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SHIBATA, Tokutaro / 柴田, 徳太郎

(出版者 / Publisher)
法政大学比較経済研究所 / Institute of Comparative Economic Studies, Hosei University

(雑誌名 / Journal or Publication Title)
Journal of International Economic Studies

(巻 / Volume)
7

(開始ページ / Start Page)
41

(終了ページ / End Page)
66

(発行年 / Year)
1993-03

(URL)
https://doi.org/10.15002/00002098

Journal of International Economic Studies (1993), No.7, 41-66

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Tokutaro Shibata
Faculty of Economics, University of Tokyo

1. The international banking and financial markets in the 1980s

1.1 Rapid growth of the international banking and financial markets in the 1980s

According to the statistics of the Bank for International Settlements, international banking and financial transactions are defined as both cross-border and local foreign currency ones.

In the 1980s the international banking and financial markets grew much more rapidly than the GNP of any country in the world. The total assets in these markets expanded from $2,900 billion in 1983 to $8,800 billion in 1990 (Table 1). This increase is equivalent to an annual growth rate of 17.3%, which exceeded that of the GNP of any country in the world.

On a net basis, total amount of net assets in these markets expanded from $1,500

Table 1. Componets of international financing (Stocks at end of the year)
(billion dollars, %)

	1983	1985	1987	1990
Total claims in international markets ①	2,878	3,726	6,243	8,800
②/① (%)	88.9	84.2	83.1	82.0
Total claims of reporting banks ②	2,558	3,137	5,187	7,217
③/② (%)	51.5	52.7	95.6	53.6
Double counting due to redepositing among the reporting banks ③	1,318	1,652	4,960	3,867
④/② (%)	48.5	47.3	43.8	46.4
Net international bank lending ④	1,240	1,485	2,270	3,350
④/⑨ (%)	82.7	76.5	68.8	76.6
Double-counting ⑤	60	134	284	559
Net international securityu financing ⑥	320	589	1,056	1,584
⑥/⑨ (%)	21.3	30.3	32.0	36.2
Net new Euro-note placement ⑦		16	53	111
Net international bond financing ⑧	320	573	1,003	1,473
Total net international financing)⑨	1,500	1,940	3,297	4,375

Sources: BIS, *Annual Report*, 1989, 1991, *I.B.F.M.D.*, May 1991.

billion to $4,400 billion at 16.5% annually over the same period. Within this overall development, there was difference in the pace of growth between the activity of the international banking market and that of international securities market. The annual growth rate of the latter (25.7%) far exceeded that of the former (15.3%) over the 1983-1990. As a result, between these years, the latter's share of international banking and financial activity rose sharply from 21.3% to 36.2%, though the international banking sector continued to account for a large proportion of financing flows through the international banking and financial markets. The more rapid expansion in international securities market reflected a marked tendency towards "securitization" in the international markets.

1.2 Main features of international banking activity

1.2.1 Declining flows to developing countries and increasing flows to developed countries

The most significant feature in the development of International banking and financial markets during the 1980s was the contrast between the sharp expansion in bank lending to the developed countries and the stagnation in bank lending to the developing countries. The BIS reporting banks' share of claims on non-OPEC LDCs dropped sharply to 10.7% at the end of 1990, as against 23.6% at the end of 1983. The main reason for this decline was that BIS reporting banks were reluctant to lend to highly indebted developing countries after the onset of the debt crisis of 1982.

In contrast to the steep reduction in bank lending to the capital importing developing countries, international bank lending to the developed countries showed a sharp

Table 2. BIS reporting banks' claims on non-bank entities in the reporting area

(Stocks at end of year, billion dollars)

	1983	1985	1986	1987	1988	1989	1990	1991
Local foreign currency claims on ono-bank entities in:								
Japan	45.9	61.0	113.1	178.3	204.1	214.3	226.8	206.1
Canada	21.9	23.6	22.8	21.4	21.6	23.3	27.7	25.7
United Kingdom	30.4	45.2	58.7	78.2	88.0	117.6	131.7	148.7
Italy	13.2	14.0	19.4	29.0	33.4	41.3	51.8	60.6
France	10.4	11.1	11.8	21.0	18.5	18.9	21.3	21.0
Germany	1.9	1.7	1.8	2.3	3.0	2.8	4.5	6.2
Sweden	8.0	12.0	13.5	19.9	26.6	43.3	65.3	65.0
Total reporting countries	164.9	212.2	298.7	427.6	477.6	562.6	654.0	668.6
Cross-border claims on non-bank entities in:								
Japan	9.7	9.0	18.0	60.2	83.8	126.4	200.8	250.4
Canada	51.1	93.3	114.8	145.6	181.5	217.5	271.7	278.2
United Kingdom	10.3	13.5	16.6	21.5	19.6	24.2	34.6	38.3
Italy	15.0	15.6	23.7	27.4	31.8	39.4	54.7	60.3
France	22.6	22.6	24.5	29.0	32.3	44.1	73.8	81.9
Germany	15.9	19.6	19.5	20.9	19.0	20.9	29.4	13.7
Sweden	39.5	42.5	49.1	65.8	64.3	68.8	83.1	92.4
Total reporting countries	289.2	335.6	411.2	542.0	611.2	754.3	1,037.1	1,132.8

Sources: BIS, *I.B.F.M.D.*, 1986, 1991, 1992.

increase in the 1980s: the share of claims on the reporting area — including a group of major developed countries — rose remarkably from 47.6% to 73.7% between year-end 1983 and year-end 1990 [1].

In particular, the claims of BIS reporting banks on non-bank entities in Japan increased so substantially that their share of the total claims on non-bank entities within the reporting area grew from 12.2% to 25.3% for the same period. Concerning claims on non-bank entities in Japan, however, local claims in foreign currencies exceeded cross-border claims on them. In the area of cross-border claims, the share of claims on non-bank entities in the U.S. was the largest and that on non-bank entities in Japan was the second highest at the end of 1980s (Table 2).

1.2.2 Changing share of individual market centers and growing share of Japanese banks

The second notable feature of the development during the 1980s was decline in the UK's share of outstanding international banking business. The United Kingdom maintained its position as the world's largest international banking center during the 1970s, accounting for about 27% of total international banking business (Table 3). In the 1980s, however, as its position was challenged by the Tokyo money market and other off-shore markets, the UK's share of outstanding international banking assets dropped to around 18.% toward the end of 1980s. Similarly, the position of the U.S., which followed that of the U.K., tended to decline after the mid-1980s. In contrast, as the international bank assets in Japan increased rapidly in the 1980s, the share of Japan rose to 21.0% at the end of 1988, compared with only 5.0% at the end of 1980. However, the proportion of local foreign currency assets of banks in Japan was relatively high (34.4%) compared with those of banks in other major countries (U.K. 22.7%, U.S. 0%, year-end 1990). As a result, the United Kingdom still ranked first in the cross-border assets, followed by Japan and the United States [2].

Table 3. Shares of individual reporting market centres in international bank assets
(End of year, %)

	1975	1980	1985	1987	1988	1989	1990	1991
Belgium	8.8	4.2	3.8	3.8	3.4	3.2	3.4	3.4
Luxembourg		6.7	4.4	4.2	4.1	4.1	4.6	4.8
France	9.1	10.8	7.1	6.7	6.3	6.3	6.6	6.4
Germany	7.1	5.5	3.2	4.0	3.8	4.2	5.1	5.2
Italy	3.4	2.3	2.2	1.9	1.9	2.1	2.1	2.3
Netherlands	3.9	4.7	2.6	2.5	2.5	2.4	2.6	2.9
Switzerland	5.7	4.5	2.6	2.8	2.4	5.3	5.6	5.5
Swiss trust account			3.8	3.4	3.2			
United Kingdom	27.1	27.0	25.4	22.1	20.9	18.4	18.3	18.0
Canada	3.1	2.7	2.3	1.5	1.3	1.2	1.1	1.0
Japan	4.6	5.0	10.8	18.7	21.0	20.3	18.7	18.2
JOM				4.0	6.8	7.6	7.4	7.5
Other				14.7	14.2	12.6	11.4	10.6
United States	13.5	13.4	13.3	9.9	10.1	9.2	7.6	7.8
IBF			6.5	5.4	5.6	5.3	4.0	3.9
Other			6.8	4.5	4.5	4.0	3.6	4.0

Sources: BIS, *I.B.F.M.D.*, May 1991, 1992, BOE [1989].

The third feature was the dramatic change in the nationality structure of international banking activity. The U.S. banks reduced their share of international bank assets from 27.2% to 11.4% between 1983 and 1990. In contrast, Japanese banks gained the first rank in international banking activity in 1986; its share rose from 20.5% in 1983 to 32.4% in 1986 and further to 38.3% in 1988. The other important changes were the decline of U.K. banks' share and the increase of German banks' share (Table 4).

Table 4. Shares of international bank assets, by nationality of banks

(End of year, %)

	1983	1985	1986	1987	1988	1989	1990	1991
Japanese banks	20.5	26.1	23.4	35.5	38.3	36.5	33.9	31.4
US banks	27.2	21.7	17.3	14.8	14.5	13.5	11.4	11.6
French banks	8.6	9.0	8.4	8.6	8.3	8.0	8.8	8.8
German banks	6.5	7.0	7.8	7.9	7.7	8.1	9.7	10.4
UK banks	8.1	7.1	6.1	5.8	5.2	4.6	4.4	4.2
Italian banks	3.6	4.2	4.2	4.2	4.4	4.7	5.2	5.7
Swiss banks	3.6	4.0	4.4	4.3	3.8	3.4	3.7	4.0
Other	21.9	20.9	19.4	19.0	18.0	21.2	22.9	23.9

Sources: BIS, *I.B.F.M.D.*, July 1986, May 1991, 1992.

1.2.3 Gradual decline of the dollar's role as an international currency

Lastly, diversification of international currencies developed as the dollar's role decreased moderately in the 1980s. In particular, the dollar's share of external claims in domestic currency fell to 33.0% in 1990, down from 68.4% in 1984. Such decline led to narrowing the difference of the share between the dollar and the yen (Table 5). In Euro-currency market, the dollar still maintained its shares of over 50% in external

Table 5. Currency breakdown of BIS reporting banks' international assts

(End of year, billion dollars, %)

	1985	1986	1987	1988	1989	1990	1991
External claims in domestic currency 1)	688.8	898.4	1,163.4	1,227.6	1,396.5	1,552.6	1,587.3
US dollar (%)	58.3	49.5	39.5	40.0	38.4	33.0	32.4
Deutsche Mark (%)	10.1	13.0	12.7	11.8	13.5	16.0	14.8
Japanese yen (%)	10.7	15.3	24.8	28.1	26.7	26.9	29.5
External claims in foreign currencies 1)	1,305.6	1,668.9	2,114.7	2,247.1	2,720.3	3,274.0	3,196.7
US dollar (%)	66.0	63.0	58.4	59.0	57.5	52.8	51.6
Deutsche Mark (%)	12.7	12.7	13.9	13.0	13.5	14.1	13.8
Japanese yen (%)	3.9	5.1	7.0	7.1	6.7	6.7	5.9
ECU (%)	3.1	3.3	3.7	3.8	4.3	4.7	5.4
Local foreign currency claims	562.8	753.7	979.5	1,019.8	1,142.6	1,305.8	1,257.3
US dollar (%)	69.2	67.4	64.2	66.2	65.8	62.1	58.9
Deutsche Mark (%)	9.3	9.5	11.2	10.5	11.3	13.6	13.8
Swiss franc (%)	8.4	9.3	9.5	7.0	5.2	5.5	5.3
Japanese yen (%)	3.8	4.0	4.2	3.9	3.8	3.8	4.2
ECU (%)	2.9	2.7	2.9	3.2	3.3	3.6	5.4

Note: 1) External claims contained only assets of banks in developed countries.
Sources: BIS, *I.B.F.M.D.*, May 1991,1992.

claims and over 60% in local claims at the end of 1990, despite the slow declining trend of the dollar's role.

On the other hand, the yen's share in the external domestic currency claims rose remarkably throughout the 1980s, reflecting the growth of the Tokyo money market and growing current account surplus as well. In the Euro-currency market, however, the difference between the Deutsche Mark's share and the yen's share was still large even at the end of 1990. Each share of the Deutsche Mark and the ECU has increased gradually with the EC market integration near at hand.

1.3 Main features of international securities market

Turning to the international securities market, there were three salient features in the development of this market in the 1980s. The first feature was rapid increase of international securities financing, reflecting the progress of "securitization". International securities outstanding that were $320 billion at the end of 1983 grew by nearly five times to $1,580 billion at the end of 1990. The issue of Euro-notes that represents "securitization" of short-term bank loans expanded remarkably. Only $5 billion of Euro-notes outstanding in 1984 increased to $111 billion by the end of 1990 (Table 1). In the international bond market, after floating rate note issues expanded in the middle of the 1980s, equity related bond issues increased rapidly in late 1980s when stock prices soared in Japan (Table 6).

Secondly, trends in international bond issue in the 1980s were similar to the first feature of the international banking activities; the share of developing countries dropped, while that of developed countries rose (Table 7). In particular, issues by Japanese entities grew remarkably. As a result, Japan's share of total outstanding international bond issues overtook the US's and gained the first rank. On a net basis, nearly a half of new international bonds were issued by Japanese entities in 1989. This contributed to the rapid growth of total bond issues, particularly equity- related bond issues[3].

The third feature was the development in diversification of international currencies. The share of US dollar-denominated Euro-bond issues in Euro-bond issues declined. On the other hand, Euro-bond issues denominated in other major currencies such as the UK pound, Japanese yen, DM and ECU increased (Table 8).

Table 6. International bond issues

(billion dollars, %)

	Amounts outstanding end of 1985	net new issues 1986	1987	1988	1989	1990	Amounts outstanding end of 1990
Straght fixed rate	498.1	108.6	68.9	99.0	89.0	80.7	1,008.1
(%)	73.7	68.0	63.9	71.7	51.1	61.6	68.5
Floating rate notes	123.9	28.7	0.5	5.1	10.5	27.1	205.7
(%)	18.3	18.0	0.5	3.7	6.0	2.1	14.0
Equity related	54.3	22.4	38.3	34.1	74.8	23.2	258.7
(%)	8.0	14.0	35.5	24.7	42.9	17.7	17.6
Total issues	676.1	159.9	107.8	138.1	174.3	131.0	1,472.5
(%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: BIS, *Annual Report*, 1989, 1991, *I.B.F.M.D.*, May 1991.

Table 7. Announced international bond issues, by country
(billion of dollars, %)

	Amounts outstanding end of 1982	end of 1985	net new issues 1986	1987	1988	1989	1990	Amounts outstanding end of 1990
Japan	17.7	64.1	27.0	36.5	40.3	83.8	38.5	317.7
(%)	6.8	11.2	16.9	34.1	29.2	48.1	29.4	21.6
United States	36.0	102.7	32.6	11.4	6.1	−0.3	1.5	170.3
(%)	13.9	17.9	20.4	10.7	4.4	−0.2	1.1	11.6
Canada	41.4	68.6	13.6	2.1	5.8	4.1	4.2	107.9
(%)	16.0	12.0	8.5	2.0	4.2	2.4	3.2	7.3
United Kingdom	11.0	29.8	17.5	9.4	20.1	21.6	16.8	127.8
(%)	4.3	5.2	11.0	8.8	14.6	12.4	12.8	8.7
France	18.4	39.0	5.7	3.2	10.0	9.2	10.8	90.8
(%)	7.1	6.8	3.6	3.0	7.2	5.3	8.2	6.2
Other developed countries	67.3	149.9	53.5	36.6	48.1	42.0	34.4	429.7
(%)	26.0	26.2	33.5	34.2	34.8	24.1	26.3	29.2
Total developed countries	191.9	454.1	149.9	99.2	130.4	160.4	106.2	1,224.2
(%)	74.1	79.3	93.9	92.7	94.4	92.0	81.1	84.5
Developing countries	18.0	27.9	0.4	−1.1	−1.1	−0.9	2.7	33.3
(%)	6.9	4.9	0.3	−1.0	−0.7	−0.5	2.1	2.3
Eastern Europe	0.6	0.7	0.6	0.5	1.2	1.8	1.6	7.3
(%)	0.2	0.1	0.4	0.5	0.9	1.0	1.2	0.5
International institutions	48.8	89.9	8.7	8.4	7.6	12.9	20.5	187.7
(%)	18.8	15.7	5.4	7.9	5.5	7.4	15.6	12.7
Total	259.1	572.5	159.7	107.0	138.1	174.3	131.0	1,472.5
(%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: BIS, *Annual Report*, 1989,1991, *I.B.F.M.D.*, May 1991.

Table 8. Currency breakdown of international bond issues (gross, flow base)
(1985-91, billion dollars, %)

	1985	1986	1987	1988	1989	1990	1991
Euro-bond issues	139.9	187.7	140.5	178.8	212.8	180.1	248.5
Curency breaksown (%)							
US dollar	70.9	62.9	41.4	41.7	55.2	38.9	30.9
Deutsche Mark	7.0	9.1	10.7	13.3	7.7	10.2	8.0
UK pound	4.5	5.6	10.7	13.2	8.7	11.6	10.3
Japanese yen	4.8	9.9	16.1	8.9	7.3	12.7	14.4
Canadian dollar	2.1	2.7	4.3	7.3	5.9	3.6	9.1
ECU	5.1	3.8	5.3	6.3	5.9	9.9	12.7
Australian dollar	2.3	1.8	6.3	4.7	3.1	2.9	1.8
Other	3.4	4.2	5.4	4.7	6.1	10.3	12.8

Sources: OECD, *Financial Market Trends*, May 1988, 1989, 1990, 1991, 1992.

2. Three major centers in the international banking andfinancial markets

2.1 Rapid growth of the Tokyo international banking market

2.1.1 Background of rapid growth—deregulation—

The most remarkable feature in the international banking market was rapid growth of the Tokyo money market, which was strongly influenced by deregulation in Japan. First, the Foreign Exchange Control Act was revised at the end of 1980. Since then Impact Loans and deposit in foreign currency have been unrestricted. At the same time, Japanese banks' loans to nonresidents and Japanese financial institutions' investment in foreign securities were also deregulated[4)].

Second, the Japan-US Committee on the Yen and the Dollar was established under the pressure from the United States at the end of 1983. This Committee recommended deregulation in Japan and internationalization of the yen. As a result, the real demand doctrine of forward foreign exchange transactions was abolished and the restrictions on the issue of Euro-yen bonds by residents in Japan were repealed in April 1984. The restrictions on the spot foreign currency position of foreign exchange banks were removed in June 1984. Since then the residents in Japan have been able to borrow the Euro-yen from abroad (Euro-yen Impact Loan). Lastly, the Japan Offshore Market (JOM) was established at the end of 1986[5)].

2.1.2 Rapid expansion in external foreign currency positions of banks in Japan

The external foreign currency assets of banks in Japan showed a 84% increase from 1982 to 1985 (the average annual growth rate was 22.6%). The pace of their expansion accelerated in the second half of the 1980s. These assets showed a 288% increase between 1985 and 1989 (the average annual growth rate was 40.4%). On the other hand, the external foreign currency liabilities of banks in Japan expanded more rapidly than their assets. These liabilities increased by 353% between 1985 and 1989 (the average annual growth rate was 45.9%). Consequently, net external foreign currency liabilities of banks in Japan exceeded $100 billion late 1980s (Table 9).

The establishment of the JOM served as the first factor of steep expansion in the external foreign currency positions of banks in Japan. The external accounts for the JOM increased after 1986, accounting for 52.4% of assets and 43.2% of liabilities in total international accounts of banks in Japan at the end of 1989. The second factor was

Table 9. International position of banks in Japan

(end of year, billion dollars)

	1982	1985	1986	1987	1988	1989	1990	1991
External assets in foreign currency	65.6	120.9	207.4	288.3	389.3	469.3	532.8	473.9
(JOM)			69.5	122.9	200.0	246.0	280.0	230.0
External liabilities in foreign currency	85.9	129.8	254.5	368.2	503.7	588.3	645.3	575.2
(JOM)			69.7	133.1	216.0	254.0	282.0	248.0
External assets in domestic currency	25.6	73.8	137.9	288.5	344.4	372.7	417.8	468.5
(JOM)			19.2	69.0	131.0	183.0	215.0	263.0
External liabilities in domestic currency	14.3	49.5	91.5	223.8	268.8	291.4	313.2	270.5
(JOM)			18.3	58.1	112.0	117.0	136.0	118.0
Net external assets in domestic currency	11.3	24.3	46.4	64.7	75.6	81.3	104.6	198.0
Net external assets	–9.0	15.4	–0.7	–15.2	–38.8	–37.7	–7.9	96.7
Local foreign curency assets	69.5	143.9	268.4	389.8	421.0	475.1	498.3	418.6
(JOM)			5.0	15.6	41.0	67.0	92.0	71.0
Local foreign currency liabilities	65.6	142.9	229.3	319.8	332.1	381.0	415.6	373.6
(JOM)			4.8	16.1	25.0	60.0	90.0	52.0
Net local foreign currency assets	3.9	1.0	39.1	70.0	88.9	94.1	82.7	45.0

Sources: BIS, *I.B.F.M.D.*, July 1985, May 1991, 1992.

expansion of Japanese bank investment in foreign securities. Because of the restrictions on foreign currency position, bank investment in foreign currencies was "foreign-foreign" investment (mostly "dollar-dollar" investment) which means short-term borrowing in foreign currencies and buying securities in foreign currencies. "Dollar-dollar" investment increased strikingly from 1985 to 1986, when the dollar exchange rate against the yen dropped quickly [6]. In consequence, both sides of the external foreign currency accounts (assets and liabilities) of banks in Japan expanded remarkably.

The third factor was an increase of Impact Loans in foreign currencies. Banks in Japan borrowed foreign funds from abroad and lent them to non-bank entities in Japan. Impact Loans augmented rapidly from $52.7 billion at the end of 1985 to $203.8 billion at the end of 1988. This expansion contributed strongly to the rapid growth of banks' local foreign currency assets [7]. Foreign exchange banks in Japan borrowed Impact Loans from their branches abroad to lend it to non-bank entities in Japan. Japanese exporting companies wanted to borrow foreign funds to hedge the risk of foreign exchange fluctuations. Securities companies also borrowed foreign funds that they invested in foreign securities. In consequence, net external foreign currency liabilities of banks in Japan reached over $110 billion at the end of 1988 (Table 9).

2.1.3 Short-term borrowing and long-term capital outflow

In the second half of the 1980s banks in Japan increased the external foreign currency accounts, in which they increased short-term borrowing and long-term lending. Most of liabilities in foreign currencies were short-term. On the other hand, 38.5% of assets in foreign currencies were long-term claims on foreign non-bank entities, which took the form of medium and long-term lending and investment in foreign securities (at the end of 1988) [8]. Thus, on its net external foreign currency position, banks in Japan had short-term liabilities and medium and long-term claims. As the former exceeded the latter, they had a large amount of net liabilities in their total accounts.

The major parts of these net external liabilities in foreign currency corresponded to net local foreign currency assets. As banks in Japan increased local foreign currency assets in the second half of the 1980s, their net assets reached $94 billion at the end of

Table 10. Japan's international balance of payments (1983–1991)

(billion dollars)

	1983	1984	1985	1986	1987	1988	1989	1990	1991
Current balance	20.8	35.0	49.2	85.8	87.0	79.6	57.2	35.8	72.9
Long-term capital	-17.7	-49.7	-64.5	-131.5	-136.5	-130.9	-89.2	-43.6	37.1
Direct investment	-3.2	-6.0	-5.8	-14.3	-18.4	-34.7	-45.2	-46.3	-29.4
Security investment	-1.9	-23.6	-43.0	-101.4	-63.5	-66.7	-28.0	-5.0	41.0
US investment abroad	-16.1	-30.8	-59.8	-102.0	-87.8	-86.9	-113.2	-39.7	-74.3
Foreign investment in the US	14.2	7.2	16.7	0.5	-6.1	20.3	85.1	34.7	115.3
Basic balance	3.1	-14.6	-15.4	-45.6	-49.5	-51.3	-32.1	-7.8	110.0
Short-term capital	0.0	-4.3	-0.9	-1.6	23.9	19.5	20.8	21.5	-25.8
Balance of monetary movements	-5.2	15.2	12.3	44.8	29.5	29.0	33.3	7.2	-76.4
Gold & foreign exchange reserves [1]	-1.2	-1.8	-0.2	-15.7	-39.2	-16.2	12.8	7.8	8.1
Foreign exchange banks	-3.6	17.6	10.8	58.5	71.8	44.5	8.6	-13.6	-93.5
Errors & omissions	2.1	3.7	4.0	2.5	-3.9	2.8	-22.0	-20.9	-7.8

1) minus means increase of reserves.
Source: BOJ, *Balance of payments monthly*, April 1992.

1989 (Table 9). The main reason for the increase in local foreign currency assets was expansion of Impact Loans from abroad. Non-bank entities in Japan invested in foreign securities with short-term funds that they borrowed abroad. Therefore, banks in Japan were not only borrowing short and lending long on their own foreign currency accounts, but also facilitating non-bank entity short-term borrowing and long-term investment in foreign currency.

This pattern of capital flows is reflected in payment balance of Japan (Table 10). Deficit in long-term capital account more than offset surplus in current account after 1984, and deficit in basic account was financed by surplus in short-term capital account. In particular, net capital imports in foreign exchange banks' accounts amounted to $175 billion dollars within the three years from 1986 to 1988. In short, banks in Japan facilitated and supported the "short-term borrowing and long-term capital outflow" in the capital account of Japan.

2.1.4 Remarkable expansion of external position in domestic currency

Banks in Japan increased external accounts not only in foreign currency but also in domestic currency in the second half of the 1980s. External assets and liabilities in domestic currency expanded by 5.1 times and 5.9 times respectively in terms of the dollar from 1985 to 1989. Even in terms of the yen, these assets and liabilities expanded by 3.6 times and 4.2 times respectively. These growth rates exceeded those of external assets and liabilities in foreign currency (Table 9). The major reason why the external accounts in domestic currency expanded rapidly was that the banks in Japan increased borrowing and lending in the Euro-yen through the inter-office account. Assets in this account had a share of over 50% in total external domestic currency assets, and liabilities accounted for nearly three fourths of total external domestic currency liabilities at the end of 1988.

This pattern of external position in domestic currency was the same as that of the external position in foreign currencies, which was characterized as "borrowing short and lending long". In contrast to the external position in foreign currency, however, net long term external assets much more than offset net short term liabilities because the banks in Japan can raise the yen funds easily in the domestic money market. Net external assets in domestic currency increased remarkably in the second half of the 1980s and reached over $100 billion in 1990 (Table 9). In short, the banks in Japan borrowed the short-term yen funds both in Japan and abroad, and on the other hand, they lent them abroad and/or invested them in the yen denominated foreign securities[9].

2.1.5 Change of the Japanese banks' net international positions

Turning now to the international positions of the Japanese banks, they changed considerably between 1983 and 1988 (Table 11). On the foreign currency position, foreign offices of Japanese banks increased net liabilities to foreign banks by $275 billion and, on the other hand, they increased net claims on non-bank entities abroad by $148 billion and on their domestic offices by $125 billion. Thus, net foreign currency position of the foreign offices changed by only $2.8 million. In contrast, the domestic offices increased net cross-border foreign currency liabilities by $100 billion and net local foreign currency assets by $125 billion, as they increased net liabilities to the foreign offices and foreign banks by $213.5 billion and increased net claims on foreign non-bank entities by $114 billion and on Japanese entities by $125 billion.

Table 11. Change of the Japanese banks' net positions
(change from end of 1983 to end of 1988, billion dollars)

	in foreign currency	in domestic curency
External position of domestic offices	-99.4	64.9
To non-bank entities abroad	114.1	76.7
To foreign banks	-88.6	-6.7
To foreign offices	-124.9	-5.1
Domestic position of domestic offices	124.8	
To non-bank entities in Japan	124.8	
Foreign offices position	-2.8	39.1
To non-bank entities abroad	147.5	22.6
To foreign banks	-275.0	-47.6
To non-bank entities in Japan	-0.2	59.0
To domestic offices	124.9	5.1
Total international position	22.6	104.0
To non-bank entities	386.2	158.3
To foreign banks	-363.6	-54.3

Source: Uchida [1990a], p. 28, Table 10.

On the overall international domestic currency position of Japanese banks, the increase in net claims on non-bank entities ($158 billion) much more than offset the increase in net liabilities to foreign banks ($54 billion). On the yen position of foreign offices, the increase of net claims on non-bank entities in Japan ($59 billion) was larger than the increase of net liabilities to foreign banks ($48 billion). On the external yen position of the domestic offices, the increase of net claims on non-bank entities abroad amounted to 6.5 times of the increase in net liabilities to foreign offices and foreign banks. It seems reasonable to conclude that the Japanese banks borrowed short-term foreign funds from other banks abroad and lent them to entities in Japan and abroad, and that they borrowed short-term yen funs in domestic market and lent them to non-bank entities abroad.

2.1.6 Increase of Japan's foreign securities investment and Japanese entities' securities issues

Japan's foreign securities investment increased after 1984, particularly in 1986, when the restrictions on the Japanese financial institutions' investment in foreign bonds were relaxed to stem the rapid rise of the yen exchange rate against the dollar [10]. By regional breakdown, securities investment in the U.S. was the largest, the share of which in the Japanese foreign securities investment reached 56.4% in 1985. After 1986 Japan's securities investment outflow to Luxembourg augmented remarkably and overtook that to the U.S. in 1989 (Table 12).

Most of Japanese securities investment in Luxembourg was the investment in the Euro-dollar bonds with subscription warrant issued by Japanese entities. They increased issues of the Euro-dollar bonds with warrant from $19.8 billion in 1987 to $60.8 billion in 1989 (except issues in Asian dollar market) when the cost of equity-related bond issue was very cheap because of high stock prices in Japan. The Japanese investors including financial institutions purchased 80% of these Euro-dollar bonds

Table 12. Japan's foreign securities investment, by regional breakdown (flow base)
(billion dollars)

	1989	1984	1985	1986	1987	1988	1989	1990
United States	5.04	11.36	31.27	49.59	37.39	36.22	26.51	-16.11
Canada	1.05	2.06	2.25	6.64	2.50	1.36	4.76	0.86
United Kingdom	2.24	3.79	6.19	12.79	8.68	10.70	11.14	1.96
West Germany	0.17	-0.04	0.43	3.20	5.64	6.04	4.53	-2.02
Luxembourg	3.21	6.24	11.67	24.31	27.19	25.45	48.08	32.42
Netherland	0.05	0.04	0.05	0.08	0.54	0.76	0.25	0.19
France	0.07	0.02	0.04	0.42	1.05	0.56	3.86	5.56
Switzerland	0.19	0.95	0.53	0.10	0.38	0.90	1.25	1.89
Austria	0.73	1.57	0.96	-0.30	2.41	1.81	1.54	-1.14
Others	0.42	0.84	2.12	4.20	4.83	5.12	11.75	15.84
Total	13.17	26.82	55.41	101.03	90.61	88.91	113.64	39.46

Sources: MOF, *Annual Report of International Finance*, 1989, 1991.

with warrant [11]. Consequently, on one hand the Japanese investment in foreign securities soared to $113 billion in 1989, and on the other hand the Japanese entities' issue of foreign bonds also expanded remarkably. As a result, the Japanese net external securities investment decreased to $28 billion in 1989 (Table 10).

In conclusion, the Japanese money that was exported in the form of foreign securities investment repatriated through the purchase of Euro-dollar bonds issued by Japanese entities in the late 1980s. This means that the cost of bond issue was cheaper in the Euro-dollar market than in the Tokyo securities market, due to the constraints on commissions, taxes and procedures relating to bond issues in the Tokyo market [12]. In short, the Tokyo international banking market developed much faster than the Tokyo international securities market.

2.2 Financial intermediary functions of the London international money and securities market

2.2.1 Main features of the London money market

Most of the international banking activity in the U.K. was the cross-border business (Table 13). This is the first feature of the London money market. Although the international assets of the banks in Japan overtook those in the U.K. in 1988, the external assets of the banks in the U.K. have been the largest in the world (Table 3). Second, London is the center of Euro-currency transactions. The share of foreign currency assets was 90.8% in the external assets at the end of 1990 (Table 13).

Third, foreign banks have a large share of banking business in the United Kingdom. The shares of foreign banks' assets were 60.7% in the U.K. (end of 1988), 22.6% in the U.S. (end of June 1989) and 3.4% in Japan (end of March 1989) [13]. The U.K. banks' share of the international bank assets in the U.K. dropped from 22% to 17% and the U.S. banks' share also dropped more drastically from 38% (the largest) to 13% between 1975 and 1988. In contrast, the Japanese banks' share rose remarkably from 13% to 36% (the largest), and the EC banks' share also rose from 6% to 15% over the same period (Table 14).

Last, London has the largest foreign exchange market in the world. The average daily net turnover in the U.K. foreign exchange market was $187 billion (ranked first)

Table 13. International positon of banks in the U.K.
(endo of year, billion dollars)

	1983	1985	1986	1987	1988	1989	1990	1991
External assets in foreign currency	458.6	549.7	666.1	803.5	806.6	850.2	971.7	934.3
External liabilities in foreign currency	480.9	575.1	697.9	832.8	844.7	905.8	1,024.8	998.6
External assets in domestic currency	26.6	40.0	49.6	72.2	77.0	73.8	98.3	84.3
External liabilities in domestic currency	34.3	50.6	61.1	94.8	117.3	122.1	178.7	156.2
Net external assets in domestic currency	-7.7	-10.6	-11.5	-22.6	-40.3	-48.3	-80.4	-71.9
Net external assets	-30.0	-36.0	-43.3	-51.9	-78.4	-103.9	-133.5	-136.2
Local foreign currency assets	172.4	208.0	242.2	267.2	265.9	274.5	313.7	329.7
Local foreign currency liabirities	167.6	142.9	225.9	254.4	243.1	233.0	282.7	289.6
Net local foreign currency assets	4.8	65.1	16.3	12.8	22.8	41.5	31.0	40.1

Sources: BIS, *I.B.F.M.D.*, July 1985, May 1991, 1992.

Table 14. International assets of banks in the U.K., by nationality breakdown
(endo of 1975 and 1988, billion dollars, %)

		1975	1988
International assets of banks in th U.K.		184	1,124
of which:	U.K. banks (%)	22	17
	Japanese banks (%)	13	36
	U.S. banks (%)	38	13
	Other EC countries' banks (%)	6	15
	Other (%)	22	19

Source: BOE [1989], p. 519.

in April 1989. That in the U.S. was $129 billion (second), and that in Japan was $115 billion (third) in the same month[14] (see Table 20).

2.2.2 A center of the foreign currency transactions with nonresidents

As mentioned above, the London money market is the international intermediary center where Euro-banks borrow foreign funds from nonresidents and lend them to nonresidents. Turning to the external accounts of banks in the U.K. by regional breakdown.

Main creditors were banks in Switzerland & oil exporting countries and non-banks in the United States. On the other hand, main debtors were banks in Japan and non-banks in non-oil developing countries in 1985 (Table 15). This pattern of money flows changed remarkably in the second half of 1980s. First, net liabilities to the U.S. decreased to only $9 billion in 1990, as the banks in the U.S. increased the Euro-dollar borrowing. On the other hand, Germany became one of major creditors (Table 16).

Second, curtailing their external liabilities, non-oil developing countries became creditors. As a result, the net position of countries outside reporting area turned into net claims' position on banks in the United Kingdom. In contrast, only Japan increased liabilities to the banks in the U.K. as the largest debtor. This was the third transformation of money flows through the London money market in the second half of the 1980s. The fourth transformation was that the banks in the U.K. increased net liabilities by $117 billion during 1985-1990. This increase of liabilities in the banking account is

Table 15. Net external assets of banks in the U.K., by regional breakdown
(end of 1985, billion dollars)

	on banks	on non–banks	Total
Net claims on:			
BIS industrial area	–17.1	–10.9	–28.0
of which:			
US	3.7	–43.9	–40.2
Japan	33.8	1.1	34.8
Swiss	–57.2	–8.1	–65.2
Germany	–3.5	5.0	1.5
'Offshore' banking centres	10.0	–7.3	2.6
Outside reporting area	–22.9	33.1	10.2
of which, oil exporters	–26.9	–4.4	–31.2
Total	–30.0	14.9	–15.2

Source: BOE, *Qurterly Bulletin*, Sep. 1986.

Table 16. Net external position of banks in the U.K., by regional breakdown
(end of 1990, billion dollars)

	Assets	Liabilities	Net assets
Vis-à-vis:			
BIS insustrial area	805.1	801.6	3.5
of which:			
US	150.8	160.0	–9.2
Japan	223.0	109.1	113.9
Swiss	28.5	139.9	–111.4
Germany	64.9	113.9	-49.0
'Offshore' banking centers	130.7	126.1	4.6
Outside reporting area	114.7	173.2	–58.5
of which:			
Oil exporters	18.6	71.1	–52.5
Non-oil developing countries	43.7	59.6	–15.9
Other [1]	18.5	100.4	-81.9
Total	1,069.0	1,201.3	–132.3

Note: 1) Other includes international institutios, unallocated (assets & liabilities) and international issuers of securities (liabilities).
Source: BOE, *Qurterly Bulletin*, May 1991.

reflected in the "short-term borrowing and long-term capital outflow" in the U.K. balance of payments. So, it is necessary to turn to the London international securities market.

2.2.3 A center of the international securities market

London is the largest Euro-bond market. Most Euro-bonds are traded and 65% of Euro-bonds are issued in the London securities market. For example, it is estimated that about three fourths of Euro-dollar bonds, about a half of international Deutsche Mark straight fixed rate bonds and 80~90% of Deutsche Mark floating rate notes are traded in the London market. Euro-yen bond trades are also concentrated on the London market. In addition, 5~10% of U.S. government bonds, about 30% of German government bonds and nearly a half of foreign stocks are traded in the London market. As stated above, London is not only the largest market where Euro bonds are issued and traded, but also the international market where foreign governments' bonds and foreign stocks are traded. One of main factors for the concentration of international securities issues and trades on the London market is that trade taxes and fees are very cheap in the London securities market[15].

The part of the Euro-currency which banks in the U.K. borrow from nonresidents is invested in the London international securities market. Therefore, foreign short-term money that the London market absorbs is invested in foreign countries in long-terms. This pattern of "short-term borrowing and long-term capital outflow" is also seen in the U.K. balance of payments in the second half of the 1980s, except in 1987[16]. By regional breakdown, securities investment in Japan and direct & securities investment in the U.S. were very important. The U.K. securities investment in Japan amounted to $91 billion in 1989 when the issues of Euro-dollar equity related bonds by Japanese entities expanded (Table 17). Capital flows into the U.S. mainly through the direct & securities investment continued until 1990 (see Table 22)[17]. The net purchase of the U.S. federal government securities by the U.K. amounted to $20.4 billion in 1989 (ranked first)[18].

In short, the London money and securities market was the international financial intermediary center through which the Japanese money returned and the twin-deficits of the U.S. were financed in the second half of the 1980s.

Table 17. Foreign securities investment in Japan, by regional breakdown (flow base)

(billion dollars)

	1983	1984	1985	1986	1987	1988	1989	1990	1991
Unitied States	1.38	0.75	1.73	−6.66	−10.84	2.89	4.59	3.68	16.64
EC countries	6.34	3.35	11.83	11.61	15.66	21.36	92.22	30.05	86.24
United Kingdom	6.00	4.30	11.63	13.42	20.20	22.66	90.99	30.22	78.56
Other OECD countries	5.62	2.48	3.42	0.37	−1.72	2.99	2.15	1.95	2.63
Communist Bloc	−0.02	0.05	0.94	0.94	0.91	0.25	0.20	0.65	0.01
Other countries	0.90	−0.75	−3.16	−6.69	−9.72	−5.65	−11.40	−0.85	10.95
International Institutions	−0.09	−0.03	0.00	−0.06	−0.10	−1.84	−2.68	−1.08	−1.50
Unallocated	0.30	1.34	1.99	0.93	−0.27	0.30	0.06	0.27	0.32
Total	14.15	7.19	16.74	0.55	−6.08	20.30	85.14	34.65	115.28

Sources: BOJ, *Balance of Payments Monthly*, current issues.

2.3 New York money and securities market as the international funds absorber

2.3.1 Shift to the position of net liabilities

The U.S. became the largest net debtor country in the world in the second half of the 1980s accompanied by the increase of the twin-deficits. How did the role of the U.S. market change in the international banking and financial markets?

First, the external position of banks in the U.S. shifted from net assets to net liabilities (Table 18). External loans by banks in the U.S. stagnated after 1982 when the debt crisis occurred in the developing countries. External claims of banks in the U.S. on nonbank entities decreased in the second half of the 1980s. As a result, the US dollar's share in the external domestic currency assets dropped from 68.4% in 1984 to 33.0% in 1990 (Table 5). The share of banks in the U.S. in the international assets also dropped and was overtaken by that in Japan in the second half of the 1980s (Table 3). The US banks' share of the international bank assets also dropped from 27.2% to 11.4% over 1983-1990 (Table 4). On the other hand, banks in the U.S. increased external liabilities so quickly that they shifted their net external position from net assets ($100 billion, end of 1983) to net liabilities ($80 billion, end of 1990). Net claims of entities in the U.S. on BIS reporting banks also disappeared in 1991 (Table 18).

Second, however, any other currency didn't replace the U.S. dollar as the key currency. Although the dollar's share in the Euro-currency market decreased moderately, it has kept over 50% until the end of 1991 (Table 5). 90% of the foreign exchange market transactions in twenty-one countries were those against the dollar in April 1989[19]. The

Table 18. External positions of banks in the U.S.

(end of year, billion dollars)

	1983	1985	1986	1987	1988	1989	1990	1991
External assets in foreign curency	7.2	16.3	26.2	51.3	69.0	65.1	66.1	73.1
(IBF)	3.9	9.0	18.3	41.0	59.1	53.2	51.6	56.4
External liabilities in foreign currency	5.3	15.4	29.7	55.4	74.8	66.4	69.3	74.9
(IBF)	2.4	10.2	22.4	45.5	62.4	55.3	56.0	60.9
External assets in domestic currency	389.3	401.6	444.7	459.9	491.1	535.7	512.3	513.9
(IBF)	168.5	198.4	223.2	239.9	260.7	289.9	251.3	234.2
External liabilities in domestic currency	289.4	350.9	414.0	477.4	519.9	583.7	584.4	580.6
(IBF)	154.4	187.3	227.0	264.7	285.6	334.2	317.8	297.8
Net external assets in domestic currency	101.8	51.6	27.2	−21.6	−34.6	−49.3	−75.3	−68.5
Vis-à-vis non-bank entities:								
External assets		110.7	110.3	107.5	104.3	103.7	89.5	78.5
External liabilities		68.6	73.0	70.4	77.4	90.6	80.7	76.4
Net assets		42.1	37.3	37.1	26.9	13.1	8.8	2.1

Sources: BIS, *I.B.F.M.D.*, July 1985, May 1991, 1992.

Table 19. Cross border positions of BIS reporting banks *vis-à-vis* non-bank entities in the developed countries

(end of year, billion dollars)

	1985	1984	1987	1988	1989	1990	1991
Vis-à-vis non-bank entities in:							
U.S.							
Assets	93.3	114.8	145.6	181.5	217.5	271.7	278.2
Liabilities	170.6	199.0	224.6	235.7	259.2	284.7	272.8
Net assets	−77.3	−84.2	−79.0	−54.2	−41.8	−13.0	5.4
Japan							
Assets	9.0	18.0	60.2	83.8	126.4	200.8	250.4
Liabilities	3.7	6.7	9.0	10.5	24.0	23.1	17.7
Net assets	5.3	11.3	51.2	73.3	102.4	177.7	232.7
Germany							
Assets	42.5	49.1	65.8	64.3	68.8	83.1	92.4
Liabilities	13.1	34.0	46.8	48.2	81.4	123.3	136.0
Net assets	29.4	15.1	19.0	16.1	−12.6	−40.1	−43.7

Sources: BIS, *I.B.F.M.D.*, May 1991, 1992.

Table 20. Sizes of the banking and financial markets in Japan, the U.S. and the U.K.
(stock, end of 1989, billion dollars)

	Japan	US	UK
Money market [1]	627	1,721	340
	(3.69) [4]	(1.34) [4]	(2.44) [4]
bonds market [2]	2,213	5,797	339
	(1.73) [4]	(1.56) [4]	(0.85) [4]
Stock market (total current values) [2]	4,393	4,296	3,213
	(4.49) [4]	(1.52) [4]	(2.21) [4]
Foreign exchange market (daily turnover) [3]	115	129	187
	(2.40) [4]	(2.20) [4]	(2.08) [4]

Notes: 1) Money market includes interbank and open market.
2) Values in bonds and stock markets in the US and the UK were those at the end of 1989.
3) Daily turnover in foreign exchange market means average daily turnover in March 1989.
4) Figures inside ( ) mean ratios to the values at the end of 1985.
(In foreign exchange market, ratios to the average daily turnover in April 1986)
Source: The Bank of Tokyo, *Tôgin Shûhô (Weekly Report)*, 24, May 1990.

dollar's share in the official foreign exchange reserves of the IMF member countries kept 60.2% at the end of 1989, though it went down from 79.5% at the end of 1975 [20]. As mentioned above, the dollar's roles as the international transaction, settlement and reserve currency are still outstanding, though it went down in the 1980s. This has very close relations with the character of the U.S. money and securities market.

2.3.2 The international funds absorber

The U.S. has the largest banking and financial market in the world. Total assets in the U.S. money market amounted to $1,720 billion that were equivalent to 2.7 times of those in the Japanese market and to five times of those in the U.K. market respectively in 1989 (Table 22). Bonds outstanding in the U.S. amounted to $5,800 billion that corresponded to 2.6 times of those in Japan, 17 times of those in the U.K. and 4.6 times of the international bonds outstanding. In addition, the U.S. market has very high liquidity and it is open for nonresidents. In particular, the U.S. Treasury Bill that has a 25% share ($430 billion) in the US money market is the most popular short-term portfolio in the world, as it has high safety and liquidity. In contrast, the Japanese TB market is very small yet ($40 billion, less than a tenth of the U.S. TB market, end of 1989).

The U.S. money and securities market increased funds' absorption from abroad in the 1980s when the U.S. twin-deficits expanded drastically. The international investment position of the U.S. changed dramatically from net assets of $364 billion (end of 1982) to net liabilities of $440 billion (end of 1989, gold is revalued in market price, direct investment is revalued in current-cost, see Table 21). The international financial position (except direct investment) of the U.S. also changed from net assets of $163 billion (end of 1982) to net liabilities of $542 billion (end of 1989). The factor for dramatic change of international investment position was that the liabilities increased much faster (by 2.87 times during those seven years) than the assets increased (by 1.52 times). In particular, as foreign private securities investment in the U.S. expanded remarkably, foreign private holdings of U.S. Treasury securities increased by 5.21 times, U.S. securities other than Treasury securities held by the foreign private sector also increased by 5.26 times in those seven years. In contrast, U.S. private holdings of foreign securities increased only by 2.53 times in the same period (Table 21).

The rapid increase of external liabilities made U.S. money and securities market much more dependent on foreign funds than ever before. The external financial liabilities of the United States grew much faster than the U.S. money and securities market. The U.S. bond market grew by 56% and stock market grew by 52% from the end of 1985 to the end of September 1989 (Table 20). On the other hand, foreign official and private holdings of U.S. securities increased by 100% during 1985-1989 (Table 21). As a result, for example, the foreigners' share in the holding of U.S. Federal Government securities rose from 10.9% (end of 1985) to 13.3% (end of 1989)[21].

As mentioned above, the role of the U.S. money and securities market shifted dramatically from that of an international funds' exporter to that of an international funds' absorber in the 1980s. Major routes of capital import were direct & securities investment and bank borrowings (Table 22). By regional breakdown, net capital imports from

Table 21. International investment position of the U.S.

(end of year, billion dollars)

	1982	1983	1984	1985	1986	1987	1988	1989	1990
Net international position									
(1)	137	89	-2	-117	-274	-378	-531	-664	
(2)	364	285	164	64	-74	-135	-306	-440	-412
(3)	259	224	111	65	15	-42	-151	-268	-361
U.S. assets abroad (2):	1,101	1,114	1,105	1,174	1,319	1,463	1,534	1,673	1,764
U.S. assets abroad (3):	955	1,029	1,022	1,175	1,424	1,556	1,708	1,944	1,880
U.S. official reserve assets	143	123	105	118	140	162	144	169	175
U.S. Government assets, other than official reserve assets	75	80	85	88	90	89	86	84	81
U.S. private assets (2)	883	911	915	968	1,090	1,212	1,304	1,420	1,508
U.S. private assets (3)	737	826	832	969	1,195	1,305	1,478	1,691	1,624
Direct investment abroad (2)	374	358	350	380	414	485	505	536	598
Direct investment abroad (3)	228	273	268	381	519	578	679	808	714
Foreign securities	75	83	89	112	132	147	157	190	232
U.S. claims on unaffiliated foreigners reported by U.S. nonbanking concerns	29	35	30	29	36	31	34	32	34
U.S. claims reported by U.S. banks, not included elseshere	405	435	446	447	507	550	608	662	654
Foreign assets in the U.S. (2):	737	829	941	1,110	1,393	1,598	1,840	2,112	2,176
Foreign assets in the U.S. (3):	696	805	911	1,110	1,410	1,598	1,858	2,212	2,241
Foreign official assets in the U.S.	189	195	200	203	241	283	322	337	370
U.S. government securities	133	137	145	145	179	221	261	266	296
Other foreign assets in the U.S. (2)	548	634	741	907	1,152	1,315	1,518	1,775	1,807
Other foreign assets in the U.S. (3)	507	611	712	908	1,169	1,315	1,536	1,875	1,871
Direct investment in the U.S. (2)	173	181	207	227	267	316	373	434	466
Direct investment in the U.s. (3)	133	158	178	228	283	316	391	534	530
U.S. Treasury securities	26	34	62	88	96	83	101	135	134
U.S. securities other than U.S. Treasury securities	93	114	129	208	311	346	396	489	475
U.S. liabilities to unaffiliated foreigners reported by U.S. nonbanking concerns	28	27	31	30	27	30	35	40	44
U.S. liabilities reported by U.S. banks, not included elsewhere	228	278	312	355	452	541	614	677	687

Note: (1) Gold and direct investment are valued at historical prices.
(2) Gold is valued at market price, and direct investment is valued at current cost.
(3) Gold and direct investment are valued at market value.
Source: *S.C.B.*, June 1991, p.26.

Table 22. U.S. international balance of payments

(billion dollars)

	1983	1984	1985	1986	1987	1988	1989	1990	1991
Trade balance	-67.1	-112.5	-122.2	-145.1	-159.6	-127.0	-115.7	-108.9	-73.4
Current balance	-43.6	-98.8	-121.7	-147.5	-163.5	-126.7	-101.1	-90.	-3.7
Capital balance	24.5	72.8	96.9	132.1	167.6	126.8	98.7	43.1	4.8
Official sector	-0.4	-5.5	-7.8	33.9	55.5	38.8	-15.5	34.1	27.6
U.S. official assets abroad	-6.2	-8.6	-6.7	-1.7	10.2	-0.9	-24.0	0.1	9.2
Foreign official assets in the U.S.	5.8	3.1	-1.1	35.6	45.4	39.8	8.5	33.9	18.4
Private sector	24.9	78.3	104.7	98.2	112.0	88.0	114.3	9.0	-22.8
Direct investment	5.6	13.8	6.6	18.5	31.0	41.8	38.9	12.4	-15.6
U.S. investment abroad	-4.9	-10.9	-13.4	-17.1	-27.2	-15.4	-29.0	-32.7	-27.1
Foreign investment abroad	10.5	24.7	20.0	35.6	58.2	57.3	67.9	45.1	11.5
Securities investment	10.1	30.8	63.9	70.5	29.2	38.7	46.3	-29.7	6.2
U.S. investment abroad	-6.8	-4.8	-7.5	-4.3	-5.3	-7.8	-22.1	-28.8	-45.0
Foreign investment in the U.S.	16.9	35.6	71.4	74.8	34.5	46.6	68.4	-0.9	51.2
Banking sector	20.4	22.7	39.7	19.8	46.9	13.9	12.1	23.8	-18.4
U.S. claims reported by U.S. banks, not included elsewhere	-29.9	-11.1	-1.3	-60.0	-42.1	-56.3	-51.3	7.5	-4.8
U.S. liabilities reported by U.S. banks, not included elsewhere	50.3	33.8	41.0	79.8	89.0	70.2	63.4	16.4	-13.7
Other	-11.2	10.9	-5.6	-10.7	4.9	-6.5	17.0	2.4	5.1
U.S. claims on unaffiliated foreigners reported by U.S. nonbanking concerns	-11.1	6.2	-5.2	-8.0	2.0	-12.1	11.4	-2.5	5.5
U.S. liabilities on unaffiliated foreigners reported by U.S. nonbanking concerns	-0.1	4.7	-0.4	-2.6	2.9	5.6	5.6	4.9	-0.4
Statistical discrepancy	19.1	26.0	24.8	15.4	-4.1	-0.1	2.4	47.4	-1.1

Source: *S.C.B.*, June 1992.

Table 23. Capital balance of the U.S., by regional breakdown

(%)

	1983	1984	1985	1986	1987	1988	1989	1990	1991
United Kingdom	48.4	19.8	33.2	35.9	48.0	10.2	33.4	21.8	-20.4
European continent	22.5	20.4	0.5	5.7	22.3	-0.5	27.3	52.1	-319.6
Japan	9.7	22.0	26.1	19.6	15.5	32.8	-1.3	-10.2	-285.8
Other countries	19.4	37.7	40.2	38.9	14.2	57.5	40.6	36.3	725.8

Sources: *S.C.B.*, current issues.

the U.K. and Japan played a very important role in the finance of current deficit (Table 23). The UK's share in net capital export to the U.S. remained the highest until 1990 (except in 1984 and 1988), the Japanese share ranked second (first in 1984 and 1988).

3. Changing structure of the international banking and financial markets

3.1 The tripolar structure of the international banking and financial markets

In the 1980s, a movement toward integration between banking and financial markets was underway across the major industrial countries, and its development, in turn, contributed to a remarkable growth in the activities of the international banking and financial markets. With this drive toward global financial integration, the tripolar structure was shaped in the international banking and financial markets, consisting of the markets in Japan, the United Kingdom and the United States. There are, however, substantial differences in the functions among these major financial centers.

Japan played the decisively important role in the international banking and financial markets throughout the 1980s. Japan not only acted as a major capital exporter for recycling its current account surplus but emerged dramatically as an international financial intermediary for the global allocation of capital. As a result, banks in Japan as a group reached the rank with those in the U.K. in the volume of international financial activities, and the share of Japanese banks in the international banking and financial business of the world rose to around one third. Their main function is to borrow short-term funds in the international banking markets (mostly in the London market) and to lend in medium and long-terms and/or to invest in securities overseas. While the yen funds were raised in the domestic money market, short-term funds in foreign currencies (mostly U.S. dollar) were raised in the Euro-market. According to the balance of payments' statistics of Japan, net long-term capital outflows exceeded current account surplus and the balance was financed mainly by net short-term capital inflows. This pattern of capital account — short-term borrowing and long-term lending — is one of the salient features in the payment balance of Japan during the second half of the 1980s.

Along with banks, Japanese non-bank firms showed a marked tendency to raise the funds in the international bond markets in the late 1980s. On the other hand, most of the international bonds that had been issued in the Euro-bond market were purchased by Japanese investors. Thus, some of the private capital inflows into Japan were largely results of foreign bond issues by Japanese non-bank corporations. This means that the funds exported out of Japan into the Euro-bond market flowed back into Japan from Luxembourg through the London financial market. These "two way" capital flows reflected not only the financial globalization but also the constraints on commissions, taxes and procedures relating to bond issues in Japanese securities market.

The United Kingdom maintained its position as one of the world's largest international centers for intermediation of funds in foreign currencies. London performed a significant function in attracting capital from abroad such as Switzerland, West Germany and oil exporting countries and, at the same time, in lending to Japanese entities and investing in U.S. securities.

Lastly, the financial market of the U.S., with its shift from a creditor status to a position of the world's largest debtor, has tended to have recourse to the foreign capital.

3.2 The international banking and financial markets in transition

3.2.1 The sharp contraction in activity of Japanese banking and financial market

The tripolar structure of international banking and financial markets, as noted above, has been changing abruptly since 1990. The most salient feature of the change is a scaling down of international banking and financial activity of Japan. Following expansion in their assets and liabilities owing to the extraordinary boom toward the end of the 1980s, Japanese banks are now confronted with difficulties in expanding their business, in particular, due to the slump in equity prices in the early 1990s and to the need to meet BIS capital adequacy guidelines. These difficulties are reflected in the sharp contraction of international assets and liabilities of banks in Japan, with the exception of yen denominated external assets (see Table 9).

As a result of the sharp contraction in the activity of Japanese banks, the share of banks located in Japan fell in total international bank assets by nearly three percentage points between 1988 and 1991 (Table 3). The share of international assets of Japanese banks also shrank by seven percentage points over the same period (Table 4). The decline of Japanese banks' international activity was the most important factor in the contraction of activity in the total international banking markets of the world in 1991[22].

Both the cross border business and the local foreign currency business shrank in 1991. In particular, the contraction of the inter-bank business was remarkable. A scaling down of inter-bank business in 1991 was driven by the sizable repayment of earlier international borrowings by banks in Japan. The implication of this behavior is that the function of Japanese banks as a financial intermediary had shrunk and that the Japanese capital flows have been drastically reversed. Indeed, while the long-term capital outflows (securities investment and direct investment) served as a major channel for recycling Japan's surplus on current account until 1990, the recycling of its growing surplus in 1991 took the form of net short-term capital export (repayment of short-term external borrowings). On the other hand, Japan's long-term capital account in 1991 showed a surplus as foreign purchases of Japanese securities exceeded Japanese purchases of foreign securities, and Japanese direct investment in foreign countries was curtailed (see Table 10)[23]. Thus, the pattern of Japan's capital flows shifted from "borrowing short and lending long" to "repaying short-term external liabilities and borrowing long": Japan's role of international financial intermediary became less active in the early 1990s.

3.2.2 Decline in capital inflows into the United States

Such change in the pattern of Japan's international capital flows had an effect on the capital inflows into the United States. Needless to say, the U.S. growing twin deficits on both the federal government fiscal accounts and current account after 1983 were financed by massive import of foreign capital and, on the other hand, its rapid expansion of demand for foreign goods and services was one of the leading factors in expanding the world economy. However, capital inflows into the U.S. began to decline after 1988 and the pace of the decline has accelerated since 1990. Several factors stand out in this tendency. The first feature was that the U.S. payment balance on private portfolio investment shifted to a deficit of $29.7 billion in 1990. The year 1991 saw the continued increase of U.S. investment in foreign securities and the revival of foreign investment in the U.S. securities. Although the inflows were more than the outflows, net securities investment inflows amounted to only $6.2 billion (Table 22). The decline in foreign private securities investment in the U.S. may be brought about by various factors; narrowing or reversal of both nominal and real long-term interest rate differentials among major industrial countries in favor of dollar denominated assets; widening of risk premium on foreign investment in the U.S. securities investment due to the steady downward tendency in the value of the dollar; reduction in the international business of Japanese financial institutions[24].

Second, foreign direct investment flows into the United States, which accounted for

Table 24. Foreign direct investment in the U.S., by regional breakdown (flow base)

(billion dollars)

	1985	1986	1987	1988	1989	1990	1991
EC	9.9	19.1	36.2	32.1	35.7	20.5	8.4
UK	4.7	10.8	22.4	21.0	18.9	5.2	4.2
Belgium	-0.2	0.6	0.1	0.1	1.0	1.9	-1.2
France	0.0	1.0	2.5	3.1	2.7	5.7	3.7
Germany	2.3	2.0	3.2	2.4	3.7	0.7	1.3
Italy	0.0	0.1	-0.3	-0.7	0.9	0.4	-0.4
Netherland	2.8	4.4	8.3	5.8	7.3	6.4	0.0
Canada	0.9	2.5	1.6	1.2	1.8	1.4	-1.3
Japan	3.4	7.3	7.5	17.3	18.7	17.4	0.5
Australia	1.2	2.6	0.5	2.8	-0.1	1.4	0.2
L.A.	0.7	-0.3	-4.2	3.2	4.1	4.9	-0.5
Mexco	0.2	0.3	0.0	0.0	0.1	0.2	0.1
Asia & Africa	0.3	0.2	0.6	2.0	1.5	-0.4	0.8
Total	19.0	34.1	46.9	59.4	67.9	45.1	11.5

Sources: *S.C.B.*, current issues.

high proportion of the U.S. capital inflows in the second half of 1980s, began to decline after 1990, and the U.S. direct investment account moved toward deficit in 1991 for the first time in ten years (Table 22). The principal countries that decreased direct investment in the U.S. were those in western Europe, particularly the United Kingdom for 1990 and Japan for 1991 (Table 24). Several factors behind the declining trend of direct investment inflows into the U.S. may be identified: (1) a falling off in the merger and acquisition movement in the United States after its peak in 1988-89; (2) the sluggish activity of the real estate market in the United States; (3) curtailment of Japan's direct investment owing largely to the virtual completion of establishing production plants in the United States by Japanese manufacturers; (4) low rate of return on Japanese direct investment in the United States.

With contraction in net foreign private capital inflows into the United States, the U.S. trade deficit had to be financed by other sources. The sources for financing its trade deficit were the official financing through intervention in support of the dollar by foreign central banks (1990-1991), the increased positive statistical errors and omissions in the balance of payments (1991) and the payment of $42.5 billion Gulf war-related expenses by Kuwait, Germany, Japan and several other countries (1991) (see Table 22). Although the drop in merchandise import and the expansion in merchandise export due to the current recession contributed to the narrowing of the U.S. trade account deficit, foreign private sources financed less than full amount of its external deficit. Inflows of foreign official funds, which served to avoid downward pressure on the dollar, were the most important sources to finance the U.S. trade account deficit.

Decline in the foreign capital inflows into the Unites States had an impact on the movement of interest rates in the U.S.. While the short-term interest rates have been falling in response to the Federal Reserve's easy money policies since the autumn of 1990, long-term interest rates have remained firm since early 1991 . As a result, the differential between them widened : long-term interest rates were higher than short-term interest rates by 3% in the spring of 1992 [25].

The continued high long-term interest rates in the U.S. market were primarily attributable to the large Federal budget deficit and to the decline in inward capital flows to the United States affected by the tight monetary policies in both Japan and Germany. The continued relatively high long-term interest rates appear to be one of the factors limiting economic recovery of the United States. This would imply that creating an easy monetary condition for stimulating the economic expansion of the United States, while avoiding a sharp fall of the dollar, will require international monetary cooperation, in particular, the concerted reduction of interest rates in Japan, Germany and other major industrial countries. Nevertheless, it seems to be difficult for German Bundesbank to take action to ease monetary conditions, because of its fear of inflation arising from the increased government budget deficit relating to the German unification. With the deterioration of German economy, the role of Germany in global financing has been changing, as discussed below.

3.2.3 Shift of Germany to a capital importing country and contraction in the activity of the U.K. in international financial intermediation

The third significant change in international banking and financial markets since 1990 was that Germany shifted from a major capital exporting country to a capital importing country. Germany, as a surplus country, maintained its position as one of the world's largest capital exporters until the end of the 1980s, but its current account surplus began to shrink in 1990 and turned into a deficit in 1991, mainly because of increasing domestic spending associated with the German unification. Thus, the pattern of Germany's capital flows also changed. German current account deficit in 1991 had to be financed by import of foreign capital[26].

The above-mentioned three notable features of the changes after 1990 in the pattern of capital flows of Japan, the United States and Germany, also had an impact on the role of London as a major center for international financial intermediation. First, the cross-border business of the banks in the U.K. began to decline. This fall was, as noted earlier, largely attributable to the contraction in the international business by Japanese banks. The Japanese banks' share of the total outstanding international assets held by banks in the U.K. fell from a peak of 36% at the end of 1988 to 32.2% at the end

Table 25. External position of banks in the U.K., by regional breakdown
(Stocks, end of 1991, billion dollars)

	Assets	Liabilities	Net assets
Industrial reporting countries	743.5	727.0	16.5
United States	146.6	146.5	0.1
Japan	187.9	99.7	88.2
'Offshore' centers	114.2	113.7	0.5
Outside reporting area	108.8	170.3	-61.5
Oil exporting countries	15.9	68.6	-52.7
Non-oil countries	46.3	61.0	-14.7
Others	17.3	109.3	-91.7
Total	984.1	1,120.3	-136.2

Source: BOE, *Qurterly Bulletin*, May 1992.

of 1990 and further to 28.5% at the end of 1991[27]. Second, along with the reduction in the volume of funds intermediated, the pattern of international flows of funds through the London market has been changing. Table 16 and 25 show the regional breakdown of external position of banks in the United Kingdom. It demonstrates that, between the end of 1990 and that of 1991, claims on Japan fell by $35.0 billion (net claims on Japan fell by $26.0 billion) and, on the other hand, liabilities to the U.S. fell by $13.5 billion (net liabilities to the U.S. fell by $9.0 billion). These developments mean that Japanese banks repaid large amount of borrowings from the inter-bank market and, at the same time, the U.S. withdrew some amount of funds from the London market.

Moreover, the UK's traditional pattern of capital flows, characterized by short-term borrowing and long-term lending, has also been changing. As to direct investment, the outflows began to decline in 1989, and was overtaken by the inflow[28]. When examined by region, the U.K. capital account with the U.S. shifted from a deficit of $33.0 billion in 1989 and $9.4 billion in 1990 to a surplus of $1.0 billion in 1991[29] (Table 23). In contrast, long-term capital account with Japan continued to record deficit: it amounted to $80.0 billion in 1989, $26.0 billion in 1990 and $61.0 billion in 1991[30] (see Table 17).

The changing function of London market discussed above may be summarized as follows. In the course of 1991, the securities investment flows from the U.S. to the U.K. overtook those from the U.K. to the U.S. and, at the same time, the United States withdrew a large amount of funds held in London[31]. In other words, while the funds flowed into the United Kingdom through the U.S. securities investment, the funds flowed back to the United States through the U.S. withdrawal from banks in London. In contrast to the case of the United States, the funds flowed from Japan into the United Kingdom as Japanese banks repaid their earlier borrowings in London market and, on the other hand, the funds flowed into Japan through the U.K. securities investment in Japan. There was no change, with direct investment flows as exception, in the pattern of the U.K. balance of capital account — short-term borrowing and long-term capital outflow —, but the direction of the UK's capital flows from and into two major industrial countries — the U.S. and Japan — has dramatically changed since the beginning of 1990s.

In this sense, London's functions as a financial intermediary in the early 1990s differs markedly from those performed in the last half of the 1980s, and these changing functions of London financial market constitute the fourth salient feature of the development in international banking and financial markets after 1990.

In summary, in the decade of the 1980s, international banking and financial markets experienced a remarkable growth and performed the significant function in financing the global external imbalances. Of greatest importance was their role in financing the growing twin deficits of the United States. These markets became the major channel for recycling the substantial amount of funds to the United States.

However, functions of the international banking and financial markets have been shrinking since the beginning of the 1990s. The shrinkage of their function is reflected in the recent behaviors or tendency of the markets. First, the current account of Germany has turned into a deficit due largely to the demand effect of German unification and, for the first time since 1981, Germany's capital import came to exceed its capital export. Second, reflecting the slump in the Tokyo financial market, Japan's function of international financial intermediation has been declining. Such decline had an impact on London's function, since London is the largest center for Japanese financial institutions' international business outside Japan. Indeed, London's function as an international financial intermediary has also shrunk or stagnated. Third, the United States has been confronted with difficulty in financing the full amount of its external deficit by foreign private capital inflows, though its current account deficit has tended to narrow.

Thus, following rapid expansion during the last decade, the international banking and financial markets have gone through a process of adjustment since the beginning of the 1990s.

Notes

1) BIS, *Annual Report*, 1991, BIS, *I.B.F.M.D.*, July 1986.
2) UK's share of total cross-border assets was 17.1% at the end of 1990. Japan's share was 15.2% and US's share was 9.2% at the same time. BIS, *I.B.F.M.D.*,May 1992.
3) BIS, *Annual Report*, 1990.
4) Yamasaki (1990), pp.19 – 20.
5) Fukao (1990), Ch.8, Sec.2, BOJ (1991), pp.23 – 4.
6) Uchida (1988), Uchida (1990a), p.8, Yamasaki (1990)
7) Uchida (1990a), p.16.
8) *op.cit.*, p.14.
9) *op.cit.*, pp.13 –16.
10) Yamasaki (1990), pp.19 – 20, Kawai, Teruyama (1991), p.206.
11) *Interim Report of the Foreign Exchange Council*, Uchida (1990b), p.14.
12) Kawai, Teruyama (1991), p.142.
13) BOE, *Quarterly Bulletin, May 1990,* BOJ, *Economic Statistics Monthly, American Banker.*
14) BIS (1990), p.10.
15) BOE (1989), pp.519 – 20.
16) IMF, *I.F.S.*, July 1992, p.534.
17) Capital account deficit was $13.8 billion in 1988, $33 billion in 1989, $9.4 billion in 1990, *S.C.B.*, June, 1991, 1992.
18) *Treasury Bulletin*, 1990.
19) The yen's share was 27.1%, the DM's share was 26.5%. BIS (1990), Table C-1.
20) If the foreign exchange includes the ECUs, the dollar's share was 52.4%. IMF, *Annual Report*, 1990.
21) *Federal Reserve Bulletin*, March 1987, March 1991, A30.
22) BIS, *Annual Report*, 1992, p.160.
23) Foreign securities investment in Japan marked $115.3 billion , over three times of that in 1990. Its details were, (1)net purchase of Japanese equities ($46.8), (2)net purchase of bonds ($21.2 billion), (3)foreign bond issues ($47.2 billion). Yamasaki (1992a)
24) Nishimura (1991)
25) BIS, *Annual Report*, 1992, p.111.
26) BIS, *Annual Report*, 1992, p.77, 95.
27) Japanese banks in the U.K. contracted international lending by over 10% in 1991. BOE, *Qurterly Bulletin*, May 1992, p.193.
28) IMF, *I.F.S.*, July 1992, p.534.

29) *S.C.B.*, June 1992, p.107.
30) BOJ, *Balance of Payments Monthly*, April 1992, p.81.
31) Securities investment from the U.S. to the U.K ($23.6 billion) exceeded that from the U.K. to the U.S.($9.1 billion, except US Treasury securities), and banks in the U.S. contracted their claims on the U.K. by $12 billion. *S.C.B.*, June 1992, p.107.

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