Revision of the Foreign Exchange Law and the Possibility of Capital Outflow

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Introduction

Amid growing concern over the hollowing out of Japan's financial markets, the revised Foreign Exchange and Foreign Trade Law came into effect this April as the first major step of the Japanese "Big Bang." The revised law, which drops the word "control" from the name of the previous law, deregulates domestic and foreign capital transactions and foreign exchange operations, making them free in principle.

In this paper, we examine the revisions in the new law, their impact on individuals and corporations, and the possibility of capital outflow.

1. Major Revisions in the New Law

With few exceptions, the revised law almost completely liberalizes the four areas of foreign exchange operations, capital transactions, foreign direct investment, and the Tokyo offshore market.[1]

(1) Liberalization of Foreign Exchange Operations

Prior to the revision, foreign exchange operations (dealing in foreign currencies and currency options, etc.) were restricted to authorized banks, authorized securities companies, and authorized money managers (hotels, travel agencies, etc.). Under the revised law, anybody (including manufacturers and trading companies) can engage in foreign exchange operations.

(2) Liberalization of Capital Transactions

Previously, capital transactions (foreign deposits, foreign currency loans, portfolio investment, and issuance of securities) and accounts settlement in foreign currencies required prior notification and approval of the Ministry of Finance. Now these transactions require only reporting after the fact.

By eliminating complex procedures, the new requirement should facilitate speedy transactions and response to market conditions.

For deposits held abroad by residents in Japan, all yen denominated deposits and foreign currency deposits exceeding the equivalent of 200 million yen required MOF approval. Now foreign deposits need only be reported after the fact.

With the liberalization of settlements in foreign currencies, individuals can purchase products abroad and pay through a foreign bank account, as well as purchase merchandise in Japan with dollars. Corporations can now make trade settlements using foreign bank accounts. Especially important is the lifting of the ban on netting transactions (reported after the fact), which allows companies to settle accounts based on the net difference between exports and imports, instead of having to use gross account settlements in which exports and imports are treated separately.

In addition, prior notification and approval requirements were changed to reporting after the fact for foreign currency loans such as impact loans (unrestricted foreign currency loans, which were the sole domain of authorized foreign exchange banks), portfolio investments (the acquisition of foreign-denominated securities by residents from non-residents, acquisition of yen-denominated securities by non-residents from residents, etc.), and issuance of securities (securities issuance abroad by residents, issuance of foreign-denominated securities in Japan, securities issuance in Japan by non-residents, issuance of yen-denominated securities abroad, etc.).

(3) Liberalization of Foreign Direct Investment

Except for restricted industries such as narcotics, only reporting after the fact is required for investments abroad to set up subsidiaries, branches, or factories, and for acquiring more than 10 percent of the outstanding stock of a foreign company. Since foreign direct investment is essentially a tedious and time consuming endeavor, the switch from prior notification to reporting after the fact is not expected to significantly impact the number of investments.

(4) Expansion of the Tokyo Offshore Market

The Tokyo offshore market is an international financial market in which non-residents can freely raise and manage capital. It was created in 1986 with objectives including: (1) internationalizing the Tokyo market, (2) attracting foreign financial institutions, and (3) providing a convenient alternative for banks with no foreign presence. The market enjoys preferential measures such as the absence of reserve ratios and withholding taxes on financial transactions.

Before the revision, the Tokyo offshore market banks dealt only with non-residents, accepting their dollar and euro-yen deposits and offering them deposits and loans (in both yen and foreign currencies). Under the revised law, securities companies can now underwrite bonds issued by non-residents and sell them to non-residents.

2. Impact of the New Law

(1) Impact of Liberalized Foreign Exchange Operations

The liberalization of foreign exchange operations will directly impact foreign exchange transaction costs. Since liberalization eliminates the dual market structure separating the interbank market (where currencies are traded among foreign exchange banks) and customer market, transaction costs should decline to some extent.

For example, while corporations pay a transaction cost that varies depending on transaction volume, market conditions, and creditworthiness, the usual rate for large institutional investors is approximately 0.1 to 0.3 percent of transactions valued at one to ten million dollars. Considering that banks must bear exchange rate risks and operating costs, this fee is already quite low. However, dealing costs for small and mid-sized corporations are higher and have room to fall.

On the other hand, individuals pay high transaction costs. For example, to buy dollar-denominated traveler's checks the fee is approximately 2.3 yen per dollar, or 1.8 percent. For cash, the rate is even higher at 3 yen, or 2.3 percent. Although the high cost structure for individual customers is gradually breaking down, there remains much room for improvement.

Another impact of liberalization is increased competition and consolidation among financial institutions. The expected decline dealing fee revenues mentioned above will inevitably be accelerated by the lifting of the ban on netting transactions.

Under these circumstances, since banks are weak in exchange rate risk management and cannot benefit from economies of scale, their costs will exceed revenues. In that case, they are likely to be forced either to withdraw from foreign exchange operations, or else to outsource these operations to foreign banks better equipped in risk management.

At the same time the foreign exchange law was revised, the restriction on daily foreign exchange positions of banks was abolished. While banks are expected to manage their own exchange rate risk, the deregulation of foreign exchange positions is not likely to increase transaction volume. This is because BIS secondary capital rules implemented in the March 1998 term constrain the foreign exchange transactions of banks.[2] Foreign exchange transactions, which previously were done off the book and not counted as risk assets, are now included as risk transactions under the secondary rules, making it more difficult for banks to deal by holding large foreign exchange positions. In other words, foreign exchange operations will become concentrated among banks that can efficiently earn dealing profits while managing risk with limited positions.

The growing competition will not be limited to domestic financial institutions. Not only will more foreign banks enter Japan, but the lifting of the ban on direct foreign exchange transactions

between Japanese investors and banks abroad should also spur competition with foreign financial institutions.

While the revised law permits businesses to engage in foreign exchange operations, considering the difficulty of foreign exchange risk management and complexity of procedures, entry will not be easy except in the area of money changing.

(2) Impact of Liberalized Capital Transactions

The attention on capital transactions has focused on overseas deposits. However, since foreign currency deposits in Japan were liberalized in 1980, there are few advantages to holding foreign currency deposits overseas. In addition, with the lifting of the ban on foreign currency settlements, individuals with foreign currency deposits overseas can now pay for imported goods in foreign currency. Similarly, companies can also perform trade settlements in foreign currencies, enabling more efficient foreign exchange management and greatly simplifying procedures.

Second, lifting the ban on netting transactions gives significant advantages to corporations. When netting transactions were banned, companies often tried to manage foreign exchange risk by individually processing many foreign-denominated transaction credits and debts having a variety of currencies and settlement dates. This made it difficult to have a unified foreign exchange risk management. Moreover, for the foreign exchange dealing costs were high for small and mid-sized corporations: they had to buy yen if they received payment for exports in dollars, and had to buy dollars later if they had to pay for raw material imports in dollars. Thus they paid fees going both ways.

The practice of conducting netting transactions among several participants is called multi-netting, and requires the unified management of individual transaction credits and debts. It can lead to the emergence of an "inhouse bank" in a company's finance department or at an affiliated company, through which internal and external foreign currency settlements can be unified so that foreign exchange risks and costs are efficiently managed. Small and mid-sized companies without an inhouse bank do not need to go through a domestic bank, but can make settlements through an overseas account, allowing them to reduce their foreign exchange dealing cost.

In addition, since ordinary companies now have access to foreign currency loans, competition is expected to intensify. The liberalization of securities issuance domestically and abroad will expand financing alternatives at home and abroad for residents. At the same time, the Tokyo market is likely to see an increase in the issuance of yen-denominated foreign bonds and euro-yen bonds issued by non-residents.

However, the revised law's impact on portfolio investments is not expected to be large due to the following reasons.

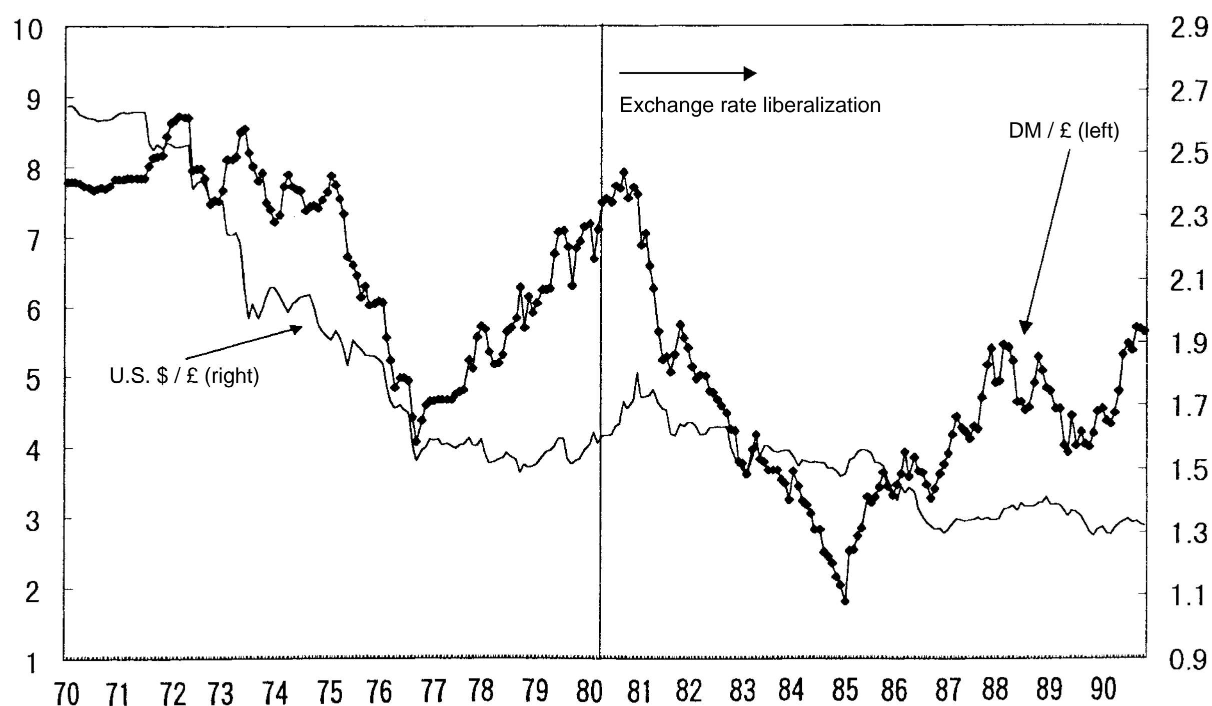
1. Foreign securities dealing through authorized securities companies did not require prior notification.
2. Direct dealing of foreign currency securities with non-residents did not require prior notification for values less than the equivalent of 100 million yen.
3. Institutional investors such as insurance companies and investment trust companies designated by the MOF were granted comprehensive permission and in effect not banned from dealing directly in foreign currency securities with non-residents.

3. The Possibility of Capital Outflow

(1) Case Studies from Abroad

In the U.K., foreign exchange controls were abolished in October 1979, freeing up capital movement domestically and abroad. Triggered by worsening economic fundamentals, since the 1980s portfolio investments abroad rose sharply, while the sterling plunged (Figure 1). During this time, the proportion of foreign securities in the assets under management by institutional investors rose significantly. For example, for insurance companies, it rose from 2.9 percent in 1979 to 11.6 percent in 1986, while pension funds saw an increase from 4.7 percent to 16.8 percent.

Figure 1 Pound Sterling Exchange Rate



Source: Datastream

From the late 1980s to early 1990s, a withholding tax on interest prompted a large capital outflow from Germany to Luxemburg, where there was no taxation. The capital outflow was all the larger since Germany had abolished foreign exchange controls in 1961.

(2) Possibility of Capital Outflow by Corporations

Compared to the U.K., where portfolio investment abroad was effectively limited prior to the abolition of foreign exchange controls, Japanese portfolio investment abroad, centered around institutional investors, was already substantially liberalized. Thus the new law's impact on capital outflow should be limited.

(3) Possibility of Capital Outflow by Individuals

Individual assets in Japan are estimated at 1,200 trillion yen. If just one percent of this (12 trillion yen) were to flow out of the country, it would be an enormous trend equivalent to Japan's annual trade surplus. However, almost 60 percent of the individual assets are in cash and deposits, while risk bearing assets such as securities and mutual funds account for only about 10 percent. Since many wealthy individuals have already been investing overseas in foreign bonds and other instruments since around 1995, the revised law is not likely to cause a sudden increase in the ratio of risk-bearing assets. However, considering the strong performance of foreign investments recently, some capital outflow can be expected.

The tax system is not is not likely to change significantly. While a flat 20 percent withholding tax rate on interest income from bonds (18 percent for refund premiums on discount bonds) and deposit accounts (whether yen or foreign currency accounts), interest income on bonds and deposit accounts held overseas is treated as general income. For wealthy individuals who can afford to invest abroad, this means paying a tax rate as high as 65 percent for foreign income-clearly a disincentive to investors (Table 1). Thus most "foreign" investments held by wealthy individuals are those subject to the 20 percent withholding tax–foreign currency deposits, bonds, and contract type mutual funds held through domestic securities companies or banks. From the perspective of taxation, there is no reason to expect individuals to increase their overseas holdings significantly.

Given these circumstances, there is strong concern regarding tax evasion and money laundering. Besides the difficulty in tracking income from foreign assets, tax authorities do not have the authority to audit financial institutions overseas. For these reasons, reporting requirements have

Table 1 Personal Income Tax Rates

	Japan	U.S.	U.K.	Germany	France
Maximum tax rate	65%	46.45%	40%	53%	54%
National tax rate range	10~50%	15~39.6%	20~40%	25.9~53%	10.5~54%
No.of brackets	5	5	3	Proportional to income	6

Note: Maximum tax rate includes local taxes. New York state tax rates are shown for U.S.
Source: MOF

been tightened. For example, money transfers of more than 2 million yen (or more than 1 million yen if carried) must be reported in detail including name, amount, payee, and purpose. Moreover, regardless of the amount, the bank is required to confirm the customer's identity and both the payer and payee must submit a notice to the bank. Those who violate the above requirements are subject to a penalty of a fine or prison sentence.

Many issues have yet to be resolved in adapting the tax system to the revised Foreign Exchange Law, including finding ways to check global taxable income, reducing the maximum income tax rates for individuals and companies, taxing interest and dividend income as ordinary income, and introducing a taxpayer number system.[3]

Conclusion

As we have seen, the new law contains major revisions affecting not only foreign exchange but overseas investments and loans in general. As such, it is an important front runner to the Big Bang.

However, from the perspective of the impact on fund outflows, even though the groundwork has been laid for the free movement of funds, the impact of the revised law in and of itself is limited. This is due not only to taxation problems, but to the fact that Japan's portfolio investments abroad were already quite unrestricted compared to the U.K. prior to deregulation.

However, considering the announcement effect of the revised law, lower credit ratings of Japanese banks, as well as the strong performance of foreign global mutual funds, some amount of capital outflow will be inevitable for the time being. Needless to say, since there is no guarantee that foreign investments will perform well forever, it is important to remember the high-risk high-return relationship (that there is no such thing as a low-risk high-return investment).

While capital outflow is one cause of the weak yen, the weak yen induces foreign investors to sell Japanese stocks (capital outflow). Thus domestic investors also must not fixate on the advantages of the weak yen lest they forget its impact on the stock market.

Notes

1. Restrictions that remain after the revision are : (1) reporting requirement for capital transactions made abroad and in Japan (transactions with banks and securities companies are reported by them) ; (2) restrictions on transactions with countries under economic sanctions ; (3) investment restrictions regarding weapons and narcotics industries; and (4) restrictions to prevent money laundering, such as requiring proper identification from customers.

2. For banks with international operations, BIS secondary restrictions supplement BIS primary restrictions. Credit risk assets under the primary restrictions, combined with market risk assets (financial transactions for short-term dealing), must meet a capital to asset ratio of at least 8 percent.

3. In the proposed taxpayer number system, individuals and corporations are assigned taxpayer numbers, which they must report to financial institutions on every transaction. The transaction details are made available to authorities, who use the information to prevent money laundering and tax evasion. The system has been criticized as an invasion of privacy.