6-1993

Japanese Investment in United States Securities: 1980-1985

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<u>JAPANESE INVESTMENT IN UNITED STATES SECURITIES</u>
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JUNE 1, 1993

This paper will deal with the topic of Japanese investment in United States securities during the years of 1980 - 1985. It is my contention that the vulnerable U.S. economic position created an opportunity for Japan to exercise political leverage over the U.S. to affect U.S. policy toward Japan. This paper will outline general and specific hypotheses, a discussion of the case and an explanation of possible methodology.

GENERAL HYPOTHESIS:

A country in a serious deficit situation will depend on foreign capital thus being subject to possible leverage being exercised by the investor nation.

SPECIFIC HYPOTHESIS:

Japanese investment in United States Securities provided the basis for equilibrium* of the U.S. economy which in turn provided an opportunity for Japan to exercise leverage over the United States.

* Definition of equilibrium: a balance between budget and debt.

CASE DESCRIPTION:

To understand the full impact of Japanese investment in American Society, the situation underlying the influx of Japanese capital into the U.S. must first be understood. This is best portrayed in a historical context.

Following World War II the United States emerged as the clear winner in the western world. As a result the U.S. found itself in the position of hegemon. This role presupposed that the United States was both capable and willing to be the world leader in enforcing the rules of free trade and free flow of capital. In the late 1970's, however, the United States began to experience the adverse effects of hegemony. Contributing to the United States' financial woes were the repercussions of a very costly Vietnam War as well as the OPEC oil embargo which had crippled the U.S. economy. Additionally, the Bretton Woods monetary regime which had been in place for the previous thirty years collapsed. Earlier in the decade President Richard Nixon had effectively eliminated the Bretton Woods regime in an attempt to minimize the adverse effects of the threat that the United States would have to convert dollars into gold.

In this sweeping move Nixon:

> "1) suspended the convertability of the dollar into gold, 2) imposed a surcharge on U.S. imports, 3) instituted wage and price controls as a means of arresting the accelerating rate of American inflation, and 4) enacted a substantial devaluation of the dollar."[1]

The result of this was floating rather than fixed exchange rates. This policy would profoundly affect the economy in the coming years.

Additionally, in response to the deteriorating health of the U.S. economy the Federal Reserve took an active monetary role and increased interest rates on U.S. securities. At the same time the Reagan Administration was pursuing a policy of deficit spending. In an attempt to stimulate a sluggish American economy, the Administration attempted a program that has been referred as "Reaganomics". This plan in effect would decrease taxes thus theoretically putting more money into the pockets of consumers. These measures were intended to stimulate and revitalize the economy. The outcome of this policy was good in the short run but more detrimental in the long run. Additionally, the Reagan Administration pursued a policy of unprecedented military spending thus straining further the empty coffers of the U.S. treasury.

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[1]Gilpin, Robert. The Political Economy of International Relations. Princeton University Press (1987) p.141.

The Reagan policy decreased the amount of tax revenue to the U.S. government while at the same time substantially increasing the debt incurred by the U.S. Almost overnight the United States went from being the world's largest creditor nation to the world's largest debtor nation. In this serious situation the U.S. was in dire need of capital from other nations. Also because of the high interest rates, investment in American institutions and securities was a lucrative business. The result of these factors was a hungry U.S. economy and an attractive securities market--thus yielding a situation ripe for foreign investment in the U.S.

Consequently that which Robert Mundell argued in 1966 proved to be true.

> "That: when international capital flows are sensitive to interest rate differences and exchange rates are floating, a country that runs a large budget deficit and does not finance by printing money will incur a large current-account deficit but will have a strong currency too. The budget deficit will push interest rates and will pull in foreign capital. When exchange rates float, however, a country with a net inflow has to have a matching current-account deficit, and its currency must appreciate sufficiently to generate that current-account deficit. In other words, the country must become less competitive in its own and world markets."[2]

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[2]Ibid. p.154.

The high returns enticed many foreign investors to bring their investments to America. Japan, because of earlier reforms was in a position to supplant the United States' expensive lifestyle. During the 1970's Japan had drastically cut it s oil consumption, expanded its exports and increased it s technological base all resulting in a healthy Japanese economy. As a result the early to late eighties saw phenomenal Japanese investment in U.S. savings bonds. In 1983, outflow of Japanese capital was 17.7 billion, in 1984, 49.7 billion and in 1985, 64.5 billion. A significant increase can be seen in the investment pattern. Additionally, in the area of securities the trend follows a similar pattern as shown by the following statistics:

Net Capital Flows: in millions U.S. $.

Securities

1978:	2,226
1979:	59*
1980:	3,001*
1981:	6
1982:	1,248*
1983:	3,943
1984:	10,591
1985:	29,874

*Indicates inflow to Japan.[3]

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[3]Stern, Robert. Trade and Investment Relations among the United States, Canada and Japan. Univ. of Chicago Press (1989) p.106.

It is widely thought that without the drastic influx of foreign capital the Reagan Administration would not have been able to have increased domestic consumption while greatly enlarging the military. Also the , "greatly overvalued dollar would [most likely] have declined and perhaps collapsed in value as a consequence of the Reagan Administration's economic policies had it not been for this Japanese financial backing."[4]

As a result the United States found itself in a vulnerable position. Japan could, if it so chose, exert a large amount of political pressure on the United States. That would be the object of this paper to prove that Japan had used or was on the verge of using its economic advantage over the United States to affect U.S. policy.

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[4]Gilpin, Robert. The Political Economy of International Relations. Princeton University Press (1987) p. 332.

METHODOLOGY:

This case presents some unique methodological problems. It is difficult to prove that Japan actually had exerted pressure on the U.S. Either the instance would be obvious or too small to detect. However, the following steps could be followed in determining Japanese political pressure.

First *political pressure* would need to be defined. For the purpose of this paper it would be defined as something as small as a verbal threat as well as more punitive actions such as withdrawal of securities held by Japanese. This would be determined by examining news sources for the years 1980 through 1985. The value of this would be to identify possible threats from the Japanese government or Japanese investors. Additionally, I would like to interview both Japanese and American financial policy makers. This would include Members of the United States Congress, the U.S. Federal Reserve as well as members of the Japanese Finance Ministry.

Also, an important clarification in doing this paper would be to determine what percentage or proportion of the total investment in government securities was Japanese. This would help greatly in determining the extent of Japanese economic power that could possibly be leveraged to affect U.S. policy.

Another interesting angle to examine would be other nations that have large investments in U.S. securities. If the general hypothesis can hold true, then the possibility of other nations threatening or actually exerting political leverage over the U.S. would be evident. Also, other nations in economic peril could be examined and compared and contrasted to the United States situation.

Finally, the case could be incorporated of into the framework of the hegemonic stability theory. Hegemonic stability theory asserts that a hegemonic power will emerge and that this power must be capable and willing to accept military and economic leadership. Thus, the hegemon can enforce the rules of free trade as well as establish a uniform currency and promote the free flow of capital. However, the hegemon may contribute to its own decline by economic and military over-stretch.

In this context the assent and decline of the United States hegemony could be charted. Then access the rise of Japanese power and protectionist policies exhibited by the U.S. and Japan. This could be used to show that when a hegemon becomes marginal then protectionism takes place and leverage will be exercised by a potential hegemon over the fading hegemon.

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