Bank of Japan

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Financing Activities of Japanese Companies in Asia
Summary of Discussions from the "Research Group on Financing Activities of Japanese Companies in Asia"

1. Introduction

After experiencing the hardships of the Asian Financial Crisis of 1997 and 1998, Asian countries have regained their economic vigor. While they still have many issues to address, they have continued dynamically down the path of development. These waves of dynamism have gone beyond the East Asian region (namely China, the newly industrializing economies, or NIEs (i.e., Korea, Taiwan, Hong Kong, Singapore) and the countries of the Association of Southeast Asian Nations, or ASEAN). There is also growing momentum in India. Indeed, the presence of Asian countries in the global economy continues to grow and strengthen.

The factors contributing to this dynamic economic development in Asia have been discussed numerous times in the past. Asian countries have actively recruited foreign direct investment[1] from overseas, including Japanese companies. These investments have served as the driving force for the creation of production centers in Asia, enabling them to emerge as "the world's factory." Another major factor has been the substantial expansion in Asian countries' domestic markets. This shows through the growing motorization resulting from steadily improving income levels. These trends have enabled substantial increases in the trade of goods and services throughout the Asian region, including Japan, and are steadily deepening the region's economic interdependence.[2]

As part of these trends, Japanese companies have traditionally been important players in Asian economic activities, and today it is more important than ever for Japanese companies to use Asia's economic vigor for their own development. Japanese companies are also involved in more regions within Asia. This broadening started with Vietnam as "China + 1," and more recently with India as well.[3] The relationship between Japanese companies and Asia is therefore broadening and

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[1] Cumulative direct investments in Asian countries (China, Indonesia, Malaysia, Philippines, Singapore, Thailand, and India) from Japan between 1980 and 2003 totaled 103.4 billion dollars, followed by the United States with 85.4 billion dollars and the UK with 23.3 billion dollars.

(Toward "Sustained Potential for Growth", White Paper on International Economy and Trade 2006)

[2] The ratio of trade within the Asian region (export based) has increased from roughly 30% in the early 1980s to nearly 50% in more recent years.

[3] According to the Japan Bank for International Cooperation's (JBIC) FY2005 Survey Report on Overseas Business Operations by Japanese Manufacturing Companies, Japanese manufacturing companies consider Vietnam and India to be the most promising countries for future expansion.

Rank	Promising locations over the medium term (Next 3 years)	Promising locations over the long term (Next 10 years)
1	China	China
2	India	India
3	Thailand	Vietnam
4	Vietnam	Russia

deepening.

However, when considering the corporate finance aspects supporting these vigorous activities, there are many issues remaining which could halt the smooth economic and business activity in Asia. Having learned from the experiences of the Asian financial crisis of 1997-1998, Asian countries have taken steps to enhance their financial and capital markets. However, it is nonetheless worth identifying the remaining financial sector issues facing Asia from the perspective of Japanese companies as major players in the region and important users of the financial infrastructure. This will be important not only for the further development of Japanese business within Asia, but also as a contribution to sustainable growth for Asian countries themselves.

With this in mind, last April, the Center for Monetary Cooperation in Asia (CeMCoA), a unit of the International Department of the Bank of Japan, organized a Research Group[4] by bringing together the financial officers of leading Japanese companies doing business in Asia. The research group identified corporate finance issues facing Japanese companies in their Asian activities and discussed potential solutions. Fundrasing, fund management, foreign exchange risk management and other points were highlighted. The CeMCoA continues its research and analysis to capture accurately the nature of these issues and to contribute to the efforts for better functioning of Asian financial markets through the network of central bank cooperation in the region.

(Reference) Members of the "Research Group on Financing Activities of Japanese Companies in Asia" (Japanese phonetic order)

Takehiko Ikushima	General Manager, Treasury Department, Nissan Motor Co., Ltd.
Teruyuki Usugaya	Manager, Finance Division, Mitsui & Co.
Tsuyoshi Endo	Deputy General Manager, Finance and Accounting Department, Mitsubishi Chemical Corp.
Tsutomu Kariyazaki	Manager, Finance Sec., Controller Dept., JFE Steel Corp.
Toshiaki Tanaka	General Manager, Finance Department, Mitsuboshi Belting, Ltd.
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2. Fundraising in Asia: Status and issues

The financial systems of Asian countries are distinguished by their relatively underdeveloped capital markets, particularly their bond markets. They are also distinguished by their reliance on indirect financing, and scholars have noted such characteristics for a long time. Along these lines, it has been pointed out that the "dual mismatch in maturity and currency" (the practice of raising short-term foreign currency funds overseas and converting it to local currency for use in long-term domestic investments) was a primary factor leading to the Asian financial crisis. Asian countries have learned from this experience and are now aiming to foster bond markets in their home currencies in order to utilize Asia's abundant savings as a source for domestic investment.[5] Nonetheless, fundraising trends in China and the leading ASEAN countries indicate that bank borrowing is still the most important fundraising method in the region and there has been no

[4] The "Research Group on Financing Activities of Japanese Companies in Asia" met 10 times between April and September.

[5] As a part of these efforts, the Asian Bond Markets Initiative (ABMI) is underway by Asian finance ministries and the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), to which the Bank of Japan belongs, is promoting the Asia Bond Fund (ABF) program.

significant change in the predominance of indirect financing (Figure 1).

Fig. 1: Fundraising Trends in China and the ASEAN 4 (end of 2004)

(Percentage of nominal GDP: %)

	Indonesia	Malaysia	Philippines	Thailand	China
Outstanding bank borrowing	23.4	104.2	29.8	76.2	111.5
Stock market capitalization	28.4	153.5	33.2	71.4	27.1
Outstanding bond issues	1.7	38.4	0.1	13.7	0.6

Source: *Toward"Sustained Potential Growth",*White Paper on International Economy and Trade 2006

One major point of discussion for the Research Group was how, given this environment, Japanese companies with operations in Asia address local fundraising demands. The Group's discussions on this issue were wide-ranging, but can be organized into five broad topics (Figure 2).

1) Regardless of a business' stage of development, bank borrowing and parent-subsidiary loans (loans from Japanese parent companies) are the main means of fundraising (however, there are substantial differences among companies depending on sector, size, individual strategies, etc.).

2) With respect to bank borrowing, there is generally heavy dependence on Japanese banks with local operations[6] (and in such cases, parent company guarantees are sometimes required).

3) Local subsidiaries in some countries (China, Thailand) are trying to reduce outside borrowing by using CMS (cash management system) functions which provide the mechanism for lending funds (Chinese yuan, Thai baht) mutually among group companies. Currently, this still appears to be experimental (for more on the use of CMS in Asia, see Section 3: Fund Management Issues in Asia).

4) Local currency-denominated bonds (corporate bonds) are a topic of much discussion and some companies (trading houses, automobile sales and finance companies, etc.) have expressed interest, but overall, this is an issue for future study.[7] Similarly, there are generally few cases of stock being listed or publicly traded on local markets.

5) While this was not a major issue in this Research Group, there are also cases where local subsidiaries, after starting operations, do not remit their earnings in the form of

[6] It is difficult to provide a quantitative picture of the breakdown of bank lenders for Japanese operations in Asia. They appear to be primarily dependent on the local offices of Japanese banks, but some firms also turned to European and American banks, and some also borrowed from local Asian banks when it was otherwise difficult to raise funds in the local currency. It is also worth noting survey results indicating 21.5% of Japanese companies with operations in China have borrowed from local Asian banks; 28.8% from ASEAN (Research Study on *Investment and Fundraising environments in East Asia and Overseas Operations by Japanese business corporations,* Japan Industrial Policy Research Institute, April 2006).

[7] None of the companies participating in the Research Group had ever issued local currency-denominated bonds in Asia, but since 2004 there have been some examples of Japanese companies issuing Thai baht-denominated bonds under the Japan Bank for International Cooperation (JBIC) credit supplementation scheme.

dividends, but retain them for future reinvestment.[8]

Fig. 2: Fundraising by Japanese Companies in Asia Broken down by Stage (Type) of Business

	Main business	Use of Funds	Major means of fundraising
At entry	Local subsidiary establishment, factory construction, etc.	Startup funding	・Parent company investment ・Parent-subsidiary lending ・Bank borrowing (primarily Japanese banks)
After entry	Production/sales — However, there are differences between the use of funds and means of fundraising (including fundraising currency) depending on whether it is an export company (imports raw materials, exports finished goods) or domestic sales company (procures raw materials locally, sells products locally, etc.).	Operating capital (including the demand for funds in conjunction with settlement of export/import prices for export firms)	・Bank borrowing (primarily Japanese banks) — Domestic sales companies generally raise funds in local currencies; export companies raise funds in foreign currencies ・Parent-subsidiary lending (including site adjustments when there is business between the parent and subsidiary) ・Use of funding from within the group via CMS (some countries only)
	Expansion of capacity	Capital investment	・Parent-subsidiary lending ・Bank borrowing (primarily Japanese banks) ・Retained funds
Other	Automobile sales and finance	Funding for automobile loans	・Bank borrowing ・Local currency-denominated bond issues (understudy)

Source: Based on Research Group discussions.

Two issues warrant further discussion: (1) bank borrowing, which every company participating

[8] For example, in its discussion of earnings after startup, the survey conducted by the Japan Industrial Policy Research Institute notes, “Rather than remitting [earnings] to Japan as dividends, the tendency is to retain them for reinvestment in factory expansions, etc., in part because of the tax benefits that are offered.”

(Reference) Investment of Earnings by Local Japanese Subsidiaries in Asia (Survey Findings)

(Ratio of responding companies: %)

	Remittance to Japan head office	Local Reinvestment	Retention in the local subsidiary
China	22.4	35.2	41.8
ASEAN	31.0	30.4	37.9

Note: Not including “no response” returns, 196 companies in China (155 manufacturing, 41 service) and 161 companies in ASEAN (126 manufacturing, 35 service) responded.

Source: Research Study on *Investment and Fundraising environment in East Asia and Overseas Operations by Japanese business corporations*, Japan Industrial Policy Research Institute (April 2006).

in the Research Group noted as an important means of fundraising, and (2) bond issues denominated in local currencies, something Asian countries are trying to develop.[9] These are discussed below in more detail.

(1) Bank borrowing

Many companies participating in the Research Group had relatively large facilities in China and Thailand. This resulted in the Group spending a considerable amount of time discussing issues in these two countries. However, it is thought that these trends reflect, to a certain extent, the general circumstances of Japanese companies with operations in Asia. As a result, the following paragraphs focus primarily on China and Thailand and attempt to outline their regional environments (Figure 3).

One distinguishing feature of bank borrowing of Japanese companies located in China and Thailand is that in addition to their needs to finance in dollars, yen and other foreign currencies in conjunction with local capital investments, exports and imports, it is becoming increasingly important to raise funds smoothly in Chinese yuan and Thai baht. The Group identified this as a major issue.[10] There are two primary factors behind this: 1) the growing tendency to procure materials from local companies (including Japanese parts manufacturers with local operations) rather than imports from overseas (including Japan), a trend that is underscored by the rising local content rates;[11] and 2) the growing weight of local markets in sales, rather than just exports to Japan and third countries. In other words, there is a growing tendency to settle funds in local currencies, which is increasing the demand for yuan and baht as operating capital.

However, there are problems to be discussed in the Research Group. The following problems were introduced, especially in China, one of the areas most emphasized by Japanese companies.

1) The People’s Bank of China regulates yuan lending rates (Figure 4) and the costs seem high from a borrower’s perspective.

2) When local subsidiaries borrow yuan from Chinese banks (including the local offices of foreign banks) backed by parent company guarantees (“RMB borrowing secured with foreign currency”), if the subsidiary defaults on the loan and the parent company fulfills the guarantee, the amount of the guarantee must be registered with the State Administration of Foreign exchange. In addition, the amount of the guarantee is subject to “contingent liability management” (the amount that can be registered [the amount that can ultimately be collected by the parent company] is limited to the total investment minus the registered capital).

With respect to lending interest-rate regulations,[12] the Group heard examples of lending funds

[9] This document does not include a discussion of parent-subsidiary lending, even though this appears to be a major means of fundraising on par with bank lending. It was noted that, 1) parent-subsidiary lending is commonly used by smaller and medium-sized companies, 2) its primary benefit is to enable funds to be raised more quickly because only a head office decision is required, and 3) fundraising costs could ultimately be higher because the interest paid by the overseas subsidiary on the loan is in principal subject to local withholding tax.

[10] In this regard, sources from the international departments of Japanese banks indicate that in China, more than 40% of lending is denominated in yuan and in Thailand, approximately 80% is denominated in baht.

[11] The local content ratios for the Asian operations of Japanese manufacturers rose steadily from 41.6% in FY 2002 to 53.7% in FY 2003. (Survey of *Overseas Business Activities of Japanese Companies*, Ministry of Economy, Trade and Industry).

[12] Another problem caused by regulated interest rates, which will be discussed below, is the impediments to the creation of a rational yuan forward rate based on differences between domestic

among companies in the same group using an "entrust loan" scheme mediated by a bank, a subject that will be discussed below in greater detail. With respect to "RMB borrowing secured with foreign currency" by parent company guarantees, early last year, the Chinese authorities issued a notice stating that parent company guarantees must be registered in advance as a "contingent liability" and must be within "total investment minus registered capital." Foreign companies, including those from Japan, voiced a great deal of concern about the impact this new rule would have on yuan fundraising. Ultimately, the notice was modified to require registration as a foreign obligation when the parent company exercised its guarantee, and limit the ultimate repayment given to the parent company to "total investment minus registered capital."[13] Consequently, the Research Group concluded it would be unrealistic for most Japanese companies to envision a case where a parent company guarantee would be fulfilled for a subsidiary, so the impact of this regulation on yuan fundraising is likely to be far smaller than originally expected.

Other points of discussion included constraints on the availability of long-term borrowing, because in both China and Thailand bank borrowing is in effect short-term, usually for periods of one year or less. Also, in the case of Thailand, there are credit ceiling regulations (no more than 25% of capital) on lending to companies in the same corporate group and these rules apply to all banks, including the local offices of Japanese banks. Some participants noted the potential for these regulations to impede fundraising (participants also noted that Indonesia and India have credit ceiling regulations similar to those of Thailand).

Fig. 3: Major Problems and Challenges in Bank Borrowing in Leading Asian Countries

Countries	Major Problems and Challenges
China	(Yuan-denominated borrowing) ・Interest-rate regulations (base rates set by the People's Bank of China) ・For foreign currency secured borrowing (including borrowing guaranteed by parent companies, etc.), should the debtor (local subsidiary) become insolvent and unable to repay the obligation and the parent company,etc., be required to fulfill the guarantee, the amount of the guarantee fulfilled must be registered with the foreign exchange authorities as external debt ・Restrictions on the geographic regions in which foreign banks are allowed to operate (until December, 2006) ・Borrowing terms are effectively short-term only (within 1 year), which imposes constraints on the availability of long-term borrowing
	(Foreign currency-denominated borrowing) ・Required to open a special account ("Exclusive Account for Domestic Foreign Currency Borrowing") for the receipt of foreign currency borrowing ・Not permitted to convert the foreign currency raised into yuan ・Restrictions on use of funds (external payments for imports, etc.).
Thailand	・Baht borrowing primarily short-term; considered a constraint on the availability of long-term baht borrowing. ・Ceilings on lending to the same corporate grouping (no more than 25% of capital) ・Required to report foreign currency borrowing to the central bank based on the real demand principle

and foreign interest rates.

[13] The reason for introducing this regulation last year was because some foreign companies, expecting the yuan to appreciate, abused parent-company guarantees by borrowing large amounts of yuan. Many commentators suspect that the authorities' primary goal in establishing these regulations was to restrain this kind of abuse.

	・Foreign nationals prohibited from acquiring land, making it impossible to use land as collateral to secure lending from foreign banks
Other Asian countries	(Indonesia) ・Ceilings on lending to the same corporate grouping (no more than 25% of capital) (India) ・Ceilings on lending to the same corporate grouping (no more than 10% of capital)

Source: Based on Research Group discussions.

Fig. 4: Lending Rates in China

(Unit: %)

Term	People's Bank of China Base Interest Rate			
	Beginning October 29, 2004	Beginning April 28, 2006	Beginning August 19, 2006	Minimum rate
Less than 6 months	5.22	5.40	5.58	5.03
6 months - 1 year	5.58	5.85	6.12	5.51
1-3 years	5.76	6.03	6.30	5.67
3-5 years	5.85	6.12	6.48	5.84
5 years or more	6.12	6.39	6.84	6.16

Note: Dates indicate when interest rates changed. Minimum rates are set at 90% of the People's Bank of China Base Interest Rate.

Source: People's Bank of China

(2) (Corporate) bond issuing

Turning to the issue of local currency-denominated corporate bonds, an area that Asian countries are trying to develop, some participants commented that they had once explored the possibility of issuing such corporate bonds in Indonesia and Thailand. However, there was almost universal agreement among the participants that they passed on such issues because of the higher fundraising costs. None of the companies participating in the Research Group had, therefore, ever issued bonds in Asia. However, with respect to automobile sales and financing, some participants said they were studying bond issues as a supplement to bank borrowing because their sales and finance companies had already been established and they needed a stable, low-cost means of raising local currency (in this case Thai baht) as their auto loan business expanded. It will be necessary to continue monitoring the impact of these trends on the development of bond markets in Asia among Japanese companies.

There have been no bond issues by non-financial companies in China. However, the participants noted that the Chinese authorities had initiated "short-term financing bills" (bills issued by companies for terms of no more than 1 year and underwritten primarily by Chinese banks) in May of last year as part of a program to develop the country's bond markets. "Short-term financing bills", which major Chinese companies often use, are distinguished by interest rates lower than those of bank borrowing[14] and the companies in the Research Group were very interested in the potential for their use by foreign companies.

[14] For example, "short-term financial bills" issued by Chinese companies last year carried an interest rate of approximately 2.9% for a 1-year term, which was lower than the interest rates offered by banks for 1-year loans.

3. Fund management in Asia

- Use of CMS (Cash Management System) and status of Asian financial subsidiaries

(1) Use of Cash Management Systems in Asia

Japanese companies active in Asia have numerous local subsidiaries, primarily in China and Thailand, and from a group-wide finance perspective, there would appear to be many cases in which they have both subsidiaries with surplus funds and subsidiaries with funding shortfalls that must increase their outside funding. This raises significant management issues with respect to the efficient deployment of funds, thus reducing external debt for the entire group by distributing surplus funds among group companies. CMS (Cash Management Systems) are mechanisms designed to meet these needs. Most companies already have financial management centers in London and New York, which are responsible for their affiliates in Europe and America respectively. These centers improve funding efficiency within the region. They are also building systems to enable the Tokyo head office to monitor overall funding (a mechanism called "Global Cash Management Systems").

In Asia, as well, there are attempts to incorporate the flow of funds in the region into the Global Cash Management system framework by establishing financial subsidiaries in Singapore and giving them central control over the funding of group companies in the Asian region. However, the consensus opinion in the Research Group is that it is currently unrealistic to build a CMS for Asia like those operating in Europe and America and that ultimately it would be up to subsidiaries in individual countries to develop ways to manage their funding efficiently.[15] Among the reasons cited were: 1) most Asian countries restrict nonresident transactions in the home currency, which makes them unsuitable for cross-border fund management for local currencies; 2) even for foreign currencies, regulations on domestic holdings (requirements to convert to local currencies) and cross-border movements of funds impede centralized, region-wide management; and 3) withholding taxes[16] on interest payments between group companies in the region raise funding costs.

Therefore, many Japanese companies are currently focusing on attempts to achieve efficiency gains by building Chinese yuan (RMB) or Thai baht CMS. These would oversee only their affiliates located within China or Thailand, where affiliates tend to be concentrated.

For example, China by law prohibits the direct borrowing and lending of funds between non-financial companies, but permits companies with surplus funds to make deposits with banks (including the local offices of Japanese and other foreign banks) and make such funds available to companies that require funding in what is called an "entrust loan" scheme. This scheme enables lending of funds among group companies, and the Research Group discussed such cases used to reduce financing costs. Another trend is establishing financial centers within Chinese holding companies, so that instead of "bilateral entrust loans" among group companies, the financial center can take in all of a group's surplus funds and supply such funds to group companies requiring funds in what is being called a "collective entrust loan" scheme. Some companies have already begun to switch to this approach.

Similarly in Thailand, some companies have established financial subsidiaries to pool funding as they experiment with creating Thai baht CMS.

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[15] Even companies that had established financial subsidiaries in Singapore said that they could only take the lead in day-to-day funds transfers among group companies located in Singapore and therefore, "CMS for Asia" could not be realized.

[16] In Singapore, however, if a financial subsidiary qualifies as a "Finance and Treasury Center," Singaporean withholding taxes on interest payments from funds gathered from other group members are waived in principle.

(2) Status of Asian financial subsidiaries

While there are still many challenges that remain in Asia for CMS functions, as previously discussed, some companies have already established Asian "finance and treasury centers" in Singapore and are attempting not only to put CMS into practice within the region but also to use Singapore as a fundraising center for their MTN programs. There are several reasons why Singapore is the preference for establishing financial subsidiaries: 1) its position as an international financial center in Asia on par with Hong Kong, 2) its political and social stability, and 3) the availability of people who speak both English and Chinese.[17] However, many members of the Research Group also believe that the tax benefits offered by the Singaporean authorities to these kinds of financial subsidiaries are a major reason why non-financial companies seek to establish financial subsidiaries in the region.

When a non-financial company establishes a financial subsidiary in Singapore which is certified as a "Finance and Treasury Center" (FTC) by the Monetary Authority of Singapore (MAS), it receives a flat waiver on withholding taxes normally levied against interest payments for funds collected from other group companies in Asia. Cross-border movements of funds always incur withholding taxes, inevitably leading to higher funding costs. However, the companies participating in the Research Group believed that Singapore's waiver of withholding taxes is a significant incentive to establish financial subsidiaries in the country.

In addition to Singapore, the Group also discussed: 1) the establishment of "finance companies" in China, and 2) the establishment of "treasury centers" in Thailand. In China's case, the "Rules for Management of Finance Companies of the Enterprise Group" apply to foreign companies and allow the establishment of a "corporate group finance company"[18] to control financing activities for the entire group in China. However, many members of the Research Group noted that these companies: 1) must undergo regular inspections by the Chinese authorities (China Banking Regulatory Commission), and 2) must have at least 100 million yuan in capital and maintain a capital adequacy ratio of at least 10%. They must also be able to meet other strict conditions including standards for annual operating revenues and pretax profits before they are established. As a result, many members commented that it would be too costly to establish group finance companies in China given the current conditions.

Turning to Thailand, in July 2004, the Thai authorities announced[19] a policy permitting the establishment of "treasury centers" by foreign companies with operations in Thailand. Many Japanese companies have shown interest in this because they tend to concentrate their ASEAN operations in Thailand.[20] However there are problems: 1) there are ceilings on fundraising by treasury centers (7 times capital); 2) group companies engaging in transactions with the treasury center require individual approvals from the Thai authorities; and 3) unlike the Singaporean FTC licenses, there are no tax benefits. A significant number of companies participating in the Research Group indicated they had studied the potential to establish a treasury center but ultimately decided against it. The Thai authorities reportedly have a goal of "growing Thailand into the financial

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[17] For example, some participants noted that even in business with group companies located in mainland China, communications were smoother if left to the staff of the Singapore financial subsidiary rather than the Tokyo head office, because the Singapore staff understood Chinese.

[18] Establishment of a corporate group finance company allows a wide range of businesses to be undertaken: 1) accepting deposits from group companies, 2) lending to group companies, 3) fundraising with bond issues, 4) entrust loans among group companies, 5) underwriting and selling of bonds issued by group companies and 6) acquisition of shares in group companies. At the end of December 2004, there were 74 corporate group finance companies (*Chinese Financial System and Banking Transactions 2006*, Mizuho Research Institute).

[19] Bank of Thailand, The Establishment of Corporate Treasury Center in Thailand, 6 July 2004

[20] Treasury centers are allowed to engage in the following activities: 1) payment agency services, 2) netting, and 3) fundraising and foreign exchange hedging for Group companies.

center for ASEAN," and are studying changes in the present conditions for treasury centers. The participants showed a great interest in how this will impact the current preference for Singapore as a regional financial center.

4. Foreign exchange risk management

After the financial crisis, most Asian currencies moved from a *de facto* peg against the dollar to a managed float. The final two currencies to stick with the dollar peg were the Chinese yuan and the Malaysian ringgit, but last July, they too moved to a "managed float with reference to a currency basket". As a result, companies operating in Asia now have to pay much more attention to Asian currencies' exchange rate changes in terms of foreign exchange risk management and hedge appropriately for the circumstances. Especially for Japanese companies expanding domestic business in Asia, sales are basically recovered in local currencies, but some purchases of raw materials are still settled in foreign currencies. So, how to manage their foreign exchange positions in Asian currencies has become an important issue. It should also be noted that in a JETRO survey of Japanese manufacturing operations in Asia, "fluctuations in the rate of the local currency against the dollar and yen" was among the highest-ranked problems noted by the companies on the "financial and foreign exchange" side (Figure 5). In light of this, one discussion point for the Research Group was how to deal with foreign exchange risks for Asian currencies, particularly the Chinese yuan.

The Chinese yuan moved to a "managed float" in July of last year, and the Chinese authorities permitted foreign banks to engage in customer foreign exchange futures trading in August as an endeavor to develop futures markets. Research Group participants noted that since about August of last year, they had been receiving more rate offers from a wider range of banks, including foreign banks, and the foreign exchange futures market was gradually becoming easier to use.[21] However, there were also a significant number of comments noting the continued requirement to present documents attesting that the trade was based on real demand. Others commented that interest rates were still regulated in China, so that it was uncertain if the foreign exchange futures rates presented by banks were really rational. In the case of the yuan, it is possible to use offshore NDF markets[22] to hedge, but none of the participants in the Research Group actually used them. Among the reasons given were: "The NDF markets are very speculative", "they lack stability and cannot be used with confidence", and "it's a 'consolidated hedge', so the distribution of profit and loss between Chinese and non-Chinese group companies becomes unnecessarily complicated".

Given the Asian currencies' underdeveloped futures markets ,not just the yuan, the Research Group noted that it would be necessary to encourage the development of the bond market in order to have free market interest rates and yield curves that form the basis for rational futures rates.

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[21] Comments also pointed out the general ability to secure terms up to 1 year.

[22] "Non-Deliverable Forwards" (NDF) are a recently-developed foreign exchange risk hedging technique designed for strongly-regulated currencies. Their key features are: 1) the ability to enter into offshore contracts without requiring access to the local foreign exchange market, and 2) the settlement of differences (the difference between the contracted price and the most recent price on the settlement date) using dollars or other negotiable currencies rather than requiring delivery or transfer of actual local currency. In addition to the Chinese yuan, NDF transactions are also available for the South Korean won, Taiwanese yuan, Philippine peso and Indian rupee etc.

Fig. 5: Financial and Foreign Exchange Issues for Japanese Manufacturers in Asia

(Top 5; percentage of respondents shown in parentheses)

	No. 1	No. 2	No. 3	No. 4	No. 5
China	Fluctuations in the local currency rate against the yen	Fluctuations in the local currency rate against the dollar; fluctuations in the yen rate against the dollar		Taxation (corporate tax, transfer pricing tax, etc).	Stiff regulations on fundraising and settlement
Respondents (%)	40.1	33.9		32.8	25.2
ASEAN total	Fluctuations in the local currency rate against the dollar	Fluctuations in the local currency rate against the yen	Taxation (corporate tax, transfer pricing tax, etc).	Fluctuations in the yen rate against the dollar	Lack of adequate cash flow for capital investment
Respondents (%)	39.0	33.7	32.1	28.9	24.5
Respondents who answered, “Thailand”	Fluctuations in the local currency rate against the yen	Fluctuations in the local currency rate against the dollar	Rising interest rates	Taxation (corporate tax, transfer pricing tax, etc).	Fluctuations in the yen rate against the dollar
Respondents (%)	37.0	33.9	31.8	30.2	19.8
India	Taxation (corporate tax, transfer pricing tax, etc).	Fluctuations in the local currency rate against the dollar	Rising interest rates	Lack of adequate cash flow for capital investment	Fluctuations in the local currency rate against the yen
Respondents (%)	53.4	32.8	24.1	22.4	19.0

Source: 2005 Survey of Japanese Manufacturers in Asia (ASEAN/India volume, China/Hong Kong/Taiwan/Korea volume), JETRO

5. Settlement and payments problems: Collection of accounts receivable

Although there are differences among sectors, Japanese companies operating in Asia generally tend to emphasize expansion in the domestic sales business as a response to growing domestic demand in Asian countries. According to a survey conducted by the Japanese Ministry of Economy, Trade and Industry, sales within the Asian region account for 2.1 trillion yen of the 3.1 trillion yen (FY 2004) generated by Japanese manufacturing operations in the region, or roughly 70% (Figure 6).

Fig. 6: Sales at Japanese Manufacturing Subsidiaries in Asia

<<FY2004>> Unit: 1 billion yen

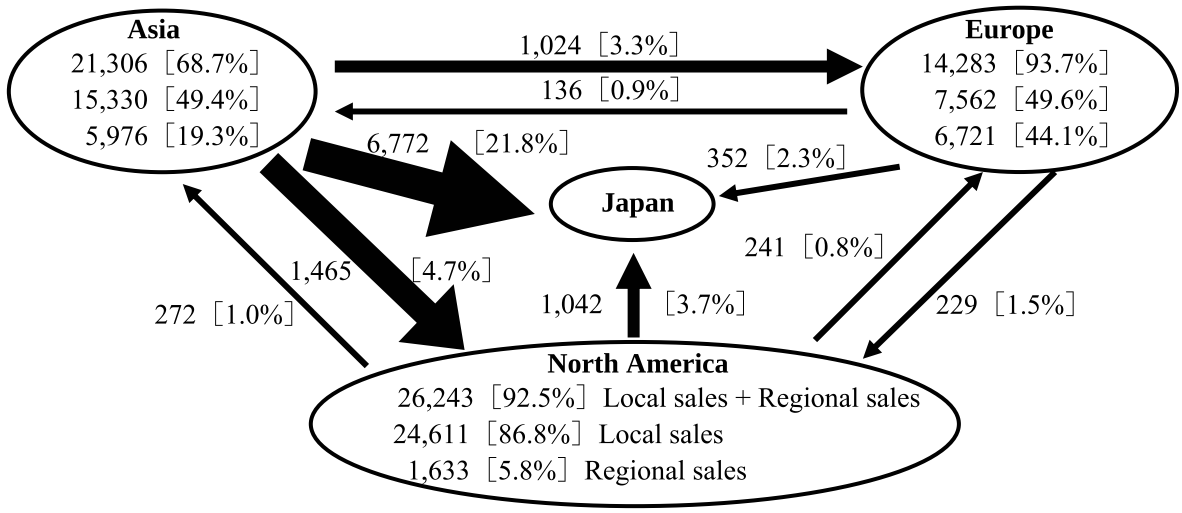

Figure shown in brackets [ ] represent ratio of regional sales to total sales

Note: Total sales generated by Japanese manufacturing in Asia totaled 3.1 trillion yen (+19.7% year-on-year).

Source: Survey of *Overseas Business Activities of Japanese Companies,* FY 2005 edition, Ministry of Economy, Trade and Industry

As a result, many Japanese companies are increasing their business with local Asian companies and have a growing need to capture the creditworthiness of local companies in order to manage the accounts receivable credits that will be generated. Unfortunately, there is not enough credit information available. In addition, even when financial statements can be accessed, they are not that reliable. The consensus in the Research Group was that it was extremely difficult to capture the creditworthiness of business partners. Some also pointed out that after the financial crisis of 1997-1998, in some cases it took as long as almost 1 year to collect money from buyers because of the deterioration in their business conditions.

In China, many Japanese companies are addressing this by: 1) requiring cash on delivery, 2) requiring prepayment, and 3) requiring settlement with bills guaranteed by banks. Even when accepting bank-guaranteed bills, some companies restrict guarantees to the four largest state-owned commercial banks and pay considerable attention to credit management. Perhaps because of these efforts, the companies participating in the Research Group had not experienced any major incidents. Nonetheless, domestic sales in Asian countries will continue to expand and in order to take advantage of this trend, individual companies must gather credit information about their counterparties and exercise due care in their risk management. At the same time, many participants noted the need to improve the infrastructure of Asian countries themselves. For example, there is a need to enhance corporate accounting systems and disclosure requirements, auditing mechanisms and the legal framework for preserving credits.

6. Other discussion points

This paper summarizes the main points of discussion in the Research Group. There is, however, another point that can be perceived throughout the discussions: the fact that even though Japanese companies are major players in the economic activities of the Asian region, the use of yen is generally very limited. For example, on the fundraising side, they use MTN programs via their Singapore financial subsidiaries by issuing yen-denominated notes to Japanese investors and usually convert the proceeds into dollars by using currency swaps. On the trade side, there are some Asian affiliates denominating imports of parts from Japan or exports of finished goods to Japan in yen, but these cases are limited. In most cases, they denominate their imports and exports in dollars. Some indicated that when operations were initially started in China, imports of parts and materials from Japan were denominated in yen, but as business reoriented towards domestic sales and sales began to be collected in yuan, they began switching their parts sourcing to Japanese parts manufacturers with operations in China and local Chinese manufacturers. This ended up reducing yen-denominated exports of parts from Japan. Some also pointed out the international practice of pricing steel and chemicals is still in dollars and there is little room for use of the yen. The "internationalization of the yen" has long been discussed and one important point to keep in mind in future discussions will be "the position of the yen within Asia" as Japanese companies become more involved in the region and economic ties with Japan grow closer.

The Research Group also discussed the activities of Japanese banks, which are becoming more proactive in their stance towards business in Asia. All of the companies participating in the Research Group depend on Japanese banks in Asia for a considerable part of their fundraising, settlement, and remittances and they expressed the hope that Japanese banks would rigorously develop their business in Asia through strong competition with their counterparts from Europe and the United States.

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