Starting in December, foreign pension-fund and investment-management companies that operate in Japan would be allowed to increase the amount of foreign stocks they hold to 70 percent of their total holding from 50 percent. The MOF would also reduce the minimum assets needed by foreign companies to qualify for management to 500 million yen from the current one billion yen. The old rules would continue to apply to their Japanese counterparts. The U.S. was not satisfied, however. Mulford noted that foreign companies were limited to the management of pension money taken only after April 1990. On the other hand, the Japanese companies complained that these measures were "reverse discrimination" against the domestic players.[73]

By the time the October meeting was held, the nature of the bilateral negotiation changed from mostly technical negotiations between close specialists to

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[73] Quentin Hardy, "Japan grants more foreign access for finance firms," *Wall Street Journal*, October 18, 1991, *Asahi Shimbun* October 18, 1991, p.1, December 28, 1991, p.7, and *Nikkei Kousyasai Joho,* October 28, 1991, p.44.

more contentious ones, reflecting the Congressional in the U.S. Tougher demands and threats of retaliation did not lead to greater achievement, however. The Japanese side stiffened its attitude in response, and the negotiations did not produce significant results.

Since the October meeting, the U.S.-Japan financial talks were not held until May 1993, after the change of the American government. However, it did not mean that the two governments stopped efforts to discuss financial issues, especially the problem of financial liberalization in Japan. The financial authorities continued their talks under the multilateral framework of the GATT Uruguay Round. The bilateral negotiations under the umbrella of the GATT will be discussed in the next chapter.

In November, interest rates for time deposits of 3 million yen or more in Japan were liberalized as scheduled.

U.S. Congress

Later in 1991 and 1992, the reciprocity bills in financial services appeared repeatedly, attached to many different bills. There were also efforts to introduce even more punitive versions of the FTFSA. Even though the various versions of the provisions were passed both by the House and Senate, they could not agree on the details. In the end of the 102nd Congress (1991-1992), all of those reciprocity provisions were dropped.

The Senate attached the FTFSA to a bill to authorize short-term extension of

the Defense Production Act (DPA), which was passed in October 1991, and another bill for long-term extension, which was enacted in October 1992 (S468 and S347). On the other hand, the House version of the DPA bills (HR3039, HR991 and HR 347) did not incorporate the provision. For both bills, the provisions were dropped in the Conference Committee in October 1992. The Senate also attached the FTFSA to the financial system overhaul, but the bill, already long overdue, did not pass due to the disagreement among industries and regulators.[74] The Fair Trade in Financial Service Act was also included in the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991 (S543), reported by the Senate Banking Committee on October 1, 1991. While it passed the Senate, this provision of the Senate bill was also dropped from the Conference Report in October 1992.[75]

The House was not indifferent to the reciprocity bill, however. In October 1991, Charles E. Schumer, Democrat from New York, submitted a strengthened version of the FTFSA (HR3505) to the House. It differed in two ways from the Senate version. First, it required the Treasury Secretary to publish the list of offending countries. In the Senate

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[74] Senate Report 103-235, Conference Report to accompany S. 1527, February 22, 1994, legislative history.

[75] Senate Report 103-235, Conference Report to accompany S. 1527, February 22, 1994, legislative history.

bill, the Treasury was not required to publish such a list. Second, the House bill narrowed the focus exclusively on Japan by exempting the existing U.S. subsidiaries of European Community and Canadian banks from its application, reflecting the fear that including the EC might invoke reciprocity there against U.S. financial firms operating there.[76]

In this Congress, other reciprocity bills that would cover securities industries were also submitted. In March 1991, Edward J. Markey, chairman of the House Telecommunications subcommittee, proposed a bill (HR1347) that stipulated similar reciprocal measures in securities and telecommunications industries.[77]

There were criticisms of the bill. The *Journal of Commerce* pointed out in its editorial that protectionist financial services laws would lead to counter-retaliation. Moreover, blocking foreign banks from operating in the United States would restrict the flow of capital into this country, and was bound to raise costs for American borrowers.[78] The opponents said that the most affected foreign banks would be small institutions, not

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[76] Congressional Record, October 7, 1991, pp. E3292-93.

[77] Clyde H. Farnsworth, "U.S. hardens trade stance with Japan," *New York Times*, January 7, 1991, D1, *CQ Weekly*, April 27, 1991, p.1050.

[78] Editorial, "Bashing Japanese Banks," *Journal of Commerce,* January 27, 1992, 8A.

large Japanese or European banks.[79] In the hearing held in November, the representative from the Federal Reserve Board opposed the bill. Alan Greenspan, chairman of the Fed, and Gerald Corrigan, the head of the New York Fed, also wanted flexibility. They did not want to stop strong foreign banks from lending to Americans.[80]

Despite these oppositions, on March 4, two subcommittees —the International Finance and the Financial Institutions Subcommittees—of the House Banking Committee approved the Fair Trade in Financial Services Act. The Treasury agreed that the implied threat of retaliation could bolster negotiations to erase Japanese banks' "unfair advantage."[81] In April 1992, Japanese Finance Minister Tsutomu Hada sent a letter to Treasury Secretary Brady to oppose the bill. In response, Brady expressed disappointment at the slow progress of Japan's financial liberalization.[82]

All these events notwithstanding, in the end, the provision was dropped in the Conference Committee in October 1992 due to the disagreements between the House and Senate. The Senate version would give the Treasury some discretion to determine

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[79] "BANKING: 'Fair trade' rules get panel's OK," *CQ Weekly,* March 7, 1992.

[80] "Foreign banks in America: concerned about Congress," *Economist*, September 7, 1991, p.76.

[81] Gary N. Kleiman, "U.S. must get tough on Japan bank barriers," *American Banker*, April 16, 1992, p.4.

[82] *Nihon Keizai Shimbun*, May 8, 1992, p.5.

whether to impose sanctions. The House version mandated action by the Secretary of Treasury in consultation with the Office of the U.S. Trade Representative and the Secretary of State.

The failure of the bill reflected the unimportance of the bill in comparison to other issues in the election year. While protectionist sentiment against Japan was still significant in the American public opinion, the financial bill was too technical to appeal general constituency. Under the circumstance that politicians hoped to adjourn by early October for election year campaigning, the priority of passing this bill was low.

5.6 Summary

During the 1990–1991 period, the relationship between the U.S. and Japan over financial liberalization grew more and more contentious. The main reason was the increased involvement of Congress in the intergovernmental relationship.

There three significant changes with respect the nature of the bilateral negotiations. First, the topics came to include an especially comprehensive and thus difficult domestic issue: the liberalization of interest rates in Japan. Second, the U.S. administration changed its attitude toward punitive bills proposed in Congress. The administration had been opposed to any Congressional moves to introduce sanctions

against Japanese financial institutions for the closed nature of the Japanese financial markets. However, during this period, it attempted to use such moves as leverage to induce greater concessions from Japan in the bilateral negotiations, even though the attitude was not that of unconditional support. Third, tougher line of the U.S. administration did not result in greater concessions on the Japanese side. Rather, the Japanese side also stiffened its attitude, and the negotiations came to a deadlock.

As the bilateral negotiations became unproductive, there was new development concerning international negotiations over financial issues. The multilateral negotiations under the GATT Uruguay Round covered international trade in services for the first time in the history of multilateral trade negotiations. Financial services were one of the main issue areas. Even though the Uruguay Round moved much slower than originally planned, by 1992, member countries started negotiating concrete proposals. The U.S.-Japan financial negotiations continued in the new multilateral stage, which is discussed in the next chapter.

Chapter 6 Financial Negotiations under a New Framework: Uruguay Round and Framework Talks

The General Agreement on Trade in Services (GATS), concluded in the Uruguay Round, is the first multilateral trade agreement to cover international trade in services. The Round ended in December 1993 after long and acrimonious negotiations, and formally signed in April 1994. The inclusion of trade in services into the multilateral trade negotiation added another point of contention. Along with disagreements over agricultural subsidies among was highly contentious point in the Round. Moreover, financial services sector was one of the issue areas over which negotiators could not reach an agreement even by the extended deadline of 1993. Negotiations continued, and the Financial Services Agreement was finally completed in 1997.

In this chapter, I discuss how the issue of services trade became the agenda of the Uruguay Round negotiations, and how the multilateral negotiations affected the bilateral financial talks between the U.S. and Japan.

6.1 Service in Multilateral Trade Negotiations

Services had not been considered to be "traded" before the early 1970s. Since services cannot be stored, sales of services involve some sort of direct relationship between sellers and buyers. It is thus difficult to distinguish direct exports from affiliate sales (Bhagwati 1987, McCulloch

1990).[1] It was only after the mid-1970s that international trade in services began to attract attention of policymakers as one of trade problems. In the 1973–1979 Tokyo Round of GATT negotiations, the issue of trade and investment in services was raised in a future negotiating agenda. Then, in the Uruguay Round, which was officially launched in 1986, service was introduced into the framework of multinational trade negotiations under the GATT for the first time.

The attention paid to the service industry in the international trade seems to reflect the growing importance of service industry in the developed economies. Both in 1960 and 1970, the share of world service output in the world GDP was about 50 percent. For the period between 1980 and 1989, the share increased to 57.4 percent. The figure was 64.7 percent for 1990–1999, and 68.0 percent for 2000–2006 (Lipsey 2009: 35, Table 1.5). However, the transformation into "service economies" occurs primarily in the domestic sectors that generate little international transaction, such as public administration and health care. The volume of world trade in services was still small compared to that of merchandise trade during the 1980s, when the issue of trade in services was included in the multilateral trade negotiations. According to the data of twenty-two countries that have reported service exports and imports to

[1] For information on definitions, comments and methods see the Technical Notes in WTO's International Trade Statistics report, 2002. Measurement of exports and imports in services is inherently more difficult than that of trade in goods. International trade in services often involves no package clearing customs or no containers shipped across national borders. Consequently, the completeness of statistics of trade in services varies significantly across countries. The problems of definition and statistics consumed a considerable period of time in the early years of Uruguay Round negotiations on trade in services.

the IMF since 1972, the ratio of service exports to goods exports grew from 21 to 28 percent between 1972–76 to 2002–2006, while the ratio for imports are 24 percent in 1972–76 and 25 percent in 2002–2006, falling short of the expectation that trade in services would lead the growth of the world trade in the 1990s and beyond (Lipsey 2009: 30–37)[2]. Moreover, two traditional service sectors, tourism and transportation, still take the lion's share of trade in services.[3]

It was thus not an inevitable consequence of transformation of economic structure that brought services on the negotiation table. It was mainly some specific American companies that pushed for the agenda.

What is Special about Service Trades?

According to Drake and Nicolaidis (1992), it took a "revolution in social ontology" to redefine the services transactions as a part of international trade. The issue of "trade in services" first appeared in public document in a 1972 OECD report to refer to what had been regarded as international transaction of invisible services.[4] The document reported the growth of trade in

[2] It should be noted that, in addition to the limited number of the reporting countries, the inconsistency of measurement both across countries and over time does not allow a decisive assessment of the actual growth rate of trade in services (Lipsey 2009: 30–37).

[3] In 1985, transportation and travel accounted for 55 percent of world exports in services and 54 percent of imports. The figures remain to be 48 percent for service exports and 52 percent for service imports in 2005 (Lipsey 2009: 36, Table 1.6).

[4] The report is titled *Report by the High Level Group on Trade and Related Problems* (Paris: OECD, 1973). The international transactions of services had appeared in national accounts under the broad label "invisibles." See Drake and Nicolaidis 1992: 42-46.

services and the problems it posed. In 1975, a seminal book, *Invisible Barriers to Invisible Trade* was published (Preeg 1995: 37).

Services are “traded” in international markets through either cross-border trade or sales through foreign affiliates. While many consumer services, such as restaurant and haircut, require physical presence to transmit, some services can be traded without physical proximity between providers and users. Traditional banking falls into this category, since loans can be made by mail or phone. Other examples include securities, insurance, advertising, and accounting. These producer services are more likely to be traded internationally. The development of telecommunication and computer technologies, which made the transmission of data across national borders easier, facilitated internationalization of services industry. The liberalization of goods and capital markets created international business opportunities for service industries (Bhagwati 1987, McCulloch 1990).

However, liberalization of trade in services has never been an easy task. In addition to all the same kinds of economic and political considerations that arise with liberalization of merchandise trade, such as employment, adjustment, and the infant-industry argument, there are some specific factors that hinder trade in services (McCulloch 1990: 342–43). The most important has been the existence of heavy local regulation. Governments typically regulate service industries rigorously. Entry into many of service industries, such as medicine, law, accounting, and finance, are licensed. Utility prices, from electricity and waters to

transportation and telecommunications, are controlled. Setting rules internationally to govern services sector, therefore, goes into the realm of domestic policies deeper than it does with the case of trade of goods (Ruggie 1994). Similarly, as trade in services usually involves foreign direct investment, liberalization in financial services requires not only lowering border barriers but harmonizing domestic regulations.[5] Moreover, many service industries are also considered to play an important role in achieving national security. Finance is no exception.

Because of these factors, liberalization of trade in services often faces more complicated domestic interests than that of trade of goods does. Liberalization of trade in services can be intrusive in other areas of national policy, and requires more harmonization of domestic regulations.

America's Push for Services Negotiations

Despite these difficulties, the U.S. led the launch of multilateral negotiations in services, while opposition came mainly from the developing countries. The U.S., whose multinational companies wanted to expand their service provisions in foreign markets, jumped on the new concept of "trade in services." This redefinition of service transactions as trade brought the issue of international liberalization of service on the GATT negotiation table, although the

[5] According to the survey conducted by the U.S. International Trade Commission, the most important non-tariff barriers U.S. service firms encounter in foreign markets was the basic right of establishment in foreign countries. Specific barriers to provision of a service by foreign firms and foreign exchange controls are also significant obstacles. United States International Trade Commission (1982), *The Relationship of Exports in Selected U.S. Service Industries to U.S. Merchandise Exports*. USITC Publication 1290, Washington, DC: United States International Trade Commission (September), cited in McCulloch 1990: 341.

multinational body took more than a decade since then to reach a comprehensive agreement on the rules to govern the international transactions of services.

Three groups of U.S. participants pushed to include services into the GATT negotiations. First, some U.S.-based financial firms, most notably American Express, sought to ensure their access to foreign markets. American Express, along with Bechtel, Peat Marwick, Citibank, and other firms, established the Coalition of Service Industry (CSI) in January 1982 (Yoffie 1990: 376). It supported the passage of the Omnibus Trade Act of 1984 and made strong commitment to reducing barriers to trade in services at the 1984 London Economic Summit and to completing the U.S. National Study on Services (Greenberg 1988: 410-11). Corporate leaders included James Robinson of American Express, Maurice Greenberg of American International Group, and John Reed of Citicorp. In the early 1980s, the American Enterprise Institute embarked on an ambitious research initiative on the issue. In the 1974 Trade Act, Congress included in the definition of international trade "trade in both goods and services" (Preeg 1995: 37–38).

Second, U.S. government officials and the business community also supported the inclusion mainly out of concern for the growing US trade deficit. However, the export potential of services in the overall U.S. trade had been exaggerated. Some advocated that liberalization of trade in services would contribute to reduce the U.S. trade deficit as the country's

comparative advantage was shifting from goods to trade services.[6] Indeed, the surplus on services grew during the first half of the 1980s. Yet, most of the services surplus during the period came from earnings on U.S. investment abroad at a time of unusually high interest rates. The U.S. net investment position reversed since then. The surplus by other services had risen, but it constituted only a small fraction in the total trade (McCulloch 1988: 371-75, Olmer 1988: 415–417).

Finally, trade-policy experts, such as Geza Feketekuty of the Office of the USTR, supported it, hoping to maintain the momentum of multilateral negotiations on trade. The expectation for increase in services trade could help revitalize waning political support at home for maintaining open markets (McCulloch 1990: 333, see also McCulloch 1988: 370–75 and Hamilton and Whalley 1989).

The introduction of services into the GATT negotiations was actively debated in the U.S. from early 1981 on, between some U.S. financial service firms led by American Express Company (under its chairman, James Robinson) and then-U.S. Trade Representative William Brock. In 1982, the U.S. Trade Representative announced that liberalization of trade in services would be one of the key elements of U.S. trade policy in the 1980s. That year, he appointed Robinson to be one of six private sector members of the American delegation to an upcoming meeting of the GATT (Yoffie 1990: 367). The U.S. trade officials first raised the subject

[6] See Olmer 1988:420, note 2.

officially at the November 1982 GATT ministerial meeting (Dobson and Jacquet 1998: 70).

6.2 The Uruguay Round

The consideration of new codes on trade in services became one of the most ambitious agendas of the GATT ministerial meeting held in Geneva in 1982.[7] The communiqué of the meeting recommended national studies on service trade (Yoffie 1990: 367). Even though GATT members could not launch a new round of negotiations as was intended, the work program that was agreed in the meeting became the basis for the agenda of the coming round.

Next year, the Reagan administration started a campaign to launch a new round of multilateral trade negotiations. Informal discussion in GATT in the early 1980s resulted in a broad understanding of the structure and problems of international trade in services by the mid-1980s. The U.S., with the support from the UK, proposed the creation of a comprehensive framework for trade in services comparable to the GATT. However, until the launch of the Uruguay Round in 1986, developing countries "refused to enter into discussion of how international rules might be developed for the sector, and of how trade in services might be liberalized (Croome 1999: 102)." After the 1982 meeting, however, 10 developing countries, led by India and Brazil, argued against including negotiations on services in the run up to the

[7] Other agenda include the action on GATT dispute settlement procedures and efforts to bring agriculture under the GATT regime.

launch of the Uruguay Round. They wanted to separate the services from goods in the GATT discussions in order to avoid the linkage between the two. Argentina, Brazil, India, Egypt and Yugoslavia formed a coalition in 1984. They had blocked the launch of the Round for some time (Haltiman and Whalley 1989: 550−551).

In September 1986, ministers finally agreed to launch the new round in a meeting held in Punta del Este, Uruguay. The new round, known as the Uruguay Round, would broaden the scope of the GATT to cover nontraditional trade issues such as services, intellectual property right, and investment. Trade in services became the subject of the multinational negotiations for the first time. The target date for conclusion of the new round was initially set in 1990.

The negotiations of the Round started in February 1987. The Group of Negotiations on Services (GNS), established under the Trade Negotiating Committee, began considering general framework of the rules governing trade in services, including the definition of trade in services, existing measures concerning such transactions, and the relationship between the new rules and the GATT. In the early years of the Uruguay Round, the new GNS spent a considerable amount of time on the problem of definition and statistics, in part because of the desire of the countries that were reluctant to start substantial negotiations on liberalization, and the progress was slow in the first two years. Countries disputed over the scope of application of the new rules. The discussion on the contents of basic principles and rules that should be applied to trade in services, such as national treatment and non-discrimination, was finally

accelerated in the late 1987 and 1988 (Croome 1999: 103–9, Miyaie 1996).

The Mid-term Review Agreement, adopted in April 1989, declared the primary inclusion of all areas in services in the new rules and the adoption of general principle of MFN. Besides, the Montreal Agreement set the timetable and identified the key principles and concepts necessary for subsequent negotiations on services. Even though the timetable was not met in the following years, it had the effect of setting the negotiations in motion (Croome 1999: 207). Since then, in addition to deliberations on general framework, sector-by-sector negotiations on services were held based on reports each member country had submitted (Miyaie 1996, Preeg 1995: 90).[8] By that time, the attitude of many developing countries toward the negotiations on services had changed. They had become more willing to participate in the negotiations to grab whatever gains the negotiations might produce (Croome 1999: 207).

In July 1990, Felipe Jaramillo, Ambassador of Colombia and Chair of GNS, proposed his own draft for a framework agreement on trade in services, which served as the basis for the subsequent negotiations. While the draft stated that all areas of services would be subject to the new rules, some countries insisted that some sectors should be exempted from the obligations (Miyaie 1996).

Special Treatment of Financial Services

In the process of incorporating trade in services into the agenda of the Uruguay Round,

[8] Financial services were discussed mainly in September 1989.

officials from financial authorities hoped not to have the area of financial services covered by broad trade negotiations for fear of the involvement of people outside of the financial circles. The U.S. Treasury, as well as financial authorities from other countries including Japan, hoped to keep the financial services sector outside of the GATS framework. The U.S. agreed to have the sector within the GATS by the time the draft was compiled, however. Within Japan, the MOF, which wanted to exclude financial services from the GATS, and the MITI, which preferred its inclusion, opposed to each other.[9] As the U.S. Treasury accepted the inclusion, the MOF backed down, and instead proposed to set a separate body within the GATT to discuss financial services, together with Canada, Switzerland, and Sweden in December 1990.[10]

Upon the insistence of financial officials, the GATS Annex on Financial Services adopted later stipulates that, if a financial service issue reaches a WTO dispute settlement panel, the panel should have the expertise necessary to deal with "the specific financial service under dispute (paragraph 4)." It is more narrowly drawn than the general standard in the GATS, which requires panels to have "necessary expertise relevant to the specific services sectors which the dispute concerns" (Key 2003:26).

Deadlock

The Uruguay Round was originally scheduled to end in December 1990. However, member

[9] *Asahi Shimbun* July 29, 1990, p.9.

[10] *Asahi Shimbun* December 4, 1990, p.1.

countries could not agree on how to reform agricultural trade, and decided to extend the talks.

The negotiations on services also came to a total deadlock. The most contentious was how to deal with the MFN principle. The U.S., concerned about the slow pace of liberalization of other countries in such areas as maritime services and basic telecommunications, jeopardized the services talks by insisting that the GATT's most-favored-nation (MFN) principle should not be extended as the automatic obligation of the GATS. It claimed that the automatic application of the MFN principle would let countries with relatively closed services markets free-ride, while enjoying wider access to American's own markets. The U.S. wanted to retain the power to decide whether to extend the MFN benefits to others based on negotiations. In November 1990, the U.S. proposed the selective application of the MFN principle in all service areas on a condition that market access and national treatment would be granted based on bilateral liberalization negotiations (Miyaie 1996: 11-12). This demand rocked the foundation of the GATT framework.

In the final session of the Uruguay Round, due to close on December 7, there was a prospect that the financial service accord was in reach. In the hope that the agreement would pave the way for their companies to enter new markets, James Robinson, then Chairman of American Express, and John Reed, then Chairman of Citicorp, were in Brussels at that time to lobby on behalf of an accord.[11] With a few days remaining before the end of the session, Japan,

[11] James R. Kraus, "Pact on Financial Services Slips Away at Trade Talks," *The American Banker*, December 6, 1990, p.8.

Canada, Sweden and Switzerland jointly submitted a new proposal to break the impasse in the financial negotiations.

The four-country proposal contained two important schemes. First, it proposed a "two-track approach." It would allow less developed countries to have the option to take a slower approach to opening their markets to financial firms. The flexibility would lure developing countries to accept the plan. On the other hand, the US was unlikely to adopt it, even though American officials welcomed the plan as a basis of further negotiations.[12]

The second feature, which is important for this study, was the call for the creation of an international supervisory group, the Financial Services Body. The purpose was to prevent cross-retaliation, in which banking disputes would spill over into other commercial sectors. This point was also aimed at attracting developing countries into the agreement. They feared that, when financial services would be subject to the multilateral disputes settlement mechanism, rich countries would deny access to their own markets for other products in retaliation for the resistance to market openings.[13] An American newspaper argued, however, that it was Japan's own concern for cross-retaliation, rather than the consideration for the LDCs, that incorporated this issue into the four-country proposal. The Japanese financial

[12] Croome 1999: 243-4, and Edward Greenspon, "Freer trade in services gains support Proposal to help banks, insurers into other countries gets favorable reviews," *The Globe and Mail*, December 4, 1990.

[13] "GATT/Services: EEC welcomes new proposal on financial services," *European Report*, December 5, 1990, p.4.

authority intended not to have the activities of Japanese financial institutions abroad restricted in retaliation for Japan's denial to open up a market for other product.[14]

This point related to the shared concern among the financial authorities for having the financial services incorporated to a broader trade framework. Together with the US officials, Japanese financial officials wanted to keep the financial services a special sector overseen by specialists. According to the *New York Times*, "finance ministries around the world jealously protect their regulatory powers from other business regulators.[15]

All these intentions notwithstanding, the financial issue became a victim of the breakdown in the broader trade talks over the crucial issue of agricultural subsidies.[16]

Resumption of the Negotiations, 1991–1993

The negotiations in the Uruguay Round resumed in 1991. In the negotiations on services, each country submitted their offer on their initial commitments by July. The issue of MFN also moved somewhat forward, as member countries agreed to establish a procedure through which each country would submit a list of MFN exemptions. The Financial Service Annex was discussed in October. However, the negotiations on services stalled again by the end of the

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[14] James Sterngold, "Japan Sees Trade Proposal Aiding its Financial Firms," *New York Times,* December 5, 1990, p.D7.

[15] Ibid. See also Edward Greenspon, "Freer trade in services gains support Proposal to help banks, insurers into other countries gets favorable reviews," *Globe and Mail*, December 4, 1990.

[16] James R. Kraus, "Pact on Financial Services Slips Away at Trade Talks," *American Banker*, December 6, 1990, p.8.

year.

In December1991, Arthur Dunkel, the then Director-General of GATT, complied the first draft of the Final Act. The paper, called the “Dunkel draft,” became the basis for the final agreement, but each country’s lists of commitment remained far from settled. The subsequent negotiations were conducted based on the framework established by his draft. Over the next two years, in the negotiating services agreement, participating countries discussed their initial commitments and the list of MFN exemptions. In January 1992, countries submitted their lists of requests to other countries. Then, they were to present their offers and schedule for liberalization based on requests they had received.[17] Initial commitment negotiations started since then.[18]

The negotiation in the service sector was based on a series of bilateral negotiations. The measures agreed bilaterally would be applied to other member countries on a MFN basis, although countries attempted to exempt certain areas from the MFN principle.[19] Along with telecommunication and lawyers, financial services sector became one of the main targets in

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[17] Most developing countries did not submit their offers that time, however.

[18] Financial authorities of developed countries were also perplexed with the procedure. They wanted to separate financial services from the overall services negotiations. The bewildered officials submitted offers that mostly listed existing measures, while they tried to secure the separation in the GATS. They were mainly concerned about dispute settlement procedures. They hoped to have an independent Financial Services Committee to deal with disputes concerning financial services. *Nihon Keizai Shimbun*, February 25, 1992, p.5.

[19] *Yomiuri Shimbun*, November 22, p.7

requests made to Japan.[20] The requests made by the U.S. toward Japan were mainly those discussed in the previous bilateral financial talks, such as the issuance of commercial papers by nonbank firms, promotion of foreign banks' participation in the ATM network, and the full liberalization of interest rates. Importantly, the U.S. added insurance sector to the list. In February 1992, Japan expanded its offer to cover 105 sectors. The offers in financial services, however, were limited to the scope of existing plans for financial liberalization.[21] The EC also called on Japan to complete abolition of interest rate ceilings and liberalization in insurance services, including full privatization of the automobile insurance business, and removal of barriers between banking, securities, and insurance businesses. The latter reflected EC's appetite for universal banking in Japan.[22]

In the first half of 1992, the negotiations on services halted as a result of stalemate in agricultural talks, even though the quad countries (the U.S., EC, Canada and Japan) originally intended to complete services negotiations in March.[23] Yet, in June, member countries decided to resume services talks, and both multilateral and bilateral negotiations were held. Then, a new series of negotiations took place in December that year, and the Japanese government

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[20] Major requests Japan made to the US and EU were in such areas as maritime transport and audiovisual services.

[21] *Yomiuri Shimbun*, February 11, 1992, p.7.

[22] *Nihon Keizai Shimbun,* January 18, 1992, p.5, February 8, 1992, p.1, *Asahi Shimbun* January 31, 1992, p.9.

[23] *Yomiuri Shimbun*, February 16, 1992, p.7.

made its second "offers." But the Uruguay Round as a whole could not be concluded by the end of that year.

In 1993, negotiations heated up. In addition to multilateral meetings, bilateral talks were held. The quad also met to discuss the sector. Participating countries tried to conclude the Round by the summer Summit meeting, but without success.

GATS and Financial Services

At the quadrilateral trade talks held on May 14, 1993 in Toronto, in which representatives from the U.S., Japan, the EC and Canada agreed to conclude the stalled Uruguay Round negotiations by the end of the year, the liberalization of access to Japan's financial-service sector was discussed.[24] However, the Japanese MOF did not attend the meeting. It implied that the MOF hoped to prevent the financial issues from being used as a tradeoff to other issues in the Uruguay Round talks, most notably the issue of rice imports, which was politically more salient than financial services.[25] In this quad meeting, the four agreed on the plan for concluding the Uruguay Round by the end of 1993. According to the time schedule, market access and services should be concluded at least in principle before the July summit meting held in Tokyo, and then overcome the issues of agriculture and other politically sensitive areas

[24] Michael Ellis, "Japan offers to cut tariffs to revive world trade talks," *Journal of Commerce*, May 17, 1993, p.16A.

[25] *Nihon Keizai Shimbun*, May 28, 1993, p.7.

in the fall.[26]

The main obstacle to the financial services negotiations was the differences between most of the OECD countries, whose financial markets were already relatively open, and many developing countries *and* Japan. Those countries with relatively closed financial sector were unwilling to commit to a substantial opening of their markets. It raised a concern that they would free ride on a new MFN-based multilateral agreement, as they would be able to enjoy wider access to other countries' financial markets while keeping their markets relatively closed. Industrialized countries, especially the U.S., were thus unwilling to commit themselves to an MFN-based multilateral agreement in the area of financial services (Dobson and Jacquet 1998: 80-85).

In October 1993, the US proposed the so-called "two-tier approach" in financial services, which would grant MFN only to countries with relatively open markets (Miyaie 1996). Just like the proposal of selective application of the MFN principle in the service sector made by the U.S. earlier in the Round, such a proposal threatened the entire process of trade negotiations. Even though the Uruguay Round negotiations finally ended in December 1993 and the General Agreement on Trade in Services (GATS) was concluded,[27] countries could not

[26] *Yomiuri Shimbun*, May 15, 1993, evening edition, p.3.

[27] The deal was signed in April 1994 in Marrakesh, Morocco. As to the agricultural trade, the U.S. and EU had settled most of their difference on agriculture in November 1992 in a deal known as the "Blair House accord."

resolve the issue of MFN treatment in the financial services sector. The sector became one of the issue areas that remained to be negotiated after the conclusion of the Round.[28] The deadline in the area of finance, together with some other areas, was thus extended to July 1, 1995, with the U.S. insisting on getting more offers from other countries.

Post-Uruguay Round Negotiations

After the conclusion of the Uruguay Round, Interim Group on Financial Services was established to oversee the post-Uruguay Round negotiations in the financial services sector (under the WTO Preparatory Committee's Sub Group on Services). The Group was taken over by the Committee on Trade in Financial Services when the Marrakesh Agreement Establishing the World Trade Organization came into force in March 1995 (Shimizu 1995).

As the negotiation stalled in the Uruguay Round, the U.S. and Japan resumed their bilateral financial talks held between the Treasury and the MOF under the Framework Talks umbrella. The issue of opening up the Japanese financial markets was mostly settled under this framework. As a result, the main focus of multilateral talks in the financial services shifted to the liberalization measures taken by developing economies especially in Asia.[29]

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[28] Other areas included telecommunications and maritime transport. Also, the end of the Uruguay Round did not mean the end of negotiations in services in general. The agreement included commitment to reopen negotiations on services, as well as agriculture, in 2000. The resumed negotiations were later incorporated into the Doha Round.

[29] *Nihon Keizai Sumbun*, January 19, 1994, p. 9 and April 7, 1994, evening edition, p.2.

6.3 U.S.-Japan Framework Talks and the Financial Services Negotiations

In 1993, Bill Clinton entered office with a mixed agenda on international economic relations. He attached weight to U.S. economic interests in overall international relations. While he gave a free trade speech, he was identified by April with a "managed trade" stance in negotiations with Japan.[30] To epitomize his pledge, President Clinton brought the vision of a new framework that would cover a wide range of issues from macroeconomics to structural and sectoral matters. In their first bilateral meeting in April 1993, President Clinton and Prime Minister Miyazawa agreed to establish a new negotiating framework for resolving problems in the trade issues by July, when the two leaders meet at the Group of Seven summit held in Tokyo.[31]

The two state leaders led the establishment of the new framework for their respective reasons, while bureaucrats of the two countries were not enthusiastic to strike a deal. For Clinton, it was the first step toward fulfilling his campaign promise to prompt Japan to open its market. Miyazawa, who had lost the vote of no-confidence in the Diet in June and was waiting for the upcoming Lower House election, was determined to establish the framework before his likely loss of prime ministership. It was to help the LDP in the election by claiming that it was the only party that could manage Japan's relationship with the U.S., as well as to make some

[30] Destler 1995: 218-222.

[31] Bergsten, Ito and Noland 2001: 163-64.In the press conference after the meeting, the two leaders bluntly criticized each other for their approaches to the bilateral economic issues.

achievements as Prime Minister to be recorded in history books. While Miyazawa's position was to oppose to U.S. demands for numerical targets, he made concessions to the U.S. side to arrange the new framework during his term in office.[32]

Within Japan's bureaucracy, the Ministry of Foreign Affairs supported Miyazawa's idea to set up a new framework to discuss economic issues with the U.S., emphasizing the importance of keeping good relationship with the U.S. On the other hand, the MITI and the MOF resisted to an agreement that could be read as a promise to introduce a numerical criteria.[33] Outside of the two countries, European countries worried that the agreements between the two, if reached, would favor American products and exclude other countries.[34]

The two national leaders set the structure of the talks in July, as was scheduled.[35] The subjects were divided into five baskets. They were government procurement (especially computers, supercomputers, satellites, medical technology, and telecommunications); regulatory reform and competitive measures; other major sectors, most notably autos and auto parts; economic harmonization; and implementation of existing agreements and measures. The

[32] *Asahi Shimbun,* July 10, 1993, evening edition, p.1.

[33] David Wessel and Jacob M. Shlesinger, "Back-room deal: How the U.S., Japan resolved the differences to reach a trade pact." *Wall Street Journal*, July 12, 1993, A1.

[34] "U.S. sais Japan trade pact won't exclude EC, others," *Wall Street Journal Europe*, July 12, 1993, p.2, and *Asahi Shimbun*, July 11, 1993, p.9.

[35] The official name of the talks was "The United States-Japan Framework for A New Economic Partnership."

achievements would be announced at the heads of government meetings that were to be held twice a year.[36] Deputy minister level meetings would be held biannually to prepare reports to be submitted to the two leaders. Consultations would be carried out either in exiting fora or newly established working groups. Three areas, including insurance, were designated as the priority areas.[37] Other trade agreements were scheduled to be finished in a year. After two years, the two governments were to decide whether to extend the negotiations in the framework.[38]

Soon after the pact was reached, however, the discord between the two countries became obvious. The most contentious was the use of quantitative targets. Although such targets had been used in an ad hoc, random manner by the Reagan and Bush administrations, the Clinton administration sought to regularize the use of such targets in bilateral talks.[39] As to the expected effects of the overall negotiations, Deputy Treasury Secretary Summers suggested his expectation that Japan's trade surplus would drop to 2 percent of its GDP or less in four to

[36] The use of semiannual meetings of the national leaders as action-forcing event did not work as it could have during the LDP one-party dominance. The party lost power in the summer of 1993 for the first time since its foundation in 1955. The resulting eight-party coalition government was unstable, leaving the political leadership of Prime Minister weak. Bergsten, Ito and Noland 2001: 167.

[37] The other two were government procurement and automobiles.

[38] Andrew Pollack, "A trade agreement born of political necessity: A new approach to old problems," *New York Times*, July 12, Page D1.

[39] Bergsten, Ito and Noland 2001: 165.

five years as a result of the talks.[40] Treasury Secretary Lloyd Bentsen and U.S. Ambassador to Japan Michael Armacost made similar suggestions. In response, Japanese officials criticized the U.S. for pretending as if there were numerical targets agreed upon.[41]

The most contentious issue within the Framework was auto and auto parts. Not as visible, financial talks were by no means an easy one.

Financial Sectors within the Framework Talks

The Framework Talks covered various issues in the field of finance. What is significant for the purpose of this analysis is that the officials set two different tracks for negotiations. The first was the financial talks, which were conducted between the Treasury and the MOF. While it was officially designated as a part of the Framework Talks, it was in reality an extension of the previous bilateral talks, and was conducted separately from the Framework. The meetings started before the two countries agreed on the structure of the new talks. On the other hand, the issues concerning the insurance market, which was picked up for the first time for the bilateral negotiations under the GATS negotiations, constituted a major part of the Framework Talk. The greatest difference was that the negotiators for the insurance issue on the U.S. side were the officials from the USTR.

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[40] The surplus at that time was more than 3 percent of GDP.

[41] They also disagreed over when to start negotiations in working groups. The Japanese side wanted to wait until the late August, while the U.S. hoped to launch such groups as early as the end of July. The U.S. intended to begin negotiations before budget compilation opened in Japan in order to maximize its influence on Japan's policies. *Nihon Keizai Shimbun*, July 17, 1993, p.3. The talks actually started in September, beginning with the insurance talks.

In what was an important development for the U.S.-Japan financial talks, the new administration announced that Lawrence Summers would take over as Treasury under-secretary for international affairs on January 21, 1993. David Mulford, who was known as a tough and sometimes brutal negotiator during his years at the Treasury, had resigned on November 5, 1992, from his job as Undersecretary of Treasury for International Affairs. Mulford joined the Treasury in March 1984 as assistant secretary for international affairs and served for nine years as a senior Treasury official responsible for international economic policy. He became treasury undersecretary for international affairs in May 1989.[42] The departure of Mulford did not mean softer stance of the U.S. government. The new Treasury Secretary, Lloyd Bentsen, was chairman of the Senate Finance Committee and a trade hawk of long standing. What was more significant is that Mulford, who had been involved in the bilateral talks for a long period of time, was gone, and new negotiators came into the process.

In the late May of 1993, the U.S. Treasury and the Japanese MOF held formal meetings over financial liberalization for the first time since October 1991. Tadao Chino, Deputy Vice Minister for Financial Affairs, and Laurence Summers, Undersecretary of the Treasury, headed the delegations respectively. The issues the U.S. negotiators raised were pension fund and asset management, corporate underwriting, derivative products, cross-border capital transactions, and interest rates. The Japanese MOF demanded the U.S. to relax the

[42] Soon after his resignation, he joined CS First Boston group.

restrictions of interstate operations of banks and the activities of securities subsidiaries of banks.[43] The fact that financial talks started before the arrangement of the Framework Talks was agreed upon meant that they were in effect conducted as a separate body from the overall Framework Talks. The MOF and the Treasury held two meetings in Washington, D.C. in May and June before the July summit meeting.

The negotiations were also intended to precede the multilateral negotiations on trade in services in the Uruguay Round. Even though the official bilateral financial talks had been suspended since October 1991, the two countries negotiated bilaterally over financial matters in the Uruguay Round services negotiations over the course of 1992. The resumed financial talks were extension of those negotiations. In order to meet the deadline of the Uruguay Round, the MOF initially hoped to conclude agreements with the U.S. and some European countries before the July summit meeting.[44]

The MOF also prepared to hold a meeting to discuss the issues in the insurance sector in June. The bilateral negotiations in the area of insurance were conducted separately from other financial services, because insurance regulation is conducted at the state level in the U.S. Because insurance does not fall under the jurisdiction of the Treasury, the American counterparts of the MOF negotiators were the officials from the USTR. With respect to

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[43] *Nihon Keizai Shimbun,* May 25, 1993, p.5. Ministry of Finance, *Okurasho Kokusai Kinyukyoku Nempo* [Annual report of the International Finance Bureau], Vol. 17, 1993, pp.58–59.

[44] *Nihon Keizai Shimbun* May 22, 1993, p.5.

institutional setting of bilateral negotiations, the issue of insurance talks provides an interesting case for comparison.

Breakdown of the Framework Talks—February 1994

In February 1994, the first highest-level meeting to oversee the developments broke down over three priority areas, auto and auto parts, government procurement, and insurance. It was a rare moment in which the two countries explicitly broke off in their summit meeting. Japan's new Prime Minister, Morihiro Hosokawa, described the collapse as a symbol that the relationship between the two countries entered in a matured phase, in which they faced with each other as equal partners. Regardless of this rhetoric, the failure of the summit meeting left a stain on the bilateral relationship.

The main cause of the breakdown was the U.S. demand for numerical targets. The consensus within the Clinton administration was that quantitative targets were essential to effectively improve access to the Japanese markets. The approach of the Clinton administration was regarded as "managed trade," and was criticized even within the U.S. On the other hand, the Japanese side, especially the MITI, was firmly set against any agreement that might contain numerical targets subject to sanctions.[45] The MOFA was more willing to make concessions in order to keep good relationship with the new administration (Bergsten, Ito and Noland 2001: 163–66).

[45] For discussion from the perspective of the MITI, see Sakamoto 2000.

The two countries formally reopened talks in May. By that time, the Clinton administration had softened its line in trade talks with Japan. After the breakdown in February, the value of dollar plummeted, as the expectation spread that the U.S. government would encourage the depreciation to reduce the bilateral trade deficit. Within the Clinton administration, officials close to the Wall Street pushed for the shift. Roger C. Altman, Deputy Treasury Secretary, and Robert E. Rubin, the White House National Economic Council Director, were both former Wall Streeters. Another factor that contributed to the change was the mounting standoff with North Korea over nuclear weapon, which increased Japan's strategic importance. Secretary of State Warren M. Christopher, U.S. Ambassador to Japan Walter F. Mondale, and White House National Security Adviser Anthony Lake pressed to avoid deterioration of overall U.S.-Japan relations.[46]

In exchange for giving up the "numerical targets," the U.S. government demanded to elevate five new issues to the priority areas: financial services, glass, intellectual property right, forest products, and regulatory reforms and competitive measures.[47] However, the talks broke out again in July, since the two countries again could not solve the problem of measuring progress over the issues of government purchases.

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[46] "So much for brinkmanship," *Business Week* June 27, 1994, p.17.

[47] *Nihon Keizai Shimbun*, May 25, 1994, evening edition, p.1, *Nikkei Kinyu Shimbun*, May 26, 1994, p.1.

6.3.1 Insurance Talks

Liberalization before the Bilateral Talks

As with the case of banking and securities, the liberalization process was already under way at the time the bilateral negotiation started. However, the international talks did play a significant role in accelerating deregulation.

The Japanese insurance industry had been regulated mostly by the Insurance Business Law of 1939 for decades. The Ministry of Finance started deliberation in its advisory body, the Insurance Council, to revise the law in the fall of 1989. Just like the case of banking and securities deregulation, the purpose was to meet economic maturity, demographic changes, and internationalization. The council produced the final report in June 1992, which called for the cross-entry of life and non-life insurance companies into each other's business through subsidiaries. The Insurance Council continued deliberation after the publication of the final report, and issued a detailed plan for the revision in May 1994. The amendment of the Insurance Business Law passed the Diet in May 1995, and came into effect on April 1, 1996.

Yet, as the economic bubble of the late 1980s burst at the beginning of the 1990s, the willingness of major insurance companies to expand their business opportunities declined by the time the Council issued its final report. Setting the general direction of liberalization of scope of business and pricing, the new Insurance Business Law left the schedule of liberalization to the ordinance of the Ministry of Finance. The expectation was that the

Ministry and the industry would confine the liberalization process to a slow and cautious one in order to avoid drastic changes that would lead to throat-cutting competition in a already damaged industry (Nishimura 2003: 284-291, Nakato 2003: 215-247).

U.S.-Japan Negotiations and Market Share

The issue of insurance was designated as one of the priority areas in the Framework Talks. The first meeting on this issue was held in September 1993 in Hawaii. It was the first working group meeting held under the Framework Talks. By February 1994, the officials had eight additional meetings either in either Tokyo or Washington, D.C.

The elevation of the issue to a priority sector puzzled the Japanese insurers, because they had no significant presence in the U.S. market. Unlike banking and securities sectors, the problem of asymmetrical penetration thus did not exist in the field of insurance. It was the pressure from some major U.S. insurance companies, most notable the AIG, on the American government, that brought the issue on the negotiation table. They claimed that Japan's insurance market was unfairly closed to foreigners.[48]

As such, the greatest concern for the U.S. officials was how to expand the market share of American insurers in Japan. American negotiators often cited the figure prepared by U.S. insurance companies, which said that the foreign market share was less than three percent in Japan, whereas those of other OECD countries were between 10 percent and 33 percent. The

[48] American Chamber of Commerce in Japan, *2001 U.S.-Japan Business White Paper*,Tokyo, p.134.

U.S. demanded that Japan should raise the share to the level of other industrialized countries in three to four years. In reaction to this claim, the Marine and Fire Association in Japan said that the U.S. market was more closed to foreigners than the Japanese one, because the diversity of insurance laws among states served as a major barrier to non-American insurance companies.[49] The Japanese negotiators also questioned the credibility of the figure presented by the U.S.[50]

To increase access to the Japanese market, the U.S. side wanted Japanese regulators to ease restrictions on pricing and types of products. Although those liberalization measures would not improve foreign access directly, they would benefit foreign insurers, which would be able to take advantage of their knowledge of latest insurance technologies. For this reason, major foreign insurance companies had preference for drastic deregulation of Japan's insurance market. As the fundamental reform of insurance system was under way for the first time in five decades, the U.S. intended to exert as much influence as possible on the liberalization process. The U.S. side also claimed that the close *keiretsu* relationship among Japanese companies and the opaque regulatory system had blocked the entry of foreign insurance companies into the Japanese markets. The Japanese side complained that the U.S. markets also had some entry

[49] Margo D. Beller, "U.S., Japanese insurers dispute claims on market access," *Journal of Commerce*, January 24, 1994, p.9A.

[50] *Nihon Keizai Shimbun*, October 14, 1993, p.5. According to Gordon Cloney, president of the International Insurance Council in Washington D.C., foreign share of U.S. insurance market was about nine percent. Eisuke Sakakibara, then MOF's Senior Deputy Director-General of the International Bureau, contended that the figure for the U.S. was seven percent.

barriers, such as the differences in oversight structures across states.[51]

The "Third" Sector

On the other hand, they also tried to block further liberalization in one specific area: the so-called "third sector." It is a part of the insurance business, which does not easily fall into traditional life insurance (the "first sector") or nonlife insurance (property and casualty insurance or general insurance, the "second sector"). The major products in this sector include casualty insurance, as well as more recent innovations such as cancer insurance and nursing care insurance. American insurers operating in Japan were strong in this third sector.[52] AIU was strong in casualty insurance, raising 45 percent of all premiums it collected in fiscal year 1993. AFLAC had about 90-percent share in cancer insurance, and relied almost completely on cancer insurance and nursing care insurance in 1993.[53] This near-monopoly position was a product of Japanese government's policy. AFLAC introduced the cancer insurance when it started operation in Japan in 1974. It enjoyed the monopoly over the product until 1982, when Nippon Dantai Insurance obtained permission to sell it. Since then, some second-tier Japanese insurers entered the market, but major insurance companies refrained from applying for it. Behind the exceptional and exclusive approval for the innovative product from the Ministry of

[51] *Nikkei Kinyu Shimbun,* October 7, 1993.

[52] For more detail on the third sector, see Tone 1996.

[53] *Nikkei Kinyu Shimbun*, May 17, 1994, p.3.

Finance in 1974 was the already existing transpacific conflict over the entry of foreign insurers to the Japanese market. Significantly, major Japanese insurance companies even provided know-how of selling the cancer insurance in Japan to the AFLAC.[54]

The attitude of the U.S. side toward the third sector embodied the "result-oriented" nature of the administration. Rather than advocating liberalization and competition, the U.S. negotiators tried to set numerical targets by using foreign share to measure the access to the Japan's insurance market. An U.S. official told in a press conference that the U.S. might resort to retaliatory measures based on the Super 301 if the figure would not go up to 10 percent in three to four years.[55]

Resumption of Framework Talks

After the February breakdown, the Framework Talks were reopened in June 1994. Although they scheduled to announce some agreements at the summit meeting in July, they could not resolve differences in all of three priority areas. One factor was the advent of the new Murayama government. Uncertain about the foreign policies of the socialist prime minister,

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[54] *Nikkei Bijiinesu*, November 1, 1993, pp124–128. In fiscal year 1998, foreign insures held 4.65 percent total market share in Japan. They had a 3.6 percent share of the total nonlife insurance market and a 5.02 percent share of the total life insurance market. On the other hand, in the third sector, they dominated the markets. Foreign life insurers had 69.1 percent of the life third-sector market in 1998. Foreign nonlife insurers had 17.25 percent of the nonlife third-sector market in 1999. American International Underwriters (AIU) and American Life Insurance Company (Alico), both of which are part of American International Group (AIG), have significant shares of the cancer and personal accident markets. The third sector was Y2000bn ($16.6bn) large, and was expected to grow rapidly as the Japanese population would age. *Financial Times*, May 11, 1999, American Chamber of Commerce in Japan, *2001 U.S.-Japan Business White Paper*,Tokyo, p.133.

[55] *Nihon Keizai Shimbu*n, October 14, 1993, p.5.

Tomiichi Murayama, the U.S. side wanted to wait and see how the new government would approach the bilateral economic relations.[56] Yet, the overall Framework Talks broke off again in the late July over the use of quantitative targets.

The insurance negotiation was the first of the priority sectors to be resumed. Both sides reevaluated their positions, and reviewed the report Japan's Insurance Council had issued on May 13, which would be the basis for the upcoming revision of Insurance Business Law.[57] Their disagreement on the issue of the third sector and *keiretsu* system continued.

1994 Accord

1994 Insurance Accord
(1) Deregulation in Japanese insurance system
Three-step liberalization plan of products and rates
(2) Entry into the third sector
Avoidance of radical change
(3) Transparency and procedural protection
(4) Keiretsu relationship
Analysis of keiretsu relationship
(5) Harmonization of U.S. state regulations
(6) Assessing implementation

In early October, the two governments struck deals in four issue areas under the Framework umbrella: telecommunications, medical technology, flat glass, and insurance. The two sides failed to produce an agreement in the most prominent sector of auto and auto parts, however. The U.S government suggested the use of retaliatory measures under section 301 of the Trade Act.[58]

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[56] *Asahi Shimbun* ,July 7, 1994, p.12.

[57] Mark Magnier, "U.S., Japan fail to strike deal on insurance issues," *Journal of Commerce*, June 3, 1994, p.7A.

[58] For auto and auto parts, the Clinton administration filed a WTO case and announced the imposition of 100 percent punitive sanctions against Japanese luxury cars in May 1995. The Japanese filed a countercase against the U.S. In June, they reached a face-saving compromised and dropped the WTO cases.

Among the four issue areas that came under agreements, the accord in the insurance sector was considered to be the most sweeping. Under the accord, Japan promised to implement a three-step deregulation plan of products and rates in the primary life and non-life sectors. The file and use system and notification system, which would make it easier to obtain approval for new products, would be introduced and expanded in a step-by-step manner. The use of data collected outside of Japan to support applications of new products would be also permitted for certain products. The types of products for which benchmark or free rates could be used would be also expanded. The first stage was before the implementation of the insurance system reform legislation, the second was upon the implementation of the law, and the third was after the implementation. Japan also agreed to introduce the broker system to promote competition.

The government also ensured more transparency in its regulatory system. Japan agreed to give foreign insurance providers and intermediaries fair opportunities to exchange information with government officials. On the *keiretsu* relationship, "the two governments will request foreign and domestic insurance providers to instruct and allow the independent research organization to analyze *keiretsu* relationship as appropriate to the Japanese insurance market…"[59]

[59] 1994 Measures by the Government of the United States and the Government of Japan regarding Insurance, October 11, 1994.

While the “third sector” would be eventually opened, the Japanese government committed to shield the sector from large Japanese insurers until the primary life and non-life sectors would be made more accessible to foreign competition. It promised to avoid “radical change” in the business environment in introducing new or expanded products in the third sector until foreign insurers had a “reasonable period” to compete in a deregulated market.

As to the issue of numerical targets, the two governments avoided the explicit market-share targets. In each area, the Japanese agreed to include some sort of quantitative measures used to track the future developments. The insurance accord stated that “[t]hese criteria do not constitute numerical targets, but rather are to be used for the purpose of evaluating progress achieved toward the goals of the Framework.”

To make the negotiations two-way at least on the surface, the U.S. side also made some commitments by agreeing to encourage harmonization of insurance regulation at the state level. However, due to the decentralized regulatory system of the U.S., all the negotiators could promise was “to encourage National Association of Insurance Commissioners (NAIC)” to promote harmonization of state insurance regulations and to facilitate the entry of non-U.S. insurance providers to states’ markets.[60]

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[60] The National Association of Insurance Commissioners (NAIC) is the national-level regulatory support organization of state insurance regulators.

Follow-up Sessions and Supplementary Measures of 1996

In 1995, the issue came to the fore again, concerning the interpretation of the 1994 Accord. The USTR brought it out again mainly as a result of lobbying by AIG.[61] As the talk continued, the new Insurance Business Law and related laws came into effect in April 1996. Under the new law, "cross-entry" subsidiaries of life and nonlife insurance companies would start operation in August 1996. While the MOF temporarily restricted them from selling third-sector products, it was considered that the change would mean the erosion of foreign market share (American Chamber of Commerce in Japan 2001: 134). As the Japanese insurers prepared for the establishment of new subsidiaries, the U.S. side complained that the new law violated the 1994 agreement. The 1994 Accord stated that "[w]ith regard to mutual entry of life and non-life insurance companies into the third sector," the MOF would not implement liberalization as long as a substantial portion of the life and non-life insurance areas was not deregulated. After the passage of the new Insurance Business Law, the MOF and Japanese insurers interpreted this phrase as prohibiting the entry into the third sector by the main bodies of insurance companies, while the entry by their subsidiaries were possible (Tone 1996). On the other hand, the U.S. side complained that the agreement clearly prohibited the immediate entry by any type of life and non-life insurers.

In fact, even within the Japanese government, the MOFA considered that the U.S.

[61] *Asahi Shimbun,* May 31, 1996, p.11.

assertion made more sense. A MOFA official complained that the MOF was solely responsible for the disagreement because, in the negotiations in 1994, the MOF negotiators excluded the MOFA from drafting of the agreement when the issue of the third sector was discussed.[62]

On the negotiation table, the MOF gradually made concessions. In April, the MOF negotiating group led by Eisuke Sakakibara, then Director-General of the International Bureau, offered the introduction of direct response sales of automobile insurance. It also initiated legislation to eliminate the authority of the rating organizations to set mandatory industry-wide rates for automobile, fire, and accident insurance. Then, in June, it added the suspension of sales of casualty insurance by subsidiaries of life insurance companies for three month. Further, in July, flexible pricing of automobile insurance, based on criteria such as age, gender, and vehicle usage, was proposed. It could be a fatal blow for nonlife insurance companies.[63] The Japanese negotiators intended to ensure the entry of life and nonlife subsidiaries into the third sector in exchange for those concessions. However, the U.S. side was not satisfied. They feared that, once allowed in, the Japanese giant insurance firms would dominate the third sector, using profits earned in their protected life or nonlife sectors. At the same time, the Insurance Department within the Banking Bureau of the MOF complained that the International Finance Bureau, which was at the negotiation table, made too much concession, neglecting domestic

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[62] *Asahi Shimbun,* April 16, 1996, p.11.

[63] *Ekonomisuto,* August 27, 1996, p.53.

situation.[64]

The talk stalled due to the split over the timing of the third-sector entry of major Japanese insurers. The MOF claimed that the entry should be liberalized within a year or two of the start of primary-sector deregulation, while the U.S. participants maintained that it must be delayed until three years after substantial deregulation had occurred in primary sectors.[65] Under the new Insurance Business Law, newly-set subsidiaries of life and nonlife insurers were scheduled to enter the third sector on October 1, 1996. However, as the bilateral meeting held at the end of September produced no result, the entry was postponed.[66]

1996 Accord

1996 Insurance Accord

(1) Approval of a direct response system (tsushin hanbai) for automobile insurance (October 1996)
(2) Flexible pricing in automobile insurance (September 1, 1997)
(3) Expansion of notification system (April 1997)
(4) Fundamental reform of the rating organization system
(5) Measures to avoid radical changes with respect to the entry into the third sector by subsidiaries

On December 15, the two governments finally concluded the talk, resulted in the so-called 1996 Supplementary Measures.[67] The Accord would bring drastic deregulation of the heavily

[64] *Asahi Shimbun,* April 16, 1996, p.11.

[65] Susan MacKnight, "United States, Japan settle insurance claims," *JEI Report* No. 47, December 20, 1996.

[66] *Asahi Shimbun,* January 15, 1997, p.12. By the summer of 1996, as the bilateral negotiation continued, the Ministry and the insurance industry had agreed to limit the scope of business that their cross-entering subsidiaries would engage in. Unlike the case of cross-entry between banking and securities business, the Ministry even did not announce the content of the agreement publicly. *Asahi Shimbun*, August 17, 1996, p.1.

[67] Supplementary Measures by the Government of Japan and the Government of the United States Regarding Insurance, signed on December 24, 1996. American Chamber of Commerce in Japan 2001: 134.

regulated insurance industry by the mid-1998.

First, it would introduce pricing flexibility to Japan's insurance market. The new Insurance Business Law permitted flexible rating to certain types of insurance, which are consider not to entail great risks for the contractors, designated by the ordinance of the MOF. Yet, it was the U.S. pressure that expanded the scope of insurance products to which the flexible pricing system would be applied.

Starting in September 1997, writers of automobile insurance would be able to differentiate rates based on risk factors such as age and driving records. Before that, premiums had to fall within a 10 percent band around the uniform prices set by industry rating organizations. With commercial fire insurance, the MOF lowered the minimum amount per contract that could be offered at different rate from 30 billion yen to 20 billion yen in January 1997 and to 7 billion yen in April 1998. The uniform premiums for property and casualty insurance would be abolished in July 1998. In addition, the MOF promised to reform the rating organization system fundamentally, eliminating of the obligations for members of a rating organization to use rates calculated by the rating organization.

Second, the agreement would also facilitate product innovation. The MOF agreed to expand the notif

ication system. It added some types of products to the list of products sold only by notifying to the ministry instead of getting preapproval, a change that would become effective

in April 1997. Moreover, the ministry had already announced on October 1 its decision to approve applications for a direct response system (*tsushin hanbai*) for automobile insurance, in which insurance providers sell automobile insurance by mail and telephone calls.[68]

On the other hand, the negotiators agreed that the entry into the third sector by subsidiaries would be liberalized only gradually in order to avoid radical change in the third sector for small to medium and foreign insurance providers. Facilitating liberalization in Japan, the most important victory for the Clinton Administration in the 1996 Accord was that it won the protection of this sector. The protection of the third sector was extended to January 2001, two-and-a-half years after the liberalization of primary sectors.[69]

In sum, the 1996 Accord accelerated the timetable for the deregulation of the non-life insurance industry by about two to three years. At the last phase of the negotiations, however, the demand from the U.S. officials, who stuck to the protection of the third sector, ironically worked against the general trend toward deregulation.

After the 1996 Accord, liberalization was carried out steadily. In July 1998, Japan liberalized premium rates, which had previously been determined by an industry rating organization in a cartel-like manner. On January 1, 2001, the subsidiaries of life and non-life

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[68] By the time the two governments agreed on the “supplementary measures” in December, two insurance providers had received approval of their applications to provide automobile insurance through a direct response system.

[69] Susan MacKnight, “United States, Japan settle insurance claims,” *JEI Report* No. 47, December 20, 1996.

insurance subsidiaries started selling third sector insurance products. It was two and half years after all the five requirements for the termination of the measures to avoid radical changes in the third sector listed in the 1996 accord were satisfied, as scheduled. In addition to measures promised in the 1994 and 1996 accords with the U.S., the comprehensive financial liberalization program, known as the Japanese version of the "Big Bang," contributed the liberalization of the insurance markets in Japan since the latter half of the 1990s.[70]

6. 3.2 Financial Services

In the financial services talk, the main goal of the U.S. negotiators was removal of barriers to market access for foreign financial firms. Precisely, the U.S. demanded liberalization in three broad areas: fund management, domestic securities markets, and cross-border capital transactions. Rather than the elimination of formal discrimination against foreign banks and other financial institutions, the demands from the American officials focused on general deregulation that would dismantle the competition-restricting regulatory system. In addition to the lifting of barriers to new entry and the broadening of the range of permitted products, the U.S. pressed for enhancing transparency in decision-making.

In response, the MOF announced in June 1993 that it would lift the rule that had

[70] In November 1996, then Prime Minister Hashimoto announced a plan for comprehensive financial liberalization, called the Japanese Big Bang.

limited investment advisory service companies to manage funds put up only in April 1990 or later. Under the Pension Fund and Insurance Law of the time, only trust banks and insurance companies could manage pension funds put up before April 1990. Banks and insurance companies had sought for removal of this rule, and satisfied with the decision, which apparently resulted from U.S. pressure.[71] With respect to the liberalization of interest rates, which had been the center of the bilateral talks for preceding years, those for time deposits of 3 million yen or more were already liberalized in November 1991 as scheduled. Furthermore, interest rates on time deposit were completely deregulated in June 1993. As the liberalization program was implemented, the focus shifted to other issues.

In the area of asset management, the U.S. wanted wider access to Japan's public and private pension funds and to its investment trust. One of the major demands was to allow investment advisory companies to manage public pension funds. At that time, only trust banks and life insurance companies were permitted to manage public pension funds, which consisted of the national pension plan (*Kokumin Nenkin*) and the employees' pension plan (*Kosei Nenkin*). This issue emerged as an important bilateral issue due to the lobbying of some major management advisors. The U.S. government went into the negotiations in close cooperation with private firms. Since around 1992, Donald Mulvihill, president of Goldman Sachs Asset Management Japan, and John R. Alkire, president of Morgan Stanley Asset Management Japan,

[71] *Nikkei Kinyu Shimbun,* June 30, 1993, p.2.

had lobbied the Treasury to include the issue of pension-fund management into the U.S.-Japan negotiations.[72] They were active in the American Chamber of Commerce in Japan (ACCJ). In the end of 1992, the ACCJ established a committee on investment management to explore problems of pension fund management in Japan. They provided information to American policymakers. One of their accomplishments was the remark Treasury Undersecretary Summers made on the closed nature of pension fund management in Japan in his March-1993 testimony before the Senate Banking Committee.[73]

There was one specific reason for which the issue of pension fund management appealed the Treasury. The American officials could stress the benefit for the Japanese people rather than just insist on the gains U.S. firms would make. The ACCJ claimed that this restriction had caused a great loss for Japanese people, as it excluded investment advisory companies from pension management. The advisory companies, which were specialized in dealing with corporate stocks, would produce higher returns than risk-averse banks and insurance companies could.[74]

In fact, there were some powerful supporters of the U.S. position with this issue in Japan. The Ministry of Health and Welfare of Japan, which held jurisdiction over the state

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[72] *Nikkei Kinyu Shimbun*, February 9, 1995, p.1, November 21, 1995, p.1.

[73] *Nikkei Kinnyu Simbun*, November 21, 1995, p.1.

[74] *Nikkei Kinyu Shimbun*, June 7, 1994, p.6.

pension system, had already made the same demand to the MOF in 1993, and was rejected. As it wanted higher returns on the state pension investments, the Welfare Ministry hoped to use foreign pressures to persuade the MOF to deregulate the public pension fund management.[75] Some Japanese actors, who were involved in pension-fund management and were not satisfied with trust banks and life insurance companies, indeed encouraged these two presidents, Mulvihill and Alkire, as they lobby their own government.[76] European countries were also keen to open Japan's pension funds to asset management companies. The issue was brought on the table in the UK-Japan financial talks held in January 1993.

As to the corporate securities area, the U.S. was looking for rights to offer new products such as financial derivatives. Treasury Undersecretary Summers stated in a Congressional hearing that U.S. investment banks were virtually excluded from Japanese underwriting because a combination of industry practices and legal and regulatory barrier had hindered the development of viable corporate finance markets.[77] The U.S. also pushed for greater liberalization of cross-border capital movement.[78] They insisted that the restrictions

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[75] Emiko Terazawa, "Japan urged to open up pension fund investment," *Financial Times*, December 23, 1993, p.3, *Financial Times,* February 4, 1994, p.26.

[76] *Nikkei Kinyu Shimbun*, February 9, 1995, p.1, November 21, 1995, p.1.

[77] Testimony, Under Secretary of Treasury Summers before the Senate Committee on Banking, Housing, and Urban Affairs, October 1993.

[78] Mark Maginer, "Financial services pact still eludes U.S., Japan," *Journal of Commerce*, December 12, 1994.

on foreign exchange in Japan, which was the most comprehensive in the G-7 countries, had impeded Japanese investors' access to a wide range of financial products offered in overseas markets.

On the other hand, Japan insisted that the U.S. financial market was far from fully open to foreign firms. The Japanese officials maintained that regulations that vary from state to state in the fragmented U.S. financial system worked as a barrier to Japanese financial institutions opening branches there, and required that they should be standardized.

The negotiation proceeded as follows. Five bilateral meetings on financial services were held from September 1993 to February 1994 without making any significant progress. Then the Framework Talks broke down mainly because of the U.S. demand for numerical targets. In June 1994, when the U.S. and Japanese negotiators agreed to resume the framework talks, they elevated financial services and intellectual property right to primary sectors in the framework talks. While the financial officials from the two countries continued talks almost for a year, the Ministry of Finance planned to start serious efforts in this area only after reaching agreements in three other priority areas. Now it had to deal with the issue in addition to the insurance negotiations.

The talks in financial services resumed in early June. Since then, the two governments held several meetings. They nevertheless did not made significant progress by November that year, and started to concentrate on the financial issues only in the year's end. The MOF tried to

advance the bilateral negotiations along with its domestic bargaining with the Ministry of Health and Welfare through the course of the budget planning annually held in December. The MOF then made new proposals that month to win concessions from the U.S. negotiators.[79]

As the negotiations went on, the U.S. negotiators used the threat of FTFSA being discussed in Congress. Before the negotiation, Treasury Secretary Bentsen suggested that the U.S. might bring back the FTFSA if the talks would be stalemated, giving support to the reintroduction of the bill. He also implied that the U.S. would not give MFN in the financial services negotiations in the WTO to countries that would not give to the U.S. financial institutions access to their domestic markets.[80] Before the October meeting, Lawrence Summers told reporters that the U.S. decision to grant MNF treatment in financial services in the multilateral negotiations would depend "very critically on what happens in Japan in terms of opening its financial services."[81] The *1994 Report of Foreign Treatment of U.S. Financial Institutions*, released on December 2 by the Treasury, stated that the minimum capital requirement of $3 million for companies wishing to manage mutual funds in Japan served to limit foreign entry. With the pension fund management business, it also recounted a variety of legal restrictions that had limited the activities of investment advisory companies to manage

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[79] *Nikkei Kinyu Shimbun*, December 22, 1994, p.1, and December 26, 1994, p.2.

[80] *Nikkei Kinyu Shimbun*, December 6, 1994, p.2.

[81] Jon Choy, "Washington puching financial opportunities in Japan," *JEI Report*, Vol. 199, No. 42, November 4, 1999.

pension assets in Japan. The same report also criticized the lack of sufficient transparency of policies and regulations, the small foreign shares in corporate underwriting of securities, and remaining foreign exchange controls.[82]

US-Japan Accord on Financial Services in 1995

Accord on Financial Services in 1995

(1) Opening of public pension market to investment advisory companies
(2) Greater access to private pension market through gradual enlarging of the ceiling on self-managed pension money
(3) Pension funds and investment trusts business conducted in one entity
(4) Ease restrictions on the introduction of new financial instruments
(5) Easing of restrictions on corporate bond issuance
(6) Deregulation of cross-border financial transactions

In early January, just before the Summit meeting between Clinton and Murayama in Washington, the two governments announced that they reached an agreement. In February, they signed on the Measures Regarding Financial Services. The agreement covered a wide range of financial services in Japan.

The Japanese government would permit investment advisory companies to manage public pension funds, and expand the portion of private employee pension funds that investment advisory companies could manage. Investment advisory firms would be allowed into the management of public pension funds from fiscal year 1995 through offshore limited partnership, called "investment union," set up jointly with Japanese trust banks. They would be also able to access to the market by offering their services to investment trust companies. These

[82] Mark Magnier, "U.S. Firms highly critical of Japan finance markets," *Journal of Commerce*, December 12, 1994.

indirect measures were introduced in order to protect ailing Japanese trust banks.[83]

Moreover, Japanese firms would be required for the first time to disclose details of how well their fund managers perform in handling pensions. U.S. firms had long contended that the Japanese fund managers underperformed their foreign competitors. Japan also agreed to drop its requirements that foreign investment firms should offer a wide range of services. However, penetrating the market would still be difficult, since many of the pension funds had been managed by Japanese banks and insurance companies with strong ties with companies and government agencies that controlled the pension pools.[84]

In Japan, while trust banks required shelter, public and private sector pension funds' demanded increased access to foreign investment skill.[85] With the issue of domestic securities market, various measures to broaden the range of permitted instruments, which were already announced in December, were included in the accord. Regulations on cross-border capital transactions would be also simplified and made more transparent. If they get blanket authorization for one-year period, Japanese residents issuing foreign-currency-dominated bonds (*samurai* bonds) and non-residents issuing Euroyen bonds would be able to do so without obtaining approval for a specific floatation.

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[83] William Dawkins, "Japan leaves the door ajar for foreign investors," *Financial Times*, January 12, 1995, p.23

[84] *New York Times*, January 11, 1995, A1.

[85] William Dawkins, op.cit.

The agreement contains no provisions that would ease the access of foreign financial institutions per se. Rather, it would remove some restrictions that had constrained both Japanese and foreign firms, expanding the scope of business available to respective type of companies. American financial institutions, which are strong in innovative business, would benefit from general liberalization.

Foreign fund managers regarded the agreement as a "modest step forward."[86] While the accord opened a door leading to the huge pension fund markets in Japan for the first time, new players were allowed in only through a complicated mechanism, in order to protect Japanese financial institutions facing trouble after the burst of the bubble economy. On the other hand, the accord included manifold and detailed commitment. The negotiation outcome reflected the close and long-term relationship between financial authorities on the both sides of the Pacific. One of the participants from the Japanese side noted that the negotiation was based on mutual understanding of the financial markets in both countries and on trust in each other, which had been fostered through the experience of financial negotiations between the MOF and the Treasury since 1983 (Hosomi 1995: 46).

In the accord, the two governments affirmed their "commitment to the principles of national treatment and most-favored-nation treatment with respect to banking, securities and other financial services" covered by the accord. Thus, the U.S. would grant Japan the MFN

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[86] William Dawkins, op.cit.

status it had withheld.

6.4 Bilateral Agreement and GATS

What was the relationship between the bilateral negotiations concerning financial services and the Uruguay Round multilateral negotiations? After the bilateral agreements in insurance and in financial services, Japan made a new WTO offer by June 1995, which fell short of full multilateralization of its agreement with the U.S. It became one of the contentious points in the run-up toward the December 1997 agreement. The U.S. pressed Japan to multilateralize their bilateral deals to make them binding under WTO rules.[87] Japan was originally reluctant. The MOF was also reluctant to go along with the EU plan. For Japan, if it would join the financial services agreement while the U.S. remained out of the system, the U.S. would be free to exercise unilateral trade action when it finds Japanese liberalization measures unsatisfactory. On the other hand, bound by the WTO rules, Japan would not be able to counter retaliation against the U.S.[88]

In the summit meeting between the EU and Japan on June 20, however, Japan promised to improve its offer in the financial services.[89] Finally in August 1995, Japan

[87] Testimony of Robert E. Rubin, Secretary of the Treasury, Before the Senate Committee on Banking, Housing, and Urban Affairs, June 8, 1995.

[88] John Zarocostas, "Japan key to EU efforts to save financial services deal," *Journal of Commerce,* July 5, 1995, p.1A.

[89] David Buchan and Caroline Southey, "EU promised a better Tokyo offer on services," *Financial Times*,

committed itself to full extension of the agreement with the US to the multilateral framework in a letter to WTO Director General Renato Ruggiero (Dobson and Jacquet 1998: 82).[90]

As to developing countries, the U.S. remained largely unsatisfactory with their offers. Those countries included Indonesia, Malaysia, Brazil, and Argentina, as well as more developed countries such as South Korea and Singapore.[91] The U.S. thus announced the withdrawal of most of its offer on financial services and the introduction of a MFN exemption on the whole sector (Dobson and Jacquet 1998: 80-85). In December 1994, in a statement that accompanied the Treasury's report on financial openness of other countries, Treasury Secretary Bentsen said that the U.S. would continue to work on bilateral negotiations, while it would also push for integration of capital markets through technical assistance and loan programs offered by multilateral financial institutions.[92]

Interim Agreement of Financial Services: July 1995

Yet, the participants could not meet the new deadline. Instead, 43 members, without the U.S., signed an interim agreement to consolidate existing offers in July 1995 at the initiative of the EU. The U.S. withdrew its offers to grant access to its financial services on a

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June 20, 1995, p.8.

[90] The letter was dated on August 21.

[91] Brian Pearse, "Danger of falling at the trade fence," *Financial Times*, April 11, 1995, p.17.

[92] Nancy Dunne, "Financial services still face curbs to market entry," *Financial Times*, December 5, 1994, p.4.

most-favored-nation basis. It committed itself only to preserving market access and granting national treatment to existing foreign-originated service providers. The country complained that some countries had not guaranteed even the existing levels of access. To save the result of the extended negotiations, the EU campaigned to persuade other countries to remain committed to reaching an interim deal by the end of July.[93] The interim agreement would expire in the end of 1997 if the new accord would not be reached by then. It was upon the insistence of France, which was upset by the U.S. move.[94]

Indeed, it was a gamble for Washington. Most countries that did not satisfied the U.S. had little interest in competing in the U.S. market. On the other hand, the country risked losing guaranteed access for its financial institutions in most important rich-country markets.[95] However, domestic concern loomed large in the U.S., with President Clinton eyeing on the presidential election held next year. Prospect for opening China's market was another reason for Washington's decision. The U.S. did not want to hurt its chances for pressing China to open its financial services markets in the negotiations for China's accession to the WTO.[96]

The negotiations resumed in the spring of 1997. In the late April of 1997, US Treasury

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[93] Caroline Southey, "EU talks up hope of financial services deal," *Financial* Times, July 8, 1995, p.2.

[94] "US against them," *Economist*, July 29, 1995.

[95] Frances Williams, "EU eager to salvage financial services pact," *Financial Times*, July 1, 1995.

[96] John Zarocostas, op.cit.

Secretary Robert Rubin sent a letter to governments of Thailand and other Southeast Asian targeted countries to urge them to comply with three proposals, such as the rights for foreign firms to establish and operate in the form of their choice, to conclude the agreement on financial services. In August 1997, Deputy US Trade Representative Jeffery Lang visited seven Asian countries (Japan, South Korea, the Philippines, Malaysia, Indonesia, Thailand, and India) to push the governments for greater commitment in opening up their financial services industries.[97] In the new round of negotiations, the U.S., India and Thailand withdrew their broad MFN exemptions based on reciprocity, and other members also improved their offers. The Financial Services Agreement was eventually concluded on December 13, 1997. The Agreement includes a legal framework for cross-border trade and market access and a mechanism for settling the disputes. It also extends the GATS to financial services. It took effect in March 1999.

6.5 Summary: Explaining the Bargaining Outcomes

As this chapter traced, since the late 1980s, the financial services became subject to multilateral trade negotiations as a result of the inclusion of trade in services in the new framework of the trade regime. Consequently, the nature of bilateral financial negotiations also

[97] Jeerawat Na Thalang, "USTR out for Wider Access in Finance," June 5, 1997, *Tha Nation* (Thailand), N. Vasuki Rao, "India urged to open financial services," *Journal of Commerce*, August 28, 1997, p. 5A.

changed considerably. Now financial services were no longer monopolized by the financial circles. The officials of financial authorities attempted to separate the sector from other trade issues for fear of having the financial issues used as a tradeoff to other, more politically sensitive issue areas, but without much success.

The negotiations on financial services and the ones on insurance between the U.S. and Japan provide an interesting comparison. The negotiations on financial services were carried out mostly by the Treasury and the MOF, which had developed close relationship through a series of bilateral talks since the Yen-Dollar Talks in the 1980s. As a result, the agreement was a detailed, technical one, and mostly aimed at general liberalization rather than securing access of foreign financial institutions per se. It resonated with the existing call for financial liberalization within the Japanese economy. On the other hand, the insurance talks were conducted by the USTR on the U.S. side. The resulting Insurance Accord was more explicit in its "result-oriented nature" than the Accord on Financial Services. Both the accord of 1994 and the supplementary measures of 1996 no doubt accelerated the deregulation process of the Japanese insurance markets. The U.S. adherence to the protection of the third sector, however, gave strong impression that the U.S. was more interested in protecting vested interests of the U.S. companies in Japan rather than exploring profits in freer insurance markets there.

Chapter 7 Conclusion

In an increasingly integrated global financial market, financial institutions face tougher competition and greater opportunities. Although it is commonplace to regard economic integration as a natural and irreversible process that followed technological innovations, the reality is that it is a consequence of political will. After the disruption since the Great Depression of 1930, political leaders—first those from major powers in the West, and then those of emerging economies—have been conducting economic liberalization at various levels to take advantage of greater markets. As they lost competitiveness in the manufacturing sector in the face of the remarkable rise of newly industrialized economies, the economic center of advanced countries moved to service sectors. The importance of the financial sector thus continued to increase, and the search for more business opportunities in foreign economies continued in the coming years. Yet, harmonizing regulations to enhance further integration has been no easy task for those leaders. It requires strong determination and political support to move on.

This study examines the bilateral financial negotiations that occurred between the U.S. and Japan in the 1980s and 1990s. These were the world's first bilateral negotiations on the liberalization of financial markets. Through detailed case studies,

this thesis found that the intergovernmental negotiations had significant influences on the liberalization process of the formerly heavily regulated Japanese markets. Initially, the negotiations were held mostly exclusively by the officials from the U.S. Treasury and Japanese MOF specialized in international finance. The exclusiveness is often attributed to the technical nature of finance, but it was more a result of the existing network of international financial officials. Through intensive negotiations, the officials came to know each other personally and share an understanding of the issues. This led the negotiations to a moderate, step-by-step opening of Japan's financial markets, which would sometimes give preferential treatment to some foreign financial institutions.

On the other hand, the deepening of financial globalization had a profound effect on institutional settings. The increasing salience of foreign financial institutions politicized financial issues. Elected officials in the U.S. began intervening in the bilateral negotiations by submitting bills that would require reciprocity in financial regulations. With those calls as a background, the U.S. negotiators became more forceful on Japan. That, in turn, stiffened the Japanese attitude and resulted in less productive negotiations. Moreover, the inclusion of trade in services, including financial services, in the multilateral trade negotiations held under the GATT also expanded the scope of participants. This also led to more short-sighted bargaining, resulting in

rougher negotiations.

Significance in the 21st Century

How does the insight obtained in this study apply to future international negotiations on financial regulations? What is the significance of studying cases from the 1980s and 1990s in detail? This bilateral framework anticipated a new international economic order now being discussed.

Lim, Elms, and Low (2012) use the term "twenty-first century agreement" in their analysis of the Trans-Pacific Partnership Agreement (TPP). A twenty-first century agreement is different from a "twentieth century agreement" in its attempt to encompass a wide range of issues ensuring fair competition among economic players, moving far beyond just lowering tariffs and other barriers to trade of goods. In the current global economy, there is a growing tendency toward international vertical integration. Now companies do not just trade finished products across national borders, but the production chain itself spreads beyond national borders. To take full advantage of this situation, it is not enough just to promote the trade of goods. Freer flow of knowledge and people, and the harmonization of a broad range of regulation are all indispensable. However, these are even more difficult than opening borders to finished products, as discussed in Chapter 2. They require changes in the deep-rooted systems of domestic

regulation. Massive inflow of people and information also provoke nationalist sentiments in many places.

The efforts to lower barriers to a wide array of international business activities besides the trade of goods began in the 1980s. “Trade in services” became an agenda in the multilateral trade negotiations under the GATT only at the end of 1980s, as discussed in Chapter 6. The General Agreement on Trade in Services (GATS) was adopted at the conclusion of the Uruguay Round and became effective in 1995, even though it falls short of facilitating comprehensive liberalization. The multilateral agreement on the financial services was concluded even later in 1997.

Preceding these efforts at the multilateral level were bilateral agreements, and the world’s first bilateral agreement on financial liberalization was between the U.S. and Japan. The case examined in this study was thus the front runner of the “twenty-first century trade agreement.” By studying it, we can obtain an important implication for the analysis of ongoing international economic negotiations. Besides, multilateral economic negotiations are composed of a series of bilateral negotiations. Agreements among major dyads are the preconditions for concluding agreements at the multilateral level. Therefore, the argument of this thesis, which stresses the role of networks of government officials from a pair of countries, can be applied to current negotiation

processes.

It also has an implication that is particularly relevant to the future of liberalization of the Chinese financial sector. Currently, the second largest economy in the world, surpassing Japan in 2010, China's domestic markets attracts attention from companies around the world. Companies in the service sector are aggressively seeking opportunities to expand their business there. Financial service was one of the most controversial issue areas in the negotiations for China's accession to the World Trade Organization (WTO). To join the international body, China needed to conclude market opening agreements with all member countries. The agreement with the U.S. was considered to be crucial to its membership. The U.S. financial industries advocated for greater access to the Chinese markets. Eventually in the China-U.S. WTO Agreement in 2001, China promised to open its banking sector completely and give foreign banks full national treatment by the end of 2006 (Peng 2006).

The Chinese financial markets are still in the process of opening. Foreign governments, especially those of advanced countries with internationally strong financial sectors, have expressed frustration over China's implementation its financial services commitments. The situation parallels what occurred in the late 1980s and early 1990s between the U.S. and Japan in the follow-up process of the Yen-Dollar

Agreement. In China today, even though remaining regulation on a range of issues, such as interest rates, apply equally to local and foreign financial institutions, foreign financial institutions complain that such regulation serve to protect domestic ones from competition with more innovative, better capitalized, foreign ones. The lack of clarity and transparency with rules also cause concerns. For example, the difficulty to gain approval to open new branches is frustrating to foreign banks, as they are at a disadvantage with Chinese big banks that have the dense network of branches within the country.[1] On the other hand, the Chinese market remains extremely promising for foreign financial institutions. They plan to expand their presence in lucrative areas such as asset management and derivative products.

External liberalization of financial services therefore remains to be one of the important issues in intergovernmental economic talks that involve China. The U.S. government agreed with China in July 2013 to resume negotiations to reach a bilateral investment treaty that would cover the service sector, including financial services. The negotiation was launched in 2008 but stalled because of China's desire to exclude certain industries in the service sector, including financial services.[2] China and the EU

[1] "U.S., EU, Japan press China on financial services at WTO." Reuters, October 31, 2011. See also PwC 2012.

[2] Ian Talley and William Mauldin, "U.S., China to pursue investment treaty," *Wall Street Journal*, July 11, 2013.

also agreed to negotiate an investment treaty in November 2013.[3] The experience of the U.S.–Japan negotiations has an important policy implication in this context.

Prospects for the Future

In the last two decades, many advanced countries adopted substantial changes in the structure of financial regulation. There has been a shift to functional regulation to oversee various types of financial products created by technological innovations (G30: 2008). In the process, some countries, including the UK and Japan, adopted a single regulator model, in which a single financial regulator has almost all of the regulatory responsibility (Pan 2011). As a result, the link between international policy networks on currency issues and those on financial regulation is weakened. After the period of this study, Japan's MOF lost its monopoly of authority to negotiate financial issues with other countries. In 1998, the authority to oversee the financial sector was taken away from the MOF and moved to a newly established Financial Supervisory Agency (FSA) to address a series of scandals that involved the financial authority. While issues of international currencies are still under the jurisdiction of the International Bureau of the MOF, international coordination concerning financial regulation and supervision fall

[3] *Financial Times*, November 21, 2013.

under the FSA, with the Bank of Japan sharing some responsibilities.[4] The FSA is thus responsible for the international negotiations over the financial services under the WTO (Kanzaki 2004).

Simultaneously, the network of intergovernmental negotiations over the financial sector has increasingly institutionalized. There have been international forums for financial regulators established after the financial turmoil of the 1970s. For example, the Basel Committee on Banking Supervision was established in 1975 by G10 advanced countries as a forum for bank regulators.[5] After the global financial crisis of 2008, those bodies expanded the membership to include newly industrialized countries. Moreover, the Financial Stability Board (FSB), established in 2009, coordinates national regulatory agencies, international institutions, and sector-specific international groups and regulators (Helleiner 2010). Through these organizations, national regulators develop long-term relationships. The officials from Japan's FSA consolidate their position as the core members of the international network of experts in the field of financial regulation, such as the Basel Committee, International Organization of

[4] The Financial Supervisory Agency was reorganized to take over responsibility for planning of the financial system from the MOF and renamed the Financial Services Agency in 2000.

[5] The International Organization of Securities Commissions (IOSCO), established in 1983, brings together the world's securities regulators.

Securities Commissions (IOSCO), and International Association of Insurance Supervisors (IAIS).[6] The reorganization of the Japanese government agencies is unlikely to result in the breakdown of international networks of financial officials.

On the other hand, after the Lehman Shock in September 2008 and the global financial crisis that followed, the public became more attentive to financial regulation. In their efforts to restore stability in the financial sector, governments and international institutions such as the IMF injected public money to ailing financial institutions. The fact that highly paid bankers were rescued with taxpayers' money caused resentment in many countries. The prolonged difficulties in the financial sector also spread to the real sector of the economy, aggravating the anger of the public about the injection of money to the financial sector. Immediately after the eruption of the global financial crisis, bank rescue plans prepared by governments in many advanced democracies were subject to severe public criticism. In the U.S., the Troubled Asset Relief Program (TARP) bill was initially rejected by Congress, further aggravating the financial turmoil.

The issues concerning financial regulation also became politicized. Issues usually regarded as highly technical, such as executive pay in financial institutions and regulation of hedge funds, were exposed to public scrutiny. Affected by the public

[6] Anonymous interview with an official from Japan's FSA, August 9, 2011.

demands for tough treatment to financial elites, for example, political leaders who met in the G20 meetings held in September 2009 endorsed the "Principles for Sound Compensation Practices," which set principles and standards in order to align compensation with long-term risks. While these standards were not legally binding, it was unusual for the summit meeting to approve numerical targets, such as "A substantial portion of variable compensation, such as 40 to 60 percent, should be payable under deferral arrangements over a period of years" and "A substantial proportion, such as more than 50 percent, of variable compensation should be awarded in shares or share-linked instruments."[7]

Consequently, it is becoming increasingly difficult for the network of financial experts to monopolize the process of negotiations. This study suggests that such politicization would change the negotiation processes outcomes into a more contentious and less productive one. Whether this holds is to be seen.

Policy Implications

What policy implications does the finding of this study have? It underscores the importance of developing long-lasting relationships among government officials at the international level. In a sense, the study also emphasizes the significance of knowledge.

[7] Financial Stability Board, "Principles for Sound Compensation Practices: Implementation Standards," September 25, 2009, http://www.financialstabilityboard.org/publications/r_090925c.pdf

Shared expertise, such as understandings of economic theories, plays an important role in international policymaking, as the theory of epistemic community suggests. However, the main finding of this study is the importance of networks built on shared understandings and the responsibility of government agencies rather than the importance of policy expertise per se. The international networks of governmental officials do not constitute an epistemic community, as the officials represent the interests of their respective governments. Yet, their shared views and long-term personal relationships do affect the manner in which intergovernmental negotiations are organized. Deep personal relationships and mutual understanding are the keys to mutually beneficial negotiations. We can thus conclude that it is be crucial to spread such networks across countries, including emerging economies.

Moreover, this study highlights the significance of insulating the negotiation process from political intervention. When elected officials intervene in the technical issues of finance, the policies often become too radical. On the other hand, democratic control of policymaking remains crucial in ensuring sound and sustainable governance. Government officials should be always accountable to the public and provide accurate information.

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