Faculty of Business and Law

Assignment Authentication Declaration

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Name	Student Number
Barry Ackers	400088489
Chen Zhe	300488444
Andy Susanto Hendrawan	2000491433
Haibin Jiang	300300517

"We hereby declare that the material submitted in this assignment is our own work except where specifically acknowledged and referenced."

Date: 26th April 2004

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1. Introduction

Over the past few years the Japanese economy has been under careful scrutiny with eminent economists lamenting a decade of economic stagflation in Japan. More recently, indications are that the Japanese economy is beginning to emerge from this economic quagmire.

2. Background

With a GDP of US$3,450 billion, Japan is the third largest economy in the world after the US and China. Industry, the most important sector of the Japanese economy, is heavily dependent on imported raw materials and fuels. After three decades of spectacular overall real economic growth, Japan's growth slowed markedly, becoming into a recession. Government's efforts to revive economic growth were further hampered in 2000/01 by the slowing of the US and Asian economies. [Phrasebase™]

Japan is the world's largest and technologically advanced producers of motor vehicles, electronic equipment, machine tools, steel and nonferrous metals, ships, chemicals, textiles and processed foods. It has an export-oriented economy where primary exports include motor vehicles, semiconductors, office machinery and chemicals. Major export trading partners are the USA, Taiwan, South Korea, China and Hong Kong. Japan's primary imports are fuels, foodstuffs, chemicals, textiles and office machinery, from the USA, China, South Korea, Taiwan, Indonesia and Australia.

3. Balance of Payments

The Balance of Payments (BOP) is a "double-entry" accounting system measuring and recording all economic transactions between residents of the home country and residents of foreign countries during a particular time period. It comprises two sections, i.e. the Current Account and the Capital and Financial Account, equalling each other. It is an important indicator of relative economic performance and stability, signalling fundamental changes in national competitiveness. BOP statistics help to identify emerging markets for goods and services. However, since the statistics are based on estimates, using combined data from a myriad of sources, it often only approximates what is being measured. The Trade Balance tends to be more accurate since it usually utilises data received from one source only, i.e. the Customs Department. [Mahoney et al]

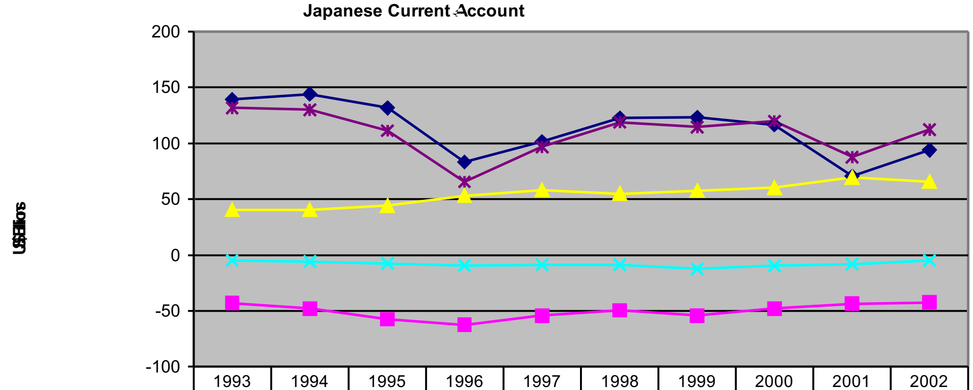
3.1 Current Account

The Current Account is a record of receipts from the sale of goods and services to residents of other countries, and payments for goods and services bought from residents of foreign countries. The Current Account reflects the accumulated flow of transactions, i.e. the total of exports and imports. The Current Account comprises the following four transaction types [Mahoney et al]:

- Exports and imports of goods (Goods include all moveable goods that change ownership between residents and non -residents).
- Exports and imports of services (Services relate to services by residents to non-residents, as well as services by non-residents to residents and include transport, travel, telecommunications, legal and consultancy services).
- Income (Income refers to earnings from the deployment of factors of production, i.e. land, labour and financial capital).
- Current transfers (Entries recorded when resources are provided by residents to non-residents without something of economic value being provided in return).

Exports are **sources of funds,** represented by credits (+) on the Current Account, whereas imports are **uses of funds,** represented by debits (-) on the Current Account.

FIGURE 1
Japanese Current Account

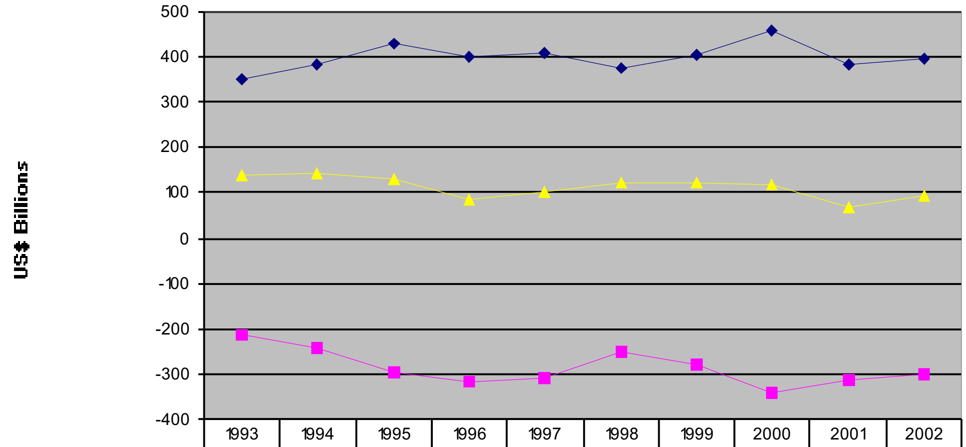


	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
TRADE BALANCE (SURPLUS)	139.42	144.19	131.786	83.585	101.6	122.389	123.325	116.716	70.214	93.83
SERVICES BALANCE	-43.08	-48.06	-57.352	-62.2758	-54.1505	-49.421	-54.1598	-47.6259	-43.7328	-42.228
INCOME BALANCE	40.41	40.23	44.286	53.4897	58.198	54.6231	57.5779	60.4005	69.2213	65.7687
CURRENT TRANSFER BALANCE	-5.1	-6.11	-7.67611	-9.00678	-8.83409	-8.84216	-12.1388	-9.83071	-7.90435	-4.9225
CURRENT ACCOUNT	131.65	130.25	111.0439	65.79212	96.81341	118.7489	114.6043	119.6599	87.79815	112.4482

In Figure 1 above, Japan's Current Account (in US$'s) clearly illustrates the extent of Japan's Current Account surplus for the period 1993 to 2002, with all components except for services and transfers consistently reflecting strong surpluses. As the graph indicates, Japan's Current Account balance fluctuated between US$66 billion and US$132 billion from 1993 to 2002. The dominance of the Trade Balance during that period is evident by how closely it emulates the trends depicted by the Current Account. During the period 1993 to 1996, the Current Account surplus steadily weakened, halving from a high of US$132 to US$66, almost heralding the Asian economic crisis that exploded in July of 1997. Moreover, the effect was further exaggerated by the impact of the "Bubble Economy[1]".

[1] When a country's stock and real estate markets have risen far and fast to unsustainable 'bubble' levels that cannot be justified on the basis of fundamental values.

FIGURE 2
Current Account Trade Balance



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
GOODS EXPORTS: F.O.B. (CREDIT)	352.66	385.7	428.717	400.287	409.24	374.044	403.694	459.513	383.592	395.581
GOODS IMPORTS: F.O.B (DEBIT)	-213.24	-241.51	-296.931	-316.702	-307.64	-251.655	-280.369	-342.797	-313.378	-301.751
TRADE BALANCE (SURPLUS)	139.42	144.19	131.786	83.585	101.6	122.389	123.325	116.716	70.214	93.83

Figure 2 above, clearly shows a positive Trade Balance in respect of goods transactions, reflecting a consistently strong surplus, i.e. exports being considerably higher than imports. Interestingly, the variation in goods exports over the period approximates a mirror image of the variation in goods imports. Intuitively, since Japan is heavily dependent on imported raw materials and fuels, it is logical that imports should mirror exports.

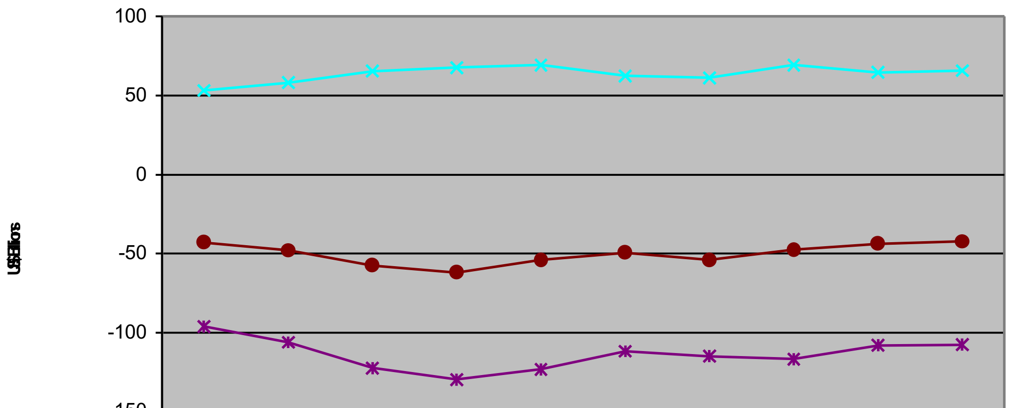
In 1996 the Trade Balance declined, as a result of both decreases in exports and increases in imports, possibly resulting from price increases of imported components and the pending Asian economic crisis. Given that the Yen depreciated by 13% during 1996, both imported and exported goods are stated at values lower that that of the previous year, since they are represented by less US Dollars.

The decline in goods exported and imported in 1998, is the result from fallout following the 1997 Asian economic crisis, during which time the Yen was also at its weakest. Since the Asian crisis economically devastated east Asia, impairing the purchasing power of these countries. Given that Asia accounts for 47% of total exports [Kyodo News – 21st

April 2004], the battered Asian economies contributed to the decline in the Trade Balance.

In 2000, goods exports peaked at US$460 billion, coinciding with a Yen devaluation of 12%. Due to a lag effect, this seems to indicate that the intervention by the Bank of Japan in 1999, when US$ were purchased in the market, resulting in the 12% devaluation of the Yen, paid dividends.

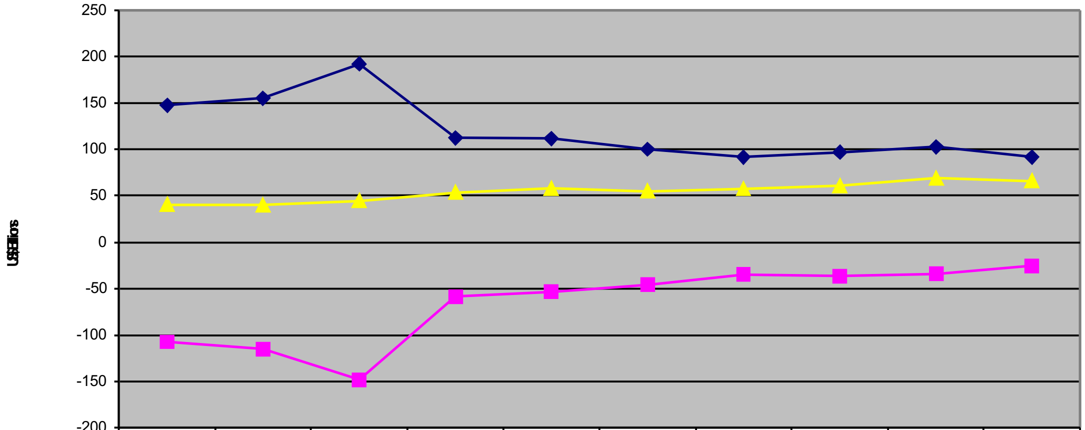
FIGURE 3
Current Account Services Balance



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
SERVICES EXPORTS (CREDIT)	53.22	58.3	65.274	67.7122	69.3035	62.412	60.9982	69.2381	64.5162	65.712
SERVICES IMPORTS (DEBIT)	-96.3	-106.36	-122.626	-129.988	-123.454	-111.833	-115.158	-116.864	-108.249	-107.94
SERVICES BALANCE	-43.08	-48.06	-57.352	-62.2758	-54.1505	-49.421	-54.1598	-47.6259	-43.7328	-42.228

Figure 3 depicts the fluctuation of the Services component of the Current Account. In contrast to goods, service imports exceed exports. A review of the underlying data reveals that the major components are transport, royalties and other business services. Apart from minor variations, the trends appear relatively stable.

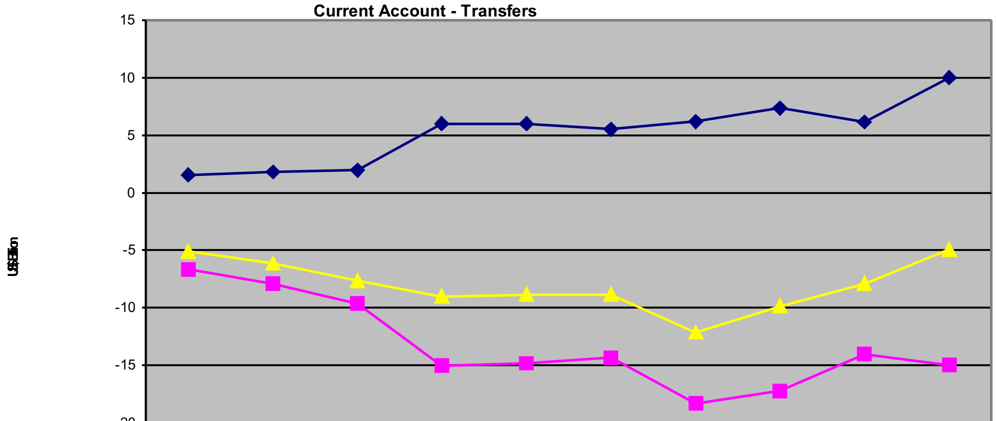
FIGURE 4
Current Account - Income Balance



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
INCOME: CREDIT	147.83	155.19	192.446	112.438	111.825	100.335	92.0486	97.1992	103.095	91.4779
INCOME: DEBIT	-107.42	-114.96	-148.16	-58.9483	-53.627	-45.7119	-34.4707	-36.7987	-33.8737	-25.7092
INCOME BALANCE	40.41	40.23	44.286	53.4897	58.198	54.6231	57.5779	60.4005	69.2213	65.7687

Figure 4 above, depicts a steadily increasing net income position on the Current Account, indicative of Japan's ongoing foreign investments. This is supported by the direct investment data in Figure 8 below. Investment income is the primary component in respect of both inflows and outflows. During 1995, both inward and outward investment income in creased significantly, followed by even larger decreases in 1996, thereafter stabilising at the lower level. Reviewing the Financial Account, this correlates with a reduction from US$123 billion to US$63 in 1996.

FIGURE 5
Current Account - Transfers



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
CURRENT TRANSFERS: CREDIT	1.58	1.83	1.98322	6.02342	6.01061	5.53114	6.21151	7.38039	6.15165	10.0379
CURRENT TRANSFERS: DEBIT	-6.68	-7.94	-9.65933	-15.0302	-14.8447	-14.3733	-18.3503	-17.2111	-14.056	-14.9604
CURRENT TRANSFER BALANCE	-5.1	-6.11	-7.67611	-9.00678	-8.83409	-8.84216	-12.13879	-9.83071	-7.90435	-4.9225

Figure 5 above shows steadily increasing transfers without any corresponding economic value being received in return (i.e. aid). Since there is no corresponding economic value, both legs of the transaction appear in the same account. As a result, the debits approxi mately mirrors the credits, after allowing for timing differences.

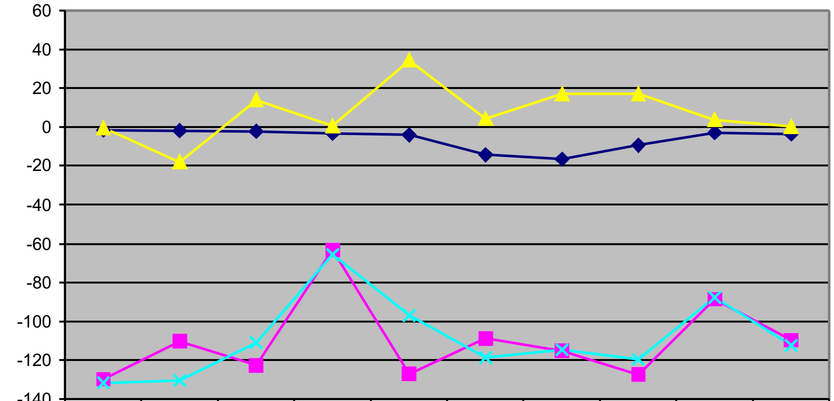
3.2 Capital and Financial Account

The Capital and Financial Account records the net effect of all financial transactions between residents and non-residents. Unlike the Current Account, where transactions are aggregated as either imports or exports, in the Capital and Financial Account the financial inflows and outflows are offset against each other with only the net effect being shown. The Capital and Financial Account reflects how the transa ctions on the Current Account were financed, in net terms. [Mahoney et al]

Exports comprise debits on the Capital and Financial Account, due to either an increase in foreign exchange financial assets or a decrease in foreign liabilities, whereas imports re present credits.

As depicted in Figure 6 hereunder, the combined Japanese Capital and Financial Account increased significantly during the period under review, reflecting the strength of Japan's export orientation and resultant Current Account Surplus. In 1996, the rate of growth in the Financial and Capital Account slowed to half of the previous year, fuelled by a reduction of 40% in the Current Account surplus. This in turn, was driven by the reduction in the Financial Account. Moreover, the relatively weakness of Yen during this period (depreciating by 13% against the US$ from 1995 to 1996), exacerbating the impact on the Capital and Financial Account.

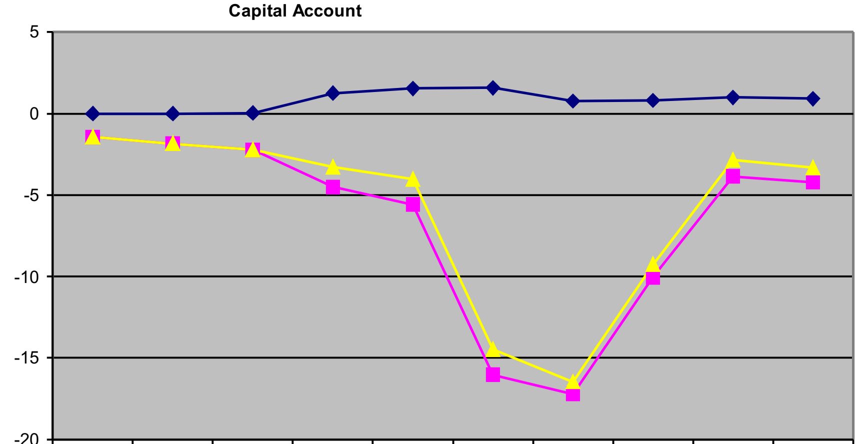
FIGURE 6
Capital & Financial Account



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
CAPITAL ACCOUNT	-1.46	-1.85	-2.23	-3.29	-4.05	-14.45	-16.47	-9.26	-2.87	-3.32
FINANCIAL ACCOUNT	-129.69	-110.39	-122.59	-63.14	-127.08	-108.65	-115.11	-127.26	-88.65	-109.52
NET ERRORS AND OMISSIONS	-0.50	-18.03	13.78	0.65	34.31	4.36	16.97	16.87	3.72	0.39
FINANCIAL & CAPITAL ACCOUNT	-131.65	-130.27	-111.04	-65.78	-96.82	-118.74	-114.60	-119.65	-87.80	-112.46

Figure 7 below, reflects a relatively stable but increasing Capital Account from 1993 to 1997, with rapid increases from 1997 to 1999 (tripling from US$4 billion to US$14 billion), due to debit capital transfers, being in respect of private sector debt forgiveness, indicative of poor credit lending policies.

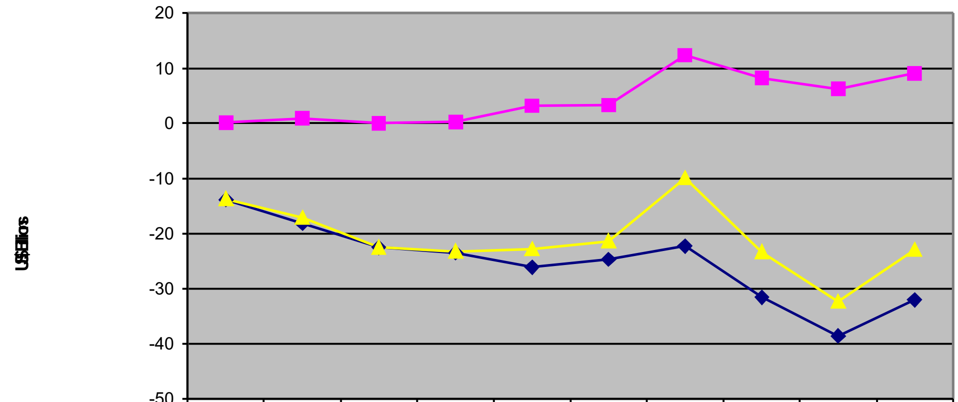
FIGURE 7
Capital Account



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
CAPITAL ACCOUNT : CREDIT	0.00	0.00	0.01	1.22	1.52	1.57	0.75	0.78	0.99	0.91
CAPITAL ACCOUNT: DEBIT	-1.46	-1.85	-2.24	-4.51	-5.57	-16.02	-17.21	-10.04	-3.86	-4.24
CAPITAL ACCOUNT	-1.46	-1.85	-2.23	-3.29	-4.05	-14.45	-16.47	-9.26	-2.87	-3.32

Figure 8 below, reflects the growth of direct investment. From 1993 to 1998, there was little investment by non-residents in the Japanese economy, becoming active disinvestment from 1999 to 2002. Japanese direct investment abroad has steadily increased from US$14 billion to US$22 by 1999, rapidly accelerating to US$39 billion by 2001.

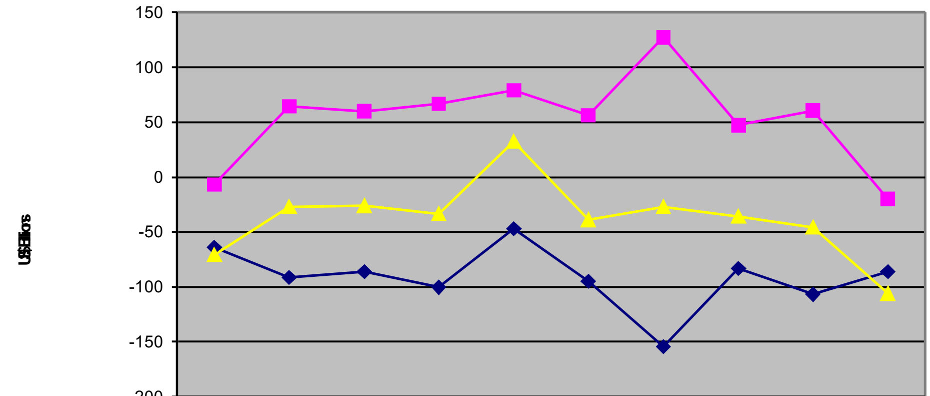
FIGURE 8
Financial Account - Direct Investment



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
DIRECT INVESTMENT ABROAD	-13.83	-18.09	-22.508	-23.447	-26.059	-24.625	-22.267	-31.534	-38.497	-32.017
DIRECT INVESTMENT IN JAPAN	0.12	0.91	0.03933	0.20764	3.20008	3.26811	12.3084	8.2272	6.19097	9.08724
DIRECT INVESTMENT	-13.71	-17.18	-22.468	-23.239	-22.859	-21.356	-9.9581	-23.307	-32.306	-22.93

Figure 9 below reflects a decline in the rate of net portfolio investment from US$71 billion in 1993 to a disinvestment of US$32 billion by 1997. This trend was reversed in 1998, peaking at US$106 billion by 2002.

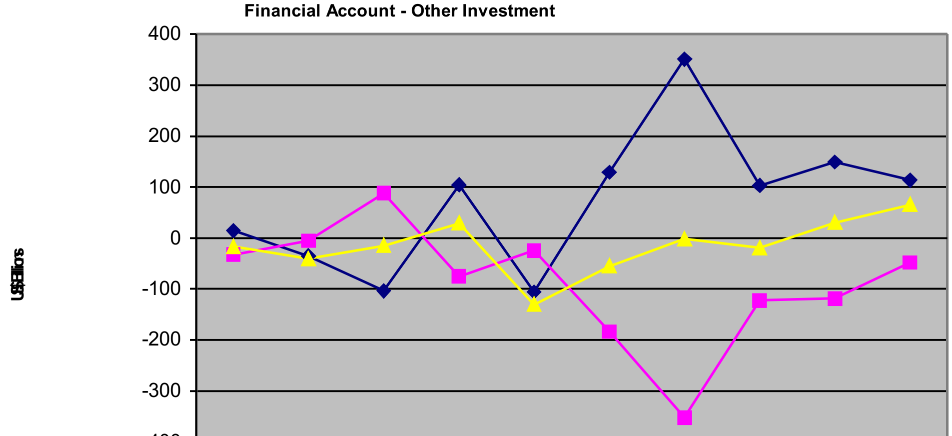
FIGURE 9
Financial Account - Portfolio Investment



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
PORTFOLIO INVESTMENT ASSETS	-64.23	-91.55	-86.05	-100.61	-47.06	-95.2357	-154.41	-83.3622	-106.788	-85.9307
PORTFOLIO INVESTMENT LIABILITIES	-6.65	64.33	59.79	66.79	79.19	56.06	126.929	47.3865	60.5027	-20.0439
PORTFOLIO INVESTMENT	-70.88	-27.22	-26.26	-33.82	32.13	-39.1757	-27.481	-35.9757	-46.2853	-105.975

Whilst Figure 10 below reflects a relatively stable net position for other investments, when reviewing the assets and liabilities separately, 19 99 shows a huge increase in liabilities from US$129 in 1998 to US$350 in 1999, and a similar increase in assets from US$183 billion to US$352 billion.

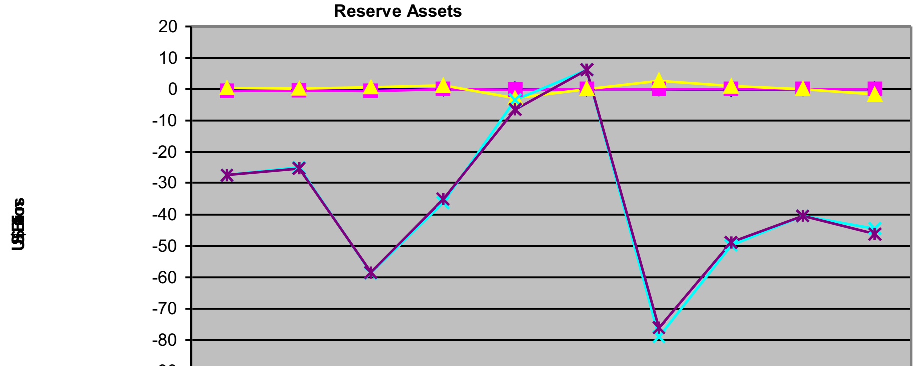
FIGURE 10
Financial Account - Other Investment



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
OTHER INVESTMENT ASSETS	15.07	-35.12	-103.439	103.912	-105.789	128.694	350.14	102.592	149.378	113.657
OTHER INVESTMENT LIABILITIES	-32.7	-5.6	88.1828	-74.8672	-23.988	-182.979	-351.547	-121.621	-118.951	-48.1363
OTHER INVESTMENT	-17.63	-40.72	-15.2562	29.0445	-129.777	-54.2855	-1.407	-19.0291	30.4273	65.5204

Figure 11 below reflects the position of the Japan's reserve assets over the period. With the exception of foreign exchange reserves, the remaining BOP accounts remained stable reflecting little activity. Overall the Central Bank appears to be increasing its foreign exchange holdings (resulting from the constant Current Account surpluses). However, the trend from 1995 to 1997 reveals a decreasing rate of foreign exchange holdings, until 1998, when there was a net outflow of foreign exchange holdings. This appears to indicate intervention by the Bank of Japan, through the sale of foreign currency to strengthen the Yen. Conversely in 1999, there was a significant increase in foreign currency holdings, indicative of the Bank of Japan purchasing foreign currency to weaken the Yen, thereby improving Japan's competitive positioning, and stimulating the economy.

FIGURE 11
Reserve Assets



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
MONETARY GOLD	0	0	0	0	0	0	0	-0.11	-0.01	0
SPECIAL DRAWING RIGHTS	-0.46	-0.44	-0.54	-0.02	-0.16	0.09	-0.04	0.09	-0.03	0.04
RESERVE POSITION IN THE FUND	0.38	0.14	0.69	1.19	-2.9	-0.02	2.79	1	0	-1.63
FOREIGN EXCHANGE	-27.39	-24.97	-58.76	-36.3	-3.51	6.1	-79.01	-49.93	-40.45	-44.55
RESERVE ASSETS	-27.47	-25.27	-58.61	-35.13	-6.57	6.17	-76.26	-48.95	-40.49	-46.14

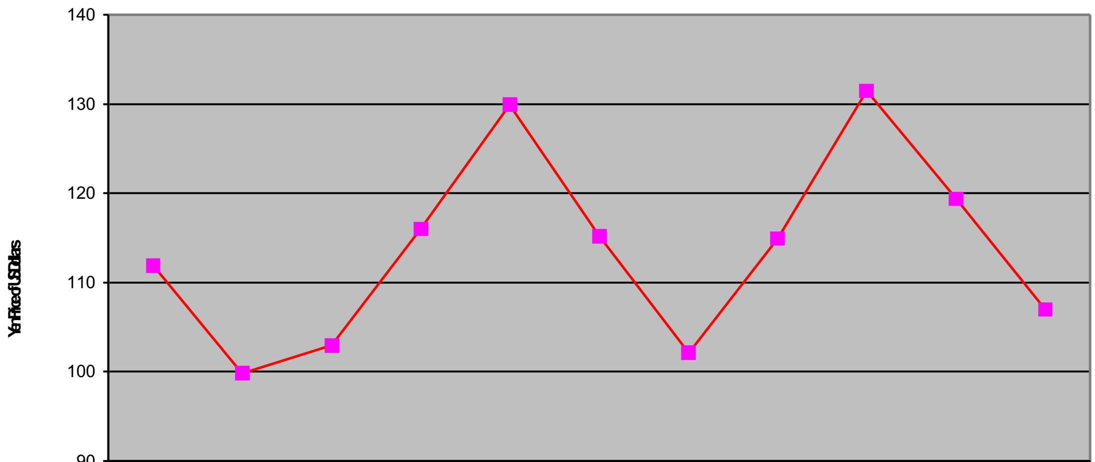
4 Foreign Exchange

Foreign exchange is a commodity consisting of currencies issued by countries other than the home country [Mahoney et al]. Given a flexible exchange rate regime, like the Japanese Yen, it is the price of foreign currency, set by the market forces of supply and demand. Assuming that a country's central bank does not intervene, all transactions affecting the BOP, are the result of Current; and Capital and Financial Account transactions and not the consequence of the official reserves.

Japan is one of the OECD members whose exchange rate is classified as Independently floating, being market determined, with any foreign exchange intervention aimed at moderating the rate change and preventing undue fluctuations in the exchange rate rather than at establishing a level for it.

According to the Bank of Japan, the foreign exchange rate should move in a stable fashion reflecting economic fundamentals, since excessive volatility would have an adverse impact on the economy and prices. It believes that the recent appreciation of the yen has been too rapid with its effects on corporate profits, being a matter of concern. The foreign exchange rate is not a direct objective of monetary policy. However, monetary policy is not pursued without considering the development of the foreign exchange rate, which is carefully monitored from the perspective of its impact on the economy and prices. In the reserve market, there are various flows of funds such as currency in circulation and Treasury funds other than those resulting from the non-sterilized intervention. The Bank accordingly conducts its daily market operations taking into account all the money flows, in order to create ample reserves. This strong commitment of fund provision is consistent with the government's current foreign exchange rate policy. [Bank of Japan – 29th September 1999]

FIGURE 12
Japanese Yen / US $ Exchange Rate



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Yen / US $	111.89	99.83	102.91	115.98	129.92	115.2	102.08	114.9	131.47	119.37	106.97

Figure 12 (above) depicts the variation in the Japanese Yen (¥) against the United States Dollar ($) over the ten-year period from 1993 to 2002. The Yen was at one of its weakest positions against the US$ in 1997, depreciating from ¥100 in 1994 to ¥130 by 1997. During this period Japan appears to have used its official reserves to weaken the Yen, as reflected by the diminishing net decrease in Foreign Exchange reserves, from US$59 billion in 1995 to an increase of US$6 billion in 1998. By 1999 the Yen had appreciated to ¥102 against the US dollar, when it appears that the Japanese Central Bank again intervened through an unprecedented decrease in foreign exchange reserves of US$79 billion. Thereafter the Yen continued to depreciate against the US Dollar. More recently the Yen has again begun to strengthen against the US Dollar, not necessarily as a result of central bank intervention but due a weakening global economy, led by the USA.

The Yen was at its strongest against the US Dollar was in 1994, as a result of Japan's "bubble economy". Since January 2002, the US dollar has depreciated by 13.2% against the Japanese yen. This happened mainly as a result of American imports of goods exceeding export of goods, as a result the exchange value or the purchasing power of money would appreciate since more goods must be exchanged for money.

By 2001, the Yen had again depreciated to its lowest points against the dollar since October 1997, as the economy struggles to emerge from the recession. The depreciation was fuelled by the revelation that the US government may favour a policy of allowing the Yen to be depreciated. The US view is that given its relative size and importance, the Japanese economy should be allowed to recover, and weakening the Yen could be one way of stimulating Japan's recovery. As a result of a depreciating Yen, investment should increase with a weak Yen making Japanese goods and services more competitive (i.e. cheaper), thereby increasing the demand for the supply of Japanese goods and services, stimulating Japanese exports. On the other hand when evaluating the comparative strength and size of the Japanese economy, the weak currency tends to distort the position.

5 Conclusion

The foregoing analysis is based on the principle of ceteris paribus. The analysis is accordingly constrained by the impact of other factors that have not been taken into account and/or the compounded effect of several minor variations. Moreover, the BOP is merely one of the tools used to evaluate the economic health of a country; other factors include GDP, inflation, interest, etc.

Whilst the BOP is overwhelmingly positive, appearing to be stable, with the prospects of recovering economic indicators, the fundamental problem that has to be overcome relates to reversing Japan's deflationary position, following the stock market crash of 1989. This requires a fundamental restructuring of Japan's economic and monetary policies. It is expected that bouyant export growth would continue to be the cornerstone of Japan's economic recovery, driven by strong demand from China.

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