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Saori N. Katada [a]
[a] School of International Relations, University of Southern California, Los Angeles, CA, USA

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From a supporter to a challenger? Japan's currency leadership in dollar-dominated East Asia

Saori N. Katada

School of International Relations, University of Southern California, Los Angeles, CA, USA

ABSTRACT

The dollar dominance in East Asia has depended on its regional support. Japan's supportive policy toward the dollar, however, shifted in the late 1990s as the Japanese government began to address the region's heavy dependence on the dollar, which was regarded as one (but an important one) of the causes of the 1997 Asian Financial Crisis (AFC), by promoting the use of the yen in the region and regional monetary initiatives. Despite emerging signs of those challenges, Japan's domestic resistance and the region's power rivalry between Japan and China still makes the dollar the currency of choice in the medium term future.

KEYWORDS

Exchange rate; international currency; dollar dominance; Japan; regionalism; East Asia.

INTRODUCTION

The status of the US dollar (hereafter dollar) as the dominant international currency has depended and will depend on the willingness of other countries to hold and use dollars for their national and international transactions. In that sense, Japan has, for the last half century, been a faithful supporter of the dollar-dominant global economy. Despite obvious economic and political gains that Japan could have expected from currency leadership, particularly in East Asia,[1] and despite the country's seeming ability to challenge the US financial power by the late 1980s,[2] the Japanese government did not show serious interest in challenging the dollar domination. Japan's supportive policy toward the dollar, however, shifted in

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the late 1990s when the Japanese government began to address the region's heavy dependence on the dollar, a dependence which was regarded as an important cause of the 1997 Asian Financial Crisis (AFC), by promoting the use of the yen in the region and by taking regional monetary initiatives.

The Japanese government's newly acquired currency interests in the regional political economy take both offensive and defensive forms. Japan's Ministry of Finance (MOF) has clearly realized the benefits that could come from an active promotion of the yen as an international currency; for one, Japanese companies would have an easier and less costly time managing their foreign exchange risks, and more importantly after the 'Big Bang' financial liberalization of the late 1990s, it would contribute to the development of Tokyo as an international financial center. The yen bloc in East Asia would also add to macroeconomic stability and microeconomic benefits.[3] A defensive rationale for promoting the yen's international role lies in the country's desire to insulate itself from the impact of the global economy as the country faced severe recession.[4] Throughout the 'lost decade' of the 1990s and as the rise of China became visible, the Japanese economy and the yen lost its clout. In this context, the renewed push toward wider use of the yen has also aimed at hanging on to its relative dominance in monetary and financial matters in the region. Those defensive instincts lead to the Japanese strategy of cultivating followership in the region: the smaller East Asian countries with limited foreign exchange reserves in their coffers might, for the same defensive reason, long to pool their resources to fend off attacks on their currencies by 'hanging together' in the face of currency competition.[5] Japan, as the regional monetary leader, can seize the opportunity to take the lead in matters of regional monetary governance.

In spite of those interests and its concern over the 'global imbalance' mainly caused by the US current account and fiscal deficits, Japan's direct challenge to the dollar dominance in the region has been very slow to surface. In agreement with Helleiner, politics of money influence greatly Japan's hesitance and inability to challenge dollar dominance in the region. Such hesitancy, arising from both indirect and direct power of the dollar as discussed below, has ironically deprived East Asia of the opportunity 'downgrade' the dollar as a 'negotiated' currency.[6] Furthermore, there are mixed signs from Japan in the face of East Asian monetary cooperation, all of which cast doubt on the likelihood of serious challenge to the dollar in the region. I argue that the difficulty of Japan's currency challenge in the region comes largely from political factors, both domestic and regional. At the domestic level, centrally important is a domestic political division regarding the foreign exchange strategies created by the country's long dependence on the dollar. The main regional political factor is the rivalry and disagreements between Japan and China regarding regional financial issues. The former has curbed Japan's motivation to de-dollarize in the

1980s and has prevented the Japanese government from swiftly moving to internationalize the yen in the 1990s. The latter, meanwhile, has since the mid-1990s given Japan a strong incentive to take measures towards increased yen's regional status, but at the same time, made it difficult to dominate the regional monetary discussion since the AFC.

In this paper, I first discuss Japan's dollar dependence and its prolonged resistance to internationalize its currency long after it gained financial prominence in the world. Then the paper analyzes the shift of Japanese currency politics in the post-AFC East Asia, as the challenges of 'double-mismatch' loomed large in threatening the monetary and financial (thus economic) stability of the region. After outlining recent actions taken by the Japanese monetary authority (mostly the MOF) to overcome the country/region's dollar dependence, the paper summarizes the multiple sources of challenge that are slowing the progress of those initiatives. Finally, the paper concludes by analyzing the future trajectory of the dollar for Japan and for East Asia.

JAPAN IN SUPPORT OF THE DOLLAR'S MASTER CURRENCY STATUS

For the five decades since end of World War II, the dollar was a 'Master' or 'Top' currency for Japan and in East Asia; Japanese external economic relations with the United States and with the rest of the world operated through the dollar. Since the early postwar years, the dollar has served an important political function of integrating the Japanese economy back into the world. On the one hand, Japan's heavy reliance, both security and economic, on the United States throughout those decades after the country regained independence made the dollar dependence inevitable. On the other hand, the dollar together with the American security interests in the region connected Japan with Southeast Asia as early as the late 1940s as China was 'lost' to Communism.[7] The stable and undervalued exchange rate under the Bretton Woods System helped increase Japanese exports to the US market, until the end of this pegged exchange rate system in the early 1970s ushered in the era of floating yen–dollar exchange rates and Japan's exchange rate 'obsession'.[8]

By the late 1980s, the Japanese government was positioned to extend its currency power at least in the region. The Japanese capital account was liberalized from 'closed in principle' to 'free unless prohibited' through revision of the Foreign Exchange and Trade Control Law on Foreign Capital Transactions in December 1980. The Japanese government also implemented steps towards both expanding the euro yen market and liberalizing Japan's financial and capital markets in response to the US pressure in the form of the 1984 Yen–Dollar Committee.[9] Within East Asia, Japan's FDI amounted to more than $11 billion between 1987 and 1990[10] supported

Source: IMF, International Financial Statistics, various issues

Figure 1 Yen-Dollar Exchange Rate Fluctuation 1971–2006

and pushed by the dramatic *endaka* (high/strong yen; Figure 1) as a result of the 1985 Plaza Accord. The migration of manufacturing firms from Japan triggered Japanese bank loans to the region, as the banks followed their old customers abroad.[11]

Yet, Japan's increased financial power throughout the decade since 1985 included only a limited increase in the use of yen to replace Japan's traditional reliance on the dollar for its economic transactions in the region. The only visible increase came in the form of Japan's use of the yen in its imports from Southeast Asia (Table 1) from 2% in 1983 to almost 20% in 1989, accounting for the reverse imports of goods produced by Japanese manufacturing companies relocated in Southeast Asia. The Japanese companies trading and/or operating in the region largely maintained their preference of invoicing their exports and imports in dollars.[12] Official holding of the yen among the Asian countries went up nominally, due the yen appreciation, from 15% of all holdings in 1983 to 30% in 1987 but then decreased to 17% by 1990.[13] Thus, the concerns for the formation of the yen bloc among American economists during this period never materialized.[14]

Market-driven currency inertia obviously played a role in the slow progress of yen's international use,[15] but more curiously, there was a clear lack of motivation on the part of the Japanese government to shift from a supporter to a challenger of the dollar's international role. First, Japan's continued dependence on the United States for security and market was an important backdrop of such reluctance. Second, there were various layers

Table 1 Currency denomination of Japan's foreign trade by region, 1980s through 2000s (percentage)

	1983		1989		1992		1998*		2001*		2004		2005	
	Yen	Other	Yen	Other	Yen	Other	Yen	Other	Yen	Other	Yen	Other	Yen	Other
Exports														
All regions	*40.5*	*59.5*	*34.7*	*65.3*	*40.1*	*59.9*	*36.0*	*64.0*	*36.1*	*63.9*	*40.1*	*59.9*	*38.4*	*61.6*
N. America	14.0	86.0	16.4	83.6	16.6	83.4	15.7	84.3	13.2	86.8	12.9	87.1	12.3	87.7
W. Europe	51.0	49.0	42.2	57.8	40.3	59.7	34.9	65.1	33.5	66.5	29.3	70.7	29.3	70.7
S.E. Asia**	48.0	52.0	43.5	56.5	52.3	47.7	48.4	51.6	50	50	45.5	54.5	48.8	51.2
Imports														
All regions	*3.0*	*97.0*	*14.1*	*85.9*	*17.0*	*83.0*	*21.8*	*78.2*	*23.5*	*76.5*	*23.8*	*76.2*	*22.1*	*77.9*
N. America	5.0	95.0	10.2	89.8	13.8	86.2	16.9	83.1	20.8	79.2	20.7	79.3	22.8	77.2
W. Europe	13.0	87.0	27.7	72.3	31.7	68.3	44.3	55.7	49.7	50.3	34.1	65.9	32.4	67.6
S.E. Asia**	2.0	98.0	19.5	80.5	23.8	76.2	26.7	73.3	24.8	75.2	27.2	72.8	26.7	73.3

*All information is based on the report in September except 1998, whose numbers come from March of the year, and 2001, whose numbers come from January.

**Southeast Asia includes Indonesia, Malaysia, Singapore, Thailand, Philippines, Brunei, Myanmar, Laos, Cambodia, Vietnam, South Korea, Taiwan, India, Pakistan, Sri Lanka, Maldives, Bangladesh, Afghanistan, Nepal, and Bhutan.

Source: Ministry of Finance, Annual Report, various issues.

of domestic resistance against internationalizing the yen. On the one hand, the Japanese monetary authority was reluctant to lose its macroeconomic policy autonomy by allowing the yen to move freely in and out of Japan. Although some parts of the MOF were in favor of the yen's increased use overseas, there was a clear split on the issue. On the other hand, there was also resistance against domestic financial liberalization. This led to the underdevelopment of short-term financial market that made the Japanese yen unattractive.[16] Furthermore, the very fact that Japanese import market remained relatively closed, and that the country has long been unwilling to run a current account deficit has also contributed to make the future scenario of the yen bloc unlikely. Finally, the dollar served as the key currency for economic transactions in East Asia, as most of those economies closely pegged their local currencies to the US dollar. Therefore, Japanese business operations in the region have never needed complex transaction with the region's local currencies, reducing the incentive to internationalize the yen or to develop the capital market to allow yen–local currency convertibility.[17]

MAKING JAPAN A CHALLENGER? ASIAN FINANCIAL CRISIS SHOCKS

The experience of the AFC and changes in Japan's domestic financial conditions in the late 1990s kicked off Japan's currency challenge. The problems associated with a soft currency peg to the dollar under the strong internal and external pressure toward financial liberalization was an important part of the AFC trigger in Thailand in the spring of 1997. In the process of academic and policy debates over the cause of the AFC, the Japanese experts labeled the crisis as capital account crisis, and attributed it fundamentally to a structural problem of 'double-mismatch'.[18] The mismatch comes both in the length of maturity of financial instruments, and in the choice of investment currency. In a way, some of those Asian countries suffered from both the 'original sin' and the 'conflicted virtue'.[19] From the post-AFC East Asian perspective, it made little economic sense to send surplus savings to Western financial centers, and then borrow in dollars with a high risk premium, and much less so if the region would become more financial crisis prone.[20]

There was also a 'politics of resentment' that added to the double-mismatch, where the United States and the IMF were blamed for East Asia's economic turmoil.[21] Such resentment was also targeted at the United States' dollar hegemony within the regional monetary structure. This concern has been exacerbated especially since the late 1990s, as dollar dominance in this surplus region has become imperative for the US government to manage its expanding net liability to the rest of the world as it services its debt in its own currency.[22] Japan shares at least a part of the blame for the Asian crisis:[23] its short-term and long-term responses illustrated below indicate Japan's struggle to establish stable currency environment for the country and the region.

The Japanese monetary authority's immediate reaction in attempt to overcome dollar dominance in East Asia was to push towards internationalization of the yen (here it is meant to increase the use of the yen in East Asia). The time was ripe for this renewed move, as the country was just starting to go through the process of the 'Big Bang' financial reform put in place by the Hashimoto Cabinet in 1996. Increased use of the yen abroad would help strengthen Tokyo's ability to become one of the world's most important financial centers by increasing the access of foreigners to the Tokyo Market.[24] Additionally, the successful launching of the euro in January 1999 created a major currency that could potentially compete with the US dollar. Following those developments, the Council on Foreign Exchange and Other Transactions published a report on 20 April 1999 emphasizing Japan's foreign exchange challenges at hand:

> [R]ecent economic and financial environments affecting Japan point to the need for the greater internationalization of the yen. On the international front, one of the causal factors of the Asian currency crises is said to be the over-dependence on the U.S. dollar, while the emergence of the euro – which may have a major impact on the present dollar-based international money system – calls for a reconsideration of the role of the yen. On the domestic front, radical measures for the liberalization of the financial and capital markets are being taken under Japan's 'Big Bang' with the aim to promote Tokyo as an international financial market on par with New York and London.[25]

Several actions were taken to make Japan's short-term capital and money market more attractive, including a withholding tax exemption for non-residents and foreign corporations that earned interest income from Japanese government bonds, maturity diversification of government bonds, and the improvement of settlement systems to facilitate cross-border transactions. These attempts to enhance yen internationalization did not bear much fruit. The recent numbers demonstrate that the Japanese currency has not made any headway in becoming more widely used either as an invoice currency for trade (Table 1), or as currency of choice for the official holdings of foreign exchange reserves (Table 2). The latter is particularly striking, as the Euro has gained more weight as a reserve currency since its establishment in 1999.

Following the (thus far failed) policy of yen promotion, the Japanese government has also launched regional currency initiatives. As the first step towards the Asian Monetary Union (AMU), economists and policymakers in Asia conducted a joint study with the European Union (the so-called

Table 2 Official holdings of foreign exchange reserves: 1980s through 2005

		1980	1985*	1990	1992	1994	1996	1997	1999	2001	2003	2005
All countries	US dollars	68.6	55.3	49.4	54.2	55.7	48.5	51.3	55.0	55.7	48.8	45.1
	Pound Sterling	2.9	2.7	2.8	3.0	3.3	2.1	2.0	2.2	2.1	1.9	2.4
	Deutsche mark	14.9	13.9	17.0	13.6	14.4	11.5	11.4	0	0	0	0
	French franc	1.7	0.8	2.3	2.5	2.4	1.4	1.1	0	0	0	0
	Japanese yen	4.4	7.3	7.9	7.6	7.9	5.3	4.5	4.7	4.1	2.8	2.6
	ECUs		11.6	10.1	10.1	8.1	5.5	4.8				
	Euros								13.9	14.3	18.3	16.9
	Other or unspecified	7.5	8.4	10.5	10.9	8.3	25.7	24.9	24.2	23.8	28.2	33.0
Industrial countries	US dollars	77.2	50.1	44.9	48.4	50.8	56.0	58.0	72.4	73.1	69.6	73.1
	Pound Sterling	0.8	1.6	1.4	2.2	2.3	2.0	2.0	2.1	2.0	1.6	2.1
	Deutsche mark	14.3	16.7	19.4	14.9	16.3	16.0	16.0	0	0	0	0
	French franc	0.7	0.1	2.3	2.8	2.4	2.0	1.0	0	0	0	0
	Japanese yen	3.3	7.6	8.5	7.5	8.2	6.0	6.0	6.5	5.8	3.9	3.4
	ECUs		20.1	14.5	16.7	14.6	12.0	11.0				
	Euros								16.9	17.0	22.3	19.3
	Other or unspecified	3.7	3.8	8.9	7.5	5.5	6.0	6.0	2.1	2.1	2.6	2.1
Developing countries	US dollars	59.9	62.5	59.5	63.1	61.7	42.1	46.2	43.3	44.6	36.8	31.8
	Pound Sterling	5.1	4.3	6.1	4.2	4.5	2.2	2.1	2.2	2.2	2.0	2.6
	Deutsche mark	15.4	9.8	11.5	11.5	12.1	8.0	8.0	0	0	0	0
	French franc	2.7	1.9	2.3	2.1	2.4	1.2	1.3	0	0	0	0
	Japanese yen	5.4	6.8	6.6	7.9	7.5	5.0	3.6	3.5	3.0	2.2	2.2
	ECUs						0.0	0.0				
	Euros								11.9	12.5	15.9	15.7
	Other or unspecified	11.5	14.7	14.0	12.5	13.4	42.5	38.8	39.1	37.7	43.1	47.7
Selected Asian countries	US dollars	48.6	58.2	56.3	55.8	57.8	**	**	**	**	**	**
	Pound Sterling	3.0	3.5	8.1	6.3	6.0	**	**	**	**	**	**
	Deutsche mark	20.6	14.6	16.6	16.3	15.0	**	**	**	**	**	**
	French franc	0.6	0.6	0.9	1.0	1.2	**	**	**	**	**	**
	Japanese yen	13.9	16.3	12.2	14.2	13.7	**	**	**	**	**	**
	Other or unspecified	13.3	6.8	5.9	6.4	6.3	**	**	**	**	**	**

Sources: IMF, Annual Report, various issues, On Asia, Tavlas and Ozeki (1992).
*The numbers for selected Asian countries is for 1984. ** Not available.

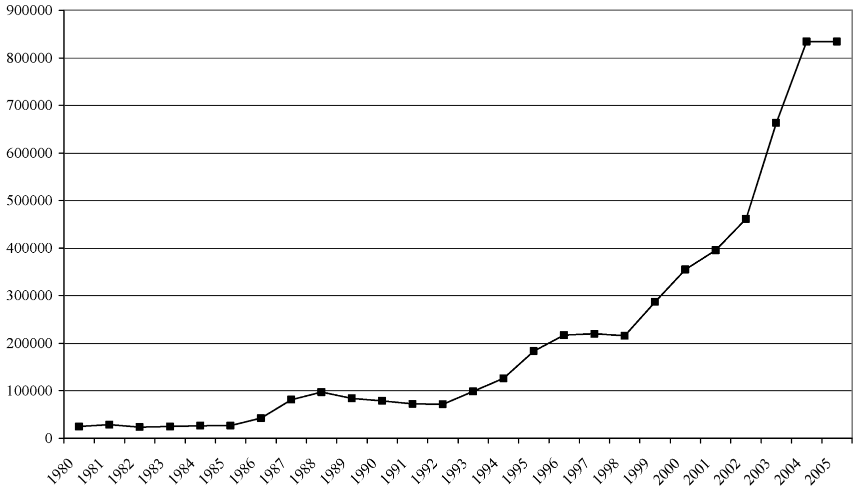
'Kobe Research Group'), whose report came out in July of 2002 and recommended monetary integration process for phase one (to be completed by 2010); preparation for a single currency for phase two (to be completed by 2030); and launching of a single currency in phase three that starts in 2030.[26] The second and most current initiative is related to the idea of Asian Currency Unit (ACU), floated initially in late 2005 by the newly established Office of Regional Economic Integration at the Asian Development Bank (ADB) under the leadership of its then director Masahiro Kawai, and the new ADB president Haruhiko Kuroda.[27] The proposed ACU models itself after the European Currency Unit (ECU) that existed as the region's currency unit before the euro came about, and constituted a unit of exchange based on the weighted average of values (basket) of currencies. The ACU idea was picked up by the ASEAN+3 at the finance ministers' meeting in May 2006, where all 13 participating governments agreed to conduct in-depth research on its feasibility.[28]

Even in the context of the Chiang Mai Initiative (CMI), the emergency currency swap mechanism which developed within a few years of the AFC, the currency issue was visible. First, when the CMI was set up in 2000–2001, the Japanese and Chinese monetary authorities agreed to denominate their bilateral swap in their own currencies, the yen and the RMB among the original total of $35 billion bilateral swaps. Furthermore, in February 2006, South Korea and Japan agreed to expand the bilateral swap between the two countries and do so between the yen and the won.[29] This is considered by all the member governments as a step forward from predominantly dollar-based currency swaps. As the success of the CMI led to the doubling of its commitment in 2005, the member countries endorsed the efforts towards multilateralization.[30] Some Japanese experts speculate that the future institution that houses the CMI process can also function as a currency clearing house, playing a role similar to that played by the Bank for International Settlements for the ECU since its inception in 1979.[31] Furthermore, at the ADB annual meeting in Kyoto in May 2007, the monetary authorities from the ASEAN+3 member countries agreed to multilateralize the collection of swap lines, a decision which would arguably be leading the CMI increasingly similar to the original Asian Monetary Fund scheme proposed by Japan at the height of the AFC.[32]

Finally, and in conjunction with currency initiatives, the Japanese government along with East Asian central bankers and finance ministries launched the Asian Bond Initiatives. Those experts, concerned about double-mismatch, argued that creation of long-term financial instruments in the region was critical.[33] The creation of a regional bond market is considered to facilitate development of regional currency markets, as this promotes the prospects of regional bond issuance denominated in the ACU.

The region has shown quite uncharacteristic activism toward monetary cooperation, and the Japanese government has clearly demonstrated its willingness to challenge dollar dominance in East Asia. Nonetheless, signs of (even increasing) dollar dependence continue in the region. The most prominent sign is the massive accumulation of US dollars within countries' foreign exchange reserves, as those governments, including Japan, have tried to buffer themselves from the challenges of volatile dollar-denominated short-term capital flows and/or foreign exchange rate fluctuations. According to the BIS research, the aggregate foreign exchange reserves among the Asian countries as of July 2006 is almost $2 trillion, and adding Japan to the mix, the total accumulation reaches close to $3 trillion.[34] Now East Asia is more than ready to fend off their currencies with such massive accumulation of the dollars in their respective coffers. Nevertheless, the region's trade surplus, governments' concerns for inflation, and its preference for weak currency for exports make it likely for the region to keep accumulating the dollars.

Pointing to Japan alone, the dramatic pace with which the Japanese monetary authority has accumulated its mainly dollar-denominated foreign exchange reserve since the late 1990s (around $300 billion) to 2006 (over $800 billion) is impressive (Figure 2).[35] Needless to say, accumulating such massive dollar reserves is both expensive and risky. It is expensive because central banks usually hold those reserves in the form of short-term US Treasury securities whose yields are much lower than other domestic or international assets. Accumulation of dollar reserves is also risky due to possible adverse exchange rate movements.[36] Furthermore, the concerns



Sources: Ministry of Finance, International Reserves/Foreign Currency Liquidity, the numbers from end of the year

Figure 2 Japan's Foreign Exchange Reserves 1980–2005 for the 'global imbalance' that could arguably lead to the collapse of the dollars would, however, force Japan and the region to consider a contingency plan.[37]

In sum, it is true that East Asia has seen a progress in regional monetary and financial cooperation since the AFC with the aim to hedge against future financial crises. Ironically, though, their dollar dependence has also intensified over the same period, demonstrating how difficult it is for the region to de-dollarize.

THE FORCES AGAINST DE-DOLLARIZATION IN EAST ASIA

The changes in expectations regarding Japan's financial market after the 'Big Bang' and the AFC have definitely triggered a shift in Japan's position towards the dollar. There are increasing gains to be had and risks to be avoided by creating its currency space in the region. By turning the dollar into at least a 'negotiated' currency, Japan would gain more leverage.[38] But why has the progress of 'de-dollarizing' Japan's economic transaction in the region and beyond been so painfully slow, and why has the Japanese position remained ambivalent? I list two forces that are stalling the shift. One is the 'porous' economies in Japan and East Asia, created by the US structural power, which firmly establishes domestic resistance against de-dollarization.[39] The other is the power relations between Japan and China.

The business concerns and Japan's export dependence on the United States continues to steer Japanese companies to use the dollars. On the business level, Japan's continued dollar dependence arises from domestic resistance among important business entities against de-dollarization. According to the survey research conducted by Keizai Doyukai (Japan Association of Corporate Executives) in 1999, 73.7% of 76 Japanese companies (both manufacturing and services) would support increased use of the yen instead of the dollars for their international business transactions. Despite of such hope, 70 to 80% of the responses from the very same companies see the increased use of the yen either very difficult or impossible.[40]

There are many obstacles toward de-dollarization for the Japanese businesses, which dwindles its political support. First, foreign exchange transactions have developed into an important business not only for Japanese banks but also for the central sections of Japan's leading trading and manufacturing companies. Because those entities make substantial profits in currency trading, hedging and arbitrage, they are at best lukewarm to the idea of the use of the yen.[41] Especially given very sophisticated foreign currency hedging instruments available for large Japanese companies over the years, there is only limited interest in shifting all transactions into the yen, which itself incurs a one-time high cost.[42] Second, globalized businesses from Japan, the largest creditor in the world, have a high level of foreign investment in the dollar areas in the world. Third, the exporting companies, which tend to price to the market and for the customers, particularly in the United States, have preferred to use the dollars. In addition, these companies would be concerned about appreciation of the yen as a result of increased use of (thus demand for) the yen. Finally, Japan's large natural resource import needs lead those importing companies to rely on the dollars, too.

On the national level, there is evidence that Japan is still vulnerable to US structural power. For example, the massive dollar reserves accumulated by Japan (and China) would have made the United States more vulnerable to Japan's actions, and in fact there is a rising concern on the part of the US government regarding East Asia's financing US government debts through the purchase of those securities. Actually, such concern emerged in the late 1980s under the Reagan Administration when the concentration of Japan's purchase in short-term US Treasury obligations was around 20%, but recently the share has reached as high as 51.8% (2000) and has hovered around 40% in the first half of the 2000s.[43] However, there is no evidence that Japan is using this massive dollar accumulation to its political leverage.[44] In addition, US skepticism has also hindered the discussion on the ACU at the ADB, where the United States has as strong a presence as Japan.[45]

The second is the strong power rivalry that exists between Japan and China, on which the success of regional monetary cooperation is dependent.[46] Both governments generally share similar concerns regarding the dollar dependence of the region, particularly given the rise of the 'global imbalance' emanating from the US's economic overextension in recent years.[47] Nevertheless, their respective focal points of the regional financial architecture are distinct, largely due the differences in level of financial development and openness between the two countries and in their contrasting position on currency matters. Japan, the currently dominant but declining power with the strongest financial and technical capacity in the region and with the internationally accepted currency, would want to use its present currency power to lock in the existing disparity by formalizing arrangements such as the wider use of yen in the region. Meanwhile, the Chinese authorities wish to prevent Japan from locking China in at a subordinate place, as the RMB currently has no way of competing against the wider use of the yen in the region.[48] The Chinese authorities are in no hurry to compete with Japan to make the RMB a key currency, for that would require liberalization of China's capital account and massive reform of the country's financial system, both of which are politically risky.[49] Furthermore, China's insistence on having high weight of the RMB in the currency mix has reportedly burdened the discussion of the ACU.[50] In addition, recent accumulation of the foreign exchange by the Chinese authority is creating heightened concern not only on the part of the US government, but also many in East Asia. The Chinese government has recently established so-called 'sovereign wealth funds (SWFs)' scheme where it would put the country's swelling foreign exchange reserves in a specialized investment agency to be invested into foreign assets other than the US treasury bonds. The China Investment Corporation, which is said to open an office in the latter part of 2007, would be managing up to $300 billion. This would add an additional unknown player in the financial market whose corporate governance would not be at all transparent, but would also increase the politicization of capital flows and buying spree.[51]

In sum, the currency challenges are very deep-rooted in both financial and political interactions within Japan and among Asia Pacific. The gradual building of a regional monetary and financial architecture has only started to layout a possible alternative scenario, but it is rife with challenges.

CONCLUSION: THE FUTURE OF THE DOLLAR FOR JAPAN AND FOR EAST ASIA

The current efforts led by the Japanese government to de-dollarize regional economic exchanges hold the key to Japan's future relationship with the dollar. Given Japan's dependence on large market and resources of the United States, US–Japan bilateral transactions are likely to remain largely dollar-based. Meanwhile, given the increased intra-regional trade and investment links, along with the AFC shock that shifted the preferences of the East Asian leaders, the region is now in search for an alternative (or 'backup') to dollar dominance. Additionally, uncertainty associated with intensifying financial globalization and the 'global imbalance' will keep the regional players motivated for the strengthened regional financial cooperation.

A mountain of challenges exist, however, both inside and outside Japan in constructing support for the yen and/or regional currencies with appropriate representation of the yen. The United States would, of course, be opposed to such moves that would 'downgrade' the dollar into a 'negotiated' currency in the region, particularly at the time when American capital needs are very high. And regional consensus is not easily forthcoming, as China would also make sure that Chinese interests in regional currency arrangements are centrally reflected. Equally important, Japanese private financial entities as well as large businesses have to back up the government initiative and be willing to pay the costs (both the one-time transformation cost and the opportunity costs of lost business) of the fundamental policy shift. Even as the Japanese economy shows signs of recovery after a long recession, a heavy doze of optimism is needed before one can imagine East Asia with a currency arrangement that can compete effectively with the dollar.

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NOTES

1 Cohen (2004: 19–24) lists four benefits of monetary monopoly: (a) macroeconomic management in the form of balance-of-payments financing, (b) seigniorage privilege, (c) political symbolism in the form of enhanced state's overall reputation, and (d) monetary insulation from external influence.
2 Burstein (1988) and Murphy (1993).
3 Kwan (2000: 115–21). He also argues that the yen bloc will stabilize the currency regime in the region thereby supporting a more stable trade and investment environment.
4 Grimes (2003) and Helleiner (2000).
5 For Japan's concerns for cultivating followership, see Katada (2002), and about the 'hang-together' dynamics, see Cohen (2004: 153–78).
6 Helleiner (this volume).
7 Borden (1984: 122).
8 Kojo (1996: 152–5) explains the political foundation of Japan's exchange rate obsession. Despite Japan's relatively low export dependence (9.5% to GDP in 1970), politically powerful industries such as steel, home electronics, textile, auto manufacturing, and ship-building can induce political actions through lobbying groups such as Keidanren. In addition, trade-dependent small and medium industries, which were very concentrated and closely tied to local economies, mobilized the rural-based LDP politicians. Despite interventions in support of weak yen to enhance export competitiveness, the Japanese yen has appreciated since the abandonment of fixed exchange rates in 1973 (Figure 1; appreciation means less yen to a dollar), until it hit relative plateau between 1978 and 1985.
9 Frankel (1984), Grimes (2003), Laurence (2001), and Kojo (1996).
10 The data from Pempel (1997: 60).
11 Hatch and Yamamura (1996: 67–71).
12 Sato (1999: 549–50) summarizes several studies on the Japanese companies' trade invoicing patterns and notes that the 'pricing-to-market' behavior has been the key determinant, and that behavior is applied not only to the exports to the United States, but also to East Asia. In addition, Japan's resource import needs, particularly that of petroleum, which is largely invoiced in the dollar, reinforces Japan's dollar reliance in trade.
13 Tavlas and Ozeki (1992: 40).
14 Frankel (1993).
15 In general, such currency inertia arises from high transaction costs of changes, vested interests, and other considerations. See Krugman (1984: 268–9).
16 There was 'dual track' liberalization: relatively fast external financial liberalization and relatively slow internal liberalization. See Katada (2006).
17 In addition, there has been a boom in Asian Non-Deliverable Forward (NDF) market trade where seven Asian currencies are traded over the counter. The NDF contracts are settled not by delivering the underlying set of currencies, but through a net payment in the US dollars proportional to the difference

between the agreed forward exchange rate and the spot rate. This would allow the hedging for the foreign investors with local currency exposure, which also minimizes the foreign exchange transaction costs. See Ma *et al*. (2004). The magnitude of daily trading in Asian NDF markets in September 2006 are: $2 billion for Korean won, $1 billion for Taiwanese dollar, and a bit more than half a billion dollars for Chinese RMB and Indian Rupee.

18 Yoshitomi and Ohno (1999).

19 According to Eichengreen and Hausmann (1999), 'original sin' occurs when, due to lack of broad and deep bond markets in the currency and due to poorly developed forward market, countries are forced to borrow in currencies other than their own without expensive hedging. McKinnon (2005: 6–9) examines 'conflicted virtue', where, due to their balance-of-payment conditions of large dollar surpluses, those countries *cannot lend* in their own currencies. In the case of East Asia, those countries lend to foreigners (especially the Americans) by acquiring dollar claims.

20 Rowley (2003).

21 Higgott (1998). Japan is not an exception in accusing the United States for Japan's own economic difficulties. As the Japanese recession of the 1990s prolonged, it became quite fashionable and accepted to accuse the United States for Japan's bubble economy and difficult recovery. For example, Kikkawa (1998).

22 D'Arista (2004: 558) characterizes these dynamics as 'the current monetary system as a primary bulwark for U.S. hegemony'.

23 The Japanese culpability of the AFC ranges from the exporting of its bubble economy (Nordhaug, 2005), rapid depreciation of the yen against the dollar after spring 1995, its reluctance to keep its investment in Thailand at the early stage of the crisis, and its reluctance to provide bilateral rescue packages prior to the IMF's involvement (Katada, 2001).

24 In addition, many note that the MOF has been quite concerned about the sustainability of the country's government bonds, and hoped to increase the number of potential customers by increasing use of the yen. Interviews, Tokyo, Japan, October 2000.

25 Council on Foreign Exchange and Other Transactions (1999: 1–2). This council and its subcouncil on the internationalization of the yen were given a mandate by the MOF to provide recommendations regarding the issue.

26 IIMA (2004).

27 Both of them have already been involved in regional financial cooperation from Japan; Kawai as an economics professor and former deputy vice-minister of international affairs of the MOF, and the director of MOF-affiliated Policy Research Institute from the late 1990s into the early 2000s. Kuroda has been the high ranking MOF official, working as the vice-minister of international affairs until shortly before his appointment to the ADB presidency.

28 *Nikkei Shimbun*, 5 May 2006.

29 *Nikkei Shimbun*, 25 February 2006. At the time of currency crisis, the agreement allows South Korea to withdraw up to $10 billion worth of the yen from Japan, and Japan's swap ceiling is $5 billion worth of won from South Korea. According to a Bank of Japan official, the Asian currencies could be only used for the swap during the time of normalcy, while the US dollar will likely to be used under the crisis. Author's interview with a Bank of Japan official, July 2007.

30 Here, the term 'multilateralization' is used to mean that the CMI will move from a collection of bilateral swaps to a minilateral (and regional) institution where emergency funding commitments are pooled under an umbrella regional organization. The idea of a multilateralized CMI is almost equivalent to

Japan's ill-fated idea of an Asian Monetary Fund that died a premature death in November 1997.

31 Author's interview with an executive at the Institute for International Monetary Affairs (IIMA), July 2006.

32 On the details of Japan's AMF proposal, see Lee (2006). The joint ministerial statement on the CMI multilateralization underlines the commitment on the part of finance ministers to work towards this objective and conduct studies on its key elements including 'surveillance, reserve eligibility, size of commitment, borrowing quota and activation mechanism' (http://www.mof.go.jp/jouhou/kokkin/frame.html, accessed 12 July 2007). The MOF official in charge of regional cooperation, however, clearly noted that this multilateralization will not mean the rebirth of the AMF. No standing institution (like the IMF) is currently envisioned.

33 For the most up-to-date analysis of Asian Bond Initiatives, see Grimes (2006: 364–6).

34 Mohanty and Turner (2006: 41).

35 China, on the other hand, has done the same and has overtaken Japan with $900 billion in reserves by early 2006.

36 For a discussion on the social cost of accumulating foreign exchange reserves, see Rodrik (2006).

37 Kishi (2007: 57–60).

38 For a discussion of international currencies as 'negotiated' currencies, see Strange (1971).

39 Katzenstein (2006).

40 Keizai Doyukai (2000).

41 For example, Bank of Tokyo (before its merger) foreign exchange dealings were substantial part of earnings in the fees and commissions category at 46% in 1995 and 1996, while, after the merger with Mitsubishi Bank, that ratio dropped to about 30% (2001). Yukashoken Hokokusho (Financial Report), various years.

42 Interview with a MOF official and a former Bankers in Tokyo, Japan, July 2006.

43 Treasury International Capital Reporting System.

44 I have repeatedly asked Japanese financial experts and officials about the possibility of using this large accumulation of US Treasury obligations to increase Japan's bargaining advantage, but all of them are, at least in my interviews, very skeptical about any means in which the Japanese government can do so. In the word of one official, 'the fate of Japan's economy is so tied to that of the United States, the Japanese government cannot call any bluff (in blackmailing the United States)'. The words in the parenthesis are added by the author. Interviews in Tokyo, Japan, July 2006.

45 Anthony Rowley (2006) notes the US opposition to use the ADB as the forum of ACU discussion because it 'divert[s] scarce human and financial resources from the ADB's core mission of combating poverty'. As such, the ACU discussion has moved to the ASEAN+3 forum (where the United States is not a member). The latter statement corroborated by my personal interviews in Tokyo, Japan, July 2006.

46 Grieco (1997) explains that the lack of institutionalization in East Asia is due to a 'relative disparity shift' that is taking place in this region, where the rapidly rising power is reluctant to make institutional commitments.

47 Duncan (2005), for example.

48 Factors that inhibit the Chinese yuan's use as a key international currency include China's relatively high inflation rate, its undeveloped financial and capital markets, and its stringent capital controls.

49 *Nikkei Shimbun*, 26 June 2006 featuring the discussion by C. H. Kwan at the conference on the Future of Asia held in Tokyo.

50 *Nikkei Shimbun*, 5 May 2006.

51 China is not the only country that is engaging in such use of foreign reserves, various countries ranging from Norway to Singapore to Botswana to Kazakhstan are in the global club of SWFs. It is estimated that there is potentially $2.5 trillion in those funds, which is larger than the global hedge fund industry. In the past, acquisition of telecommunications group owned by the ousted Prime Minister Thaskin of Thailand by the Singaporean state investment company Temasek has raised political eyebrows. See John Plender (2007), Tony Tassell and Joanna Chung (2007).

NOTES ON CONTRIBUTOR

Saori N. Katada is Associate Professor at School of International Relations, University of Southern California. She is the author of a book *Banking on Stability: Japan and the Cross-Pacific Dynamics of International Financial Crisis Management* (Michigan University Press, 2001: 2002 Masayoshi Ohira Memorial Book Award). She also edited the book *Global Governance: Germany and Japan in International System* (Ashgate, 2004). Katada has numerous articles on Japanese foreign economic policy toward countries in the Pacific Rim.

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