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# International Economics Policy Briefs

## The Looming Japanese Crisis

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After more than a decade of economic stagnation and minimal structural change, Japan stands on the brink of outright financial crisis—the only debate is whether the Japanese government can dodge its imminent economic threats for another six months at most, or ride the wave of global expansion to throw still more money at these problems with decreasing effectiveness until the public debt becomes unsustainable (which should be no later than 2005). Either way, volatility in Japanese asset markets will be extremely high for the next 36 months, with significant declines on average in asset prices and the yen.

Japanese savers remain highly risk-averse and this puts a drag on change in general and provides a buffer for policy mistakes—their passivity should not be exaggerated, however, and cannot be depended upon to stave off crisis.<sup>1</sup> In the last six

months, in anticipation of deposit insurance limits and bank failures, over ¥100 trillion in household savings has been moved from weaker banks to cash, gold, offshore accounts, and the four “too-big-to-fail” merged banks. Given the ongoing drain of liquidity from Japanese asset markets, the movement of even a few percent more of household savings, along with the remaining mobile international capital in Japan, could produce large declines in asset prices. Such movements would rapidly intensify both the current credit crunch for Japanese small- and medium-sized enterprises and the Japanese government’s mounting fiscal difficulties.

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A reasonable baseline forecast for the Japanese economy is for modest growth, driven by exports of manufactures and the end of the inventory cycle.<sup>2</sup> I argued in early 2001, however, that the Japanese government then faced a choice between decisive

1. Adam S. Posen, *Restoring Japan's Economic Growth*, Washington: Institute for International Economics, 1998, chapter 4.

2. Michael Mussa, “Prospects for the World Economy: From Global Recession to Global Recovery,” Institute for International Economics Policy Brief 02-2, April 2002.

preemptive action and outright financial crisis.<sup>3</sup> But no decisive action has been taken since the Koizumi cabinet took office in April 2001. Therefore, the downside risks make it very unlikely that the baseline forecast will be achieved—in fact, the Japanese economy is likely to tumble into crisis sometime before the Diet's supplemental budget process begins in September 2002. This reflects Japan's increasing vulnerability to shocks, now that it is caught in the tightening vise of debt-deflation and fiscal erosion. There is no shortage of potential triggers for such a crisis in coming months. One most likely trigger would be contingent claims becoming explicit on the government balance sheet, the impact of which would be amplified by policy mistakes. A crisis in Japan would not be Argentina redux, but it would have severe consequences for the country and the world economy.

Crisis in Japan is not yet inevitable. A comprehensive policy package of bank closures and recapitalization, money-financed Bank of Japan (BoJ) purchases of long-term Japanese government bonds (JGBs), and replacement of public works spending with tax cuts could still save the Japanese economy from this fate. By putting distressed assets back on the market and removing uncertainty, asset markets would soar and Japan would grow at or above potential for an extended period (2.5 percent plus per annum).<sup>4</sup> Increased explicit pressure from the US and other governments could somewhat increase the chances of such a policy package being adopted. This policy brief makes the sober but realistic assumption, however, that there will be no meaningful change in Japanese economic policy until a crisis hits, and actions taken then will likely be too late to forestall the negative impact.

### **Increasing Vulnerability to Shocks**

Japan is running out of room for error in its economic policy. President George Bush's February 2002 visit to Tokyo did not result in any new initiatives by Prime Minister Junichiro Koizumi to clean up the bad loans—in fact, the disclosure by the Financial Services Agency (FSA) that results of this year's "special inspections" of banks would be disclosed only by

bank category without revealing specific banks' situations, confirms that supervisory scrutiny is moving backwards.<sup>5</sup> The mid-February 2002 firing of former Foreign Minister Makiko Tanaka burst the bubble of Koizumi's popularity—the initial 30-plus percent drop in his approval ratings has been sustained and according to most recent polls, the Koizumi cabinet's disapproval ratings now exceed its approval ratings.<sup>6</sup> Diet opposition both within and outside of the LDP-coalition is sufficient to block any Koizumi initiative, and the opposition has increased since Tanaka's firing.

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This combination of falling popularity and Diet opposition makes it very unlikely that the Koizumi government will respond to Japan's economic problems during its remaining time in office (which is the foreseeable future). A game of chicken amongst the "responsible" ministries (BoJ, FSA, Ministry of Finance [MoF]) is stalemating any progress on policy—neither the Cabinet Office nor Koizumi can break it up in the absence of external pressure or overwhelming popular support. The lack of any clear alternative to Koizumi for prime minister makes it likely he will hold on to the office, be spared explicit pressure from the United States, and remain ineffectual, until an outright crisis hits.

Yet, in the absence of preemptive policy action, two powerful economic forces are pushing the Japanese economy toward outright crisis. One is the vi-

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3. Adam Posen, "Japan 2001: Decisive Action or Financial Panic," Institute for International Economics Policy Brief 01-4, March 2001.

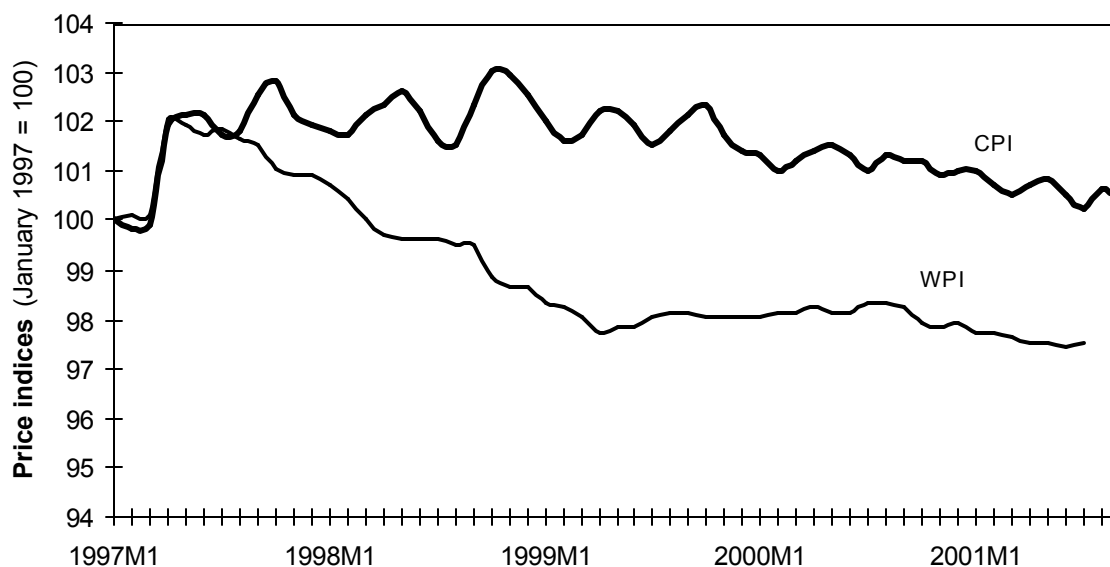
4. This potential solution is discussed in Adam S. Posen, "Macroeconomic Prospects and Policy Options for Japan," January 15, 2002 revision of speech given at "Where Does the Japanese Economy Go From Here?" Conference, Columbia Business School, November 1, 2001; see <http://www.iie.com/papers/posen0102.htm>. US Council of Economic Advisers Chair R. Glenn Hubbard advocated a nearly identical policy package for Japan in a recent speech. See "Impediments to Growth in Japan," at the NBER Conference on Structural Impediments to Growth in Japan, Tokyo, March 19, 2002.

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5. See "FSA to Release Bank Inspection Results On Combined Basis: Yanagisawa," *Nihon Keizai Shimbun*, March 19, 2002, 1.

6. In the *Asahi Shimbun* opinion poll of April 1-2, 2002, public approval fell to 40 percent, while the disapproval rating rose to 44 percent. See "Disapproval of Koizumi's Cabinet Exceeds Approval for First Time," *Japan Digest*, April 3, 2002, 1.

Figure 1 Deflation in Japan



Source: IMF International Financial Statistics, February 2002.

cious spiral of debt-deflation, which has now accelerated in Japan. Every succeeding month of deflation raises the real burden of outstanding debt and decreases consumer demand, both of which increase the number of bad loans; every additional bad loan decreases credit available to viable businesses and further depresses asset (especially real estate) prices, reinforcing deflation (figure 1 shows the declining Japanese price level).

While always theoretically possible, debt-deflation has now become a palpable reality in Japan. Even on the government's vastly understated estimates of nonperforming loans, classification IV ("risk management" or defaulted) loans have been rising more quickly than banks can provision (given their diminished capital and profits), an imbalance unseen even in 1998. Figure 2 shows the ratio of new classification IV loans to banks' write-offs of bad debt, which now is higher than one—this is an explosive process and ultimately unsustainable for more than a few quarters without government intervention in the form of bank closures and recapitalizations.<sup>7</sup> Even if attempted, that recapitalization, however, may not be easily managed.

This is because the second force at work is the well-known accumulation of gross public debt in Japan, which reached over 130 percent of GDP in FY2001 (see figure 3). Admittedly, the threat to sol-

7. Of course, if total official bad loan numbers—let alone more realistic independent estimates of outstanding bad loans—were used, rather than the minimum bound of Classification IV loans, the ratio would be many times higher.

veny this presents for the Japanese government is often exaggerated:<sup>8</sup> net public debt is much lower than gross debt, even after discounting most government assets; gross household savings remains in excess of 200 percent of the value of GDP; only 5 to 6 percent of JGBs are held by foreigners; and all Japanese public debt is denominated in yen.

There remains, however, the risk of a liquidity crisis in the JGB market from several sources, including (1) preemptive downgrades by bond rating agencies; (2) a falloff in tax revenues associated with debt-deflation;<sup>9</sup> (3) a collapse of a bankrupt local or prefectural government and the associated banks, requiring a public bailout;<sup>10</sup> and (4) the need to suddenly inject a large amount of capital into the banks or the deposit insurance system in response to a bank run.

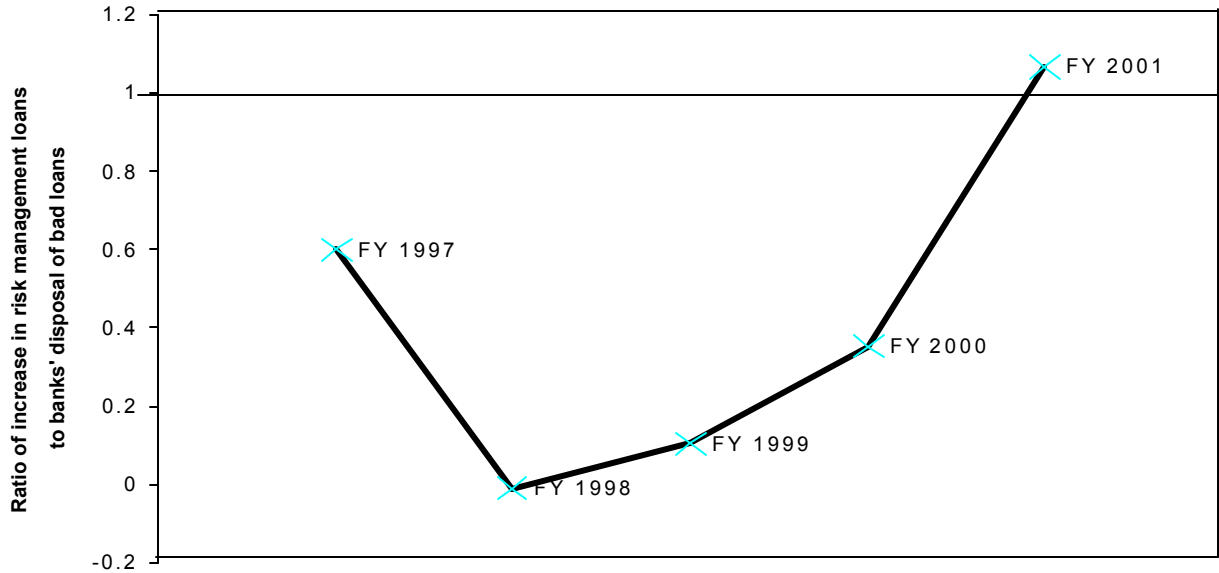
Any of these, almost certainly accompanied by a sudden rise in rates on long-term JGBs, would tip the government's debt dynamics into as unsustainable a process as the private debt, where new debt accumulates faster than principal and interest can

8. Posen, 1998, op cit, Chapter 3.

9. The drag from recession on tax revenue is the real source of Japan's rising deficits, not so much public works spending. See Kenneth N. Kuttner and Adam S. Posen, "Passive Savers and Fiscal Policy Effectiveness in Japan," Institute for International Economics working paper 02-2 (forthcoming in the *Journal of the Japanese and International Economies*), <http://www.iie.com/catalog/wp/2002/02-2.pdf>.

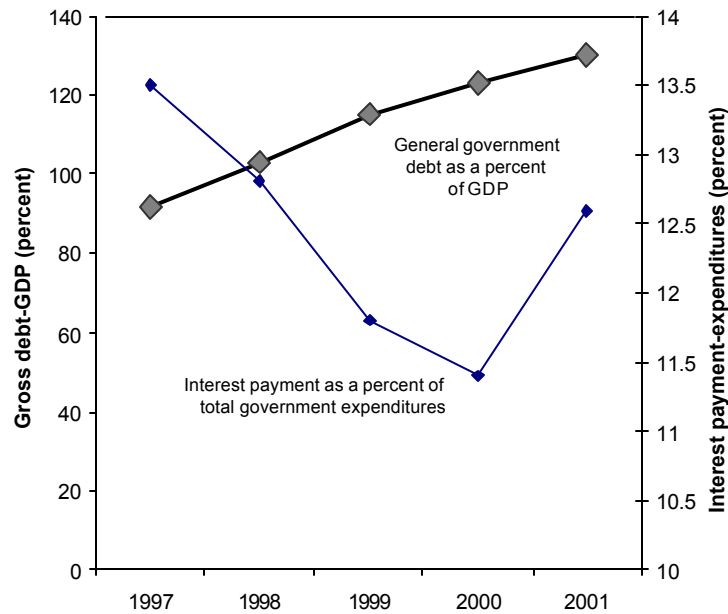
10. Almost all local and prefectural Japanese governments are in significant debt, if not bankruptcy, and fund their debt through (partly coerced) bank loans from local banks, rather than by issuing bonds.

**Figure 2 Growth of bad loan burden**



Source: Annual data from Financial Services Agency, Classification IV ("Risk Management") loans, "Loss to Banks on Disposal of Bad Loans." FY 2001 is computed from an official projection.  
<http://www.fsa.go.jp.news/e20020201-2e.html>.

**Figure 3 Fiscal indicators for Japan**



Source: OECD Economic Outlook, Japanese Ministry of Finance,  
<http://www.mof.go.jp/english/budget/brief/2001/brief04.htm>.

be paid. With the annual government deficits currently running at 8 percent of GDP, the current relatively low share of interest payments in Japanese government expenditures (shown in figure 3) would rise quickly with increasing interest rates. Even in the absence of interest rate increases, the Japanese government can afford at most three additional years of slow or negative growth before those explosive debt dynamics kick in, and 2002 will already use up one of those.

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It is reasonable to argue that neither of these underlying dynamics constitutes an “action-forcing event” in the near term, that is a shock that will move faster than Japanese authorities can respond to, in and of themselves. And the noted passivity of Japanese savers does give the government some leeway. Still, the underlying dynamics and eroding confidence act in the other direction, diminishing the Japanese government’s room for error; a pickup in exports to the United States will provide only limited additional growth cushion.<sup>11</sup> The list of potential, if not likely, shocks that could accelerate these dynamics is long (see section on “Potential Triggers for the Crisis” on page 8).

In any event, the March run-up in Japanese equities and in the yen against the dollar should not

fool anyone into thinking that the economy has meaningfully strengthened. The recent equity/exchange rate appreciation in Japan is the result of two factors unlikely to have a lasting impact: the annual repatriation of cash ahead of the March 31 fiscal year-end by indebted Japanese banks and companies holding foreign assets, and the good news on the US economy updating the markets’ expectations of exports to the United States.<sup>12</sup> These transient effects were amplified by the aggressive tactics of the MoF and FSA, including:

- new restrictions on short selling forcing those (foreign) investors already in short positions to buy in order to cover themselves;
- using threats of imposing those anti-short-selling regulations, and potential penalties, on large sales of equities to deter even normal transactions;<sup>13</sup>
- extreme pressure on the Trust Banks to buy equities;
- reminding everyone that there is money on hand to fend off bank runs, which will be disbursed without conditions.

Various investors and businesses in Japan will make their own assessments of when the debt-deflation and/or the public debt burden are getting out of hand. Until that time, the markets will be tentative at best about yen-denominated assets, but will continue to unload the better and more liquid of them. Brief sales of foreign (US) assets by Japanese banks to acquire cash will only feed further capital outflow with a lag when the banks are unwilling to lend repatriated funds domestically, and reach their limits on JGB purchases—the result will be a downward trend punctuated by occasional rallies, feeding volatility. The passage of time will only increase the actual and perceived likelihood of eventual crisis, bringing forward the day that will “eventually” come to pass.

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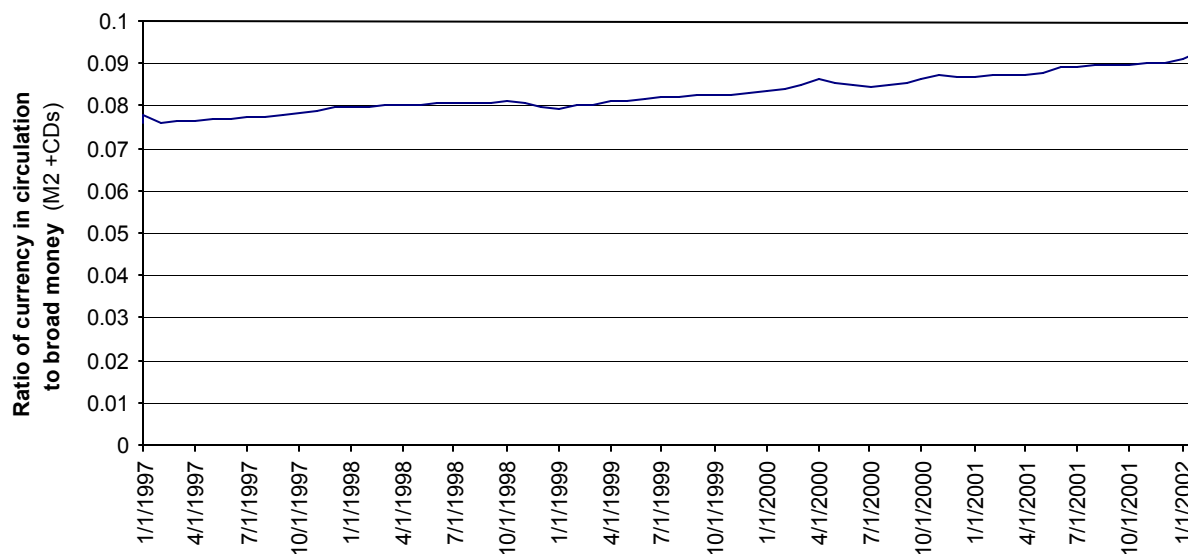
11. Only once since 1984 has either exports or net exports made a positive growth contribution of 1 percent or more to Japanese GDP. See Richard Jerram, “Exports Set to Lead the Recovery,” *Economic News*, ING Barings, March 20, 2002.

12. There seems to have been an overly optimistic reaction on this latter score. All available evidence suggests a steadily and significantly declining elasticity of Japanese exports to yen depreciation. See Satoru Horibe, “Can the Yen’s Depreciation Help to Cure the Japanese Economy?” *Tokyo-Mitsubishi Review*, 7(3): February 2002, and Mikihiro Matsuoka, “Is yen depreciation a panacea? Evidence of declining support to corporate profits,” *Deutsche Bank Group Economic Research*, February 25, 2002. Of course, there are also political and economic limits to how much one can expect US net imports and the trade deficit to increase from present levels. See Catherine L. Mann, “How Long the Strong Dollar?” Institute for International Economics Policy Brief, forthcoming.

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13. On March 22, 2002, the *Asahi Shimbun* reported that “many traders suspect the gains are just the result of excessive intervention by the financial authorities’...verbal orders and threats made privately by officials have stopped traders from making legitimate sales. Fundamentally what FSA did was to spring a bear trap, the paper said, forcing the shorts to scramble to cover their positions.” To reinforce it, *Asahi* added, “officials have persistently intervened in day-to-day activities of market players.” Translation in *The Japan Digest*, March 22, 2002, 1. Nonetheless, short-selling accounted for almost a quarter of March 2002 trading on the Tokyo Stock Exchange, see Alex Skorecki, “Short-selling forms 25% of Tokyo share deals,” *Financial Times*, April 23, 2002, 17.

Figure 4 Currency-to-deposit ratio



Note: The Bank of Japan redefined the definition of money stock in March 1998.

Source: Bank of Japan, <http://www.boj.or.jp/en/siryosiryof.htm>.

#### What a Crisis in Japan Would Look Like<sup>14</sup>

Obviously, even an outright crisis in Japan would not be on the scale of the Argentina crisis. Japan remains too wealthy, retains too large a creditor position, and its government institutions remain too entrenched for there to be a repeat of the type of collapse seen in the southern cone. Yet, Japan has far greater international implications given its size and creditor status, and still has the potential for dauntingly negative economic outcomes.

In essence, a crisis in Japan would be a repeat of what happened there in end-1997/early-1998, but on a larger scale and lasting more than a year. That would entail:

- flight of savings from Japanese banks into cash, gold, foreign banks, and foreign (mostly dollar) assets (as seen in figure 4, the currency-to-deposit ratio has been steadily rising since 1997, consistent with households putting cash under their mattresses rather than into the banking system);
- confused attempts by Japanese officials to run a “price keeping operation” by purchasing equities from banks, which will ultimately spur markets further downward and hasten the exit of foreign and sophisticated investors (this process has already begun, with those firms caught in the March short-selling trap looking to extricate themselves);

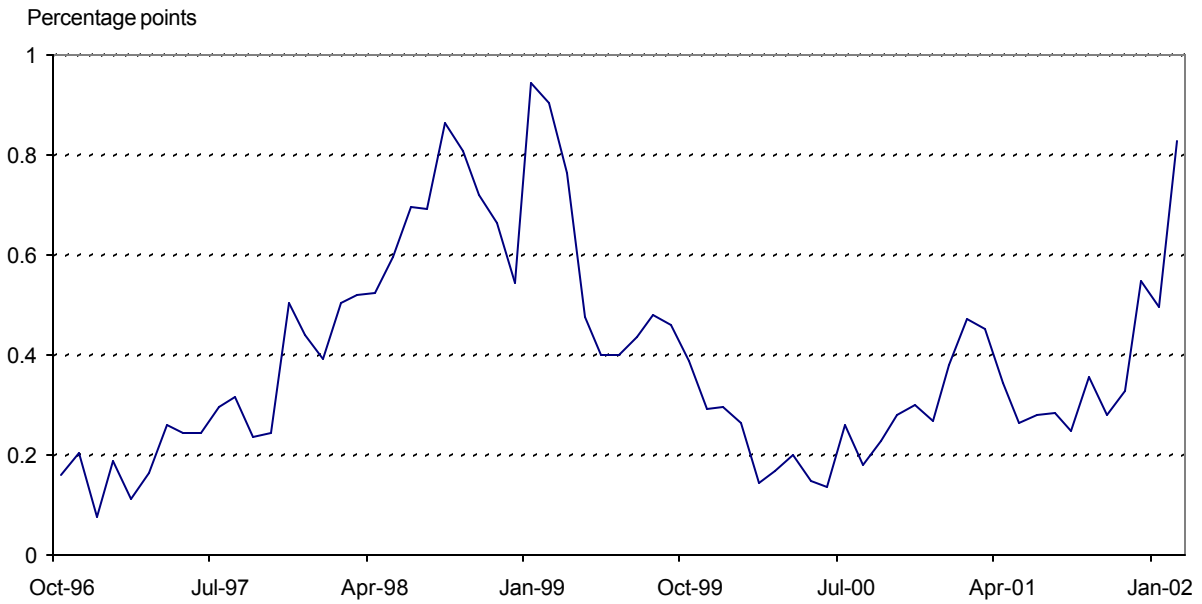
- sustained and accelerating falls in the yen (below ¥150/\$) and in Japanese stock prices (below 9,000 on the Nikkei);
- undiscounted business failures outside the banking system, likely in the construction, retail, and life insurance sectors;
- sharp declines in Japanese investment—as much as 1 or 2 percent of GDP—beyond the slowdown of the current recession (figure 5 shows the already widening spread between bank bonds and JGBs, which is indicative of tightening credit conditions);<sup>15</sup> and
- rapid large spikes in long-term JGB rates and additional downgrades by the rating agencies (figure 6 shows the rising market price for insurance against default risk on 10-year JGBs, now higher than in spring 1998).

The deservedly unsympathetic international response would be likely to exacerbate matters. There would be extreme volatility in international capital markets, with flight of money out of Asia generally and cascading regional depreciations against the US

14. I am indebted to Fred Bergsten, Mike Mussa, Marc Noland, and Ted Truman for discussions thrashing out this scenario, but do not implicate them for this forecast.

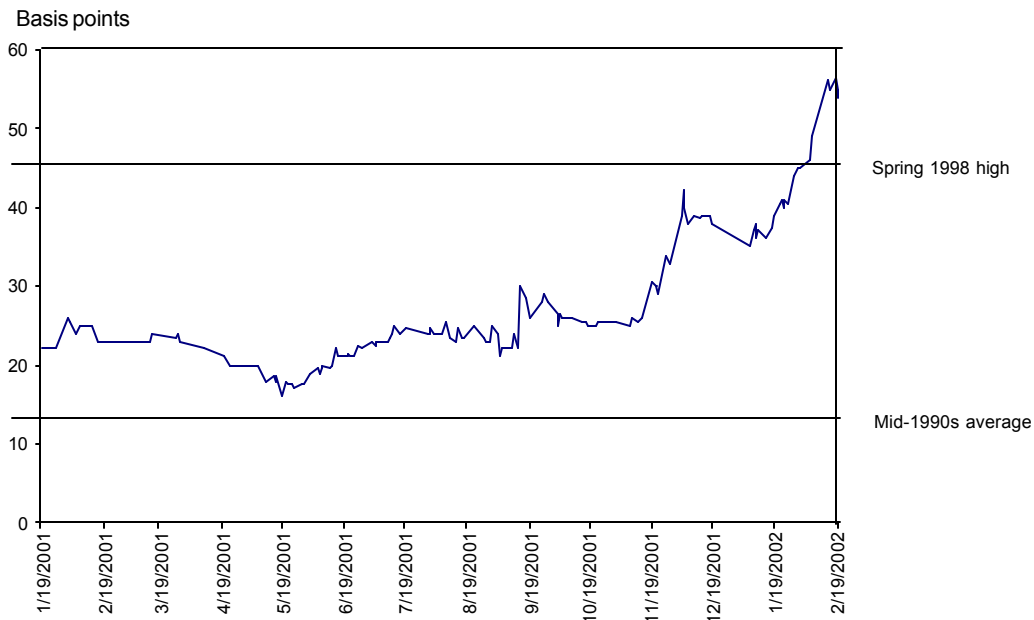
15. For a discussion of the credit crunch in Japan, see section 4 of Kenneth N. Kuttner and Adam S. Posen, “The Great Recession: Lessons for Macroeconomic Policy from Japan,” *Brookings Papers on Economic Activity*, 2001:2, 93-185. The IBJ bond spread shown in figure 5 is representative—all major bank bonds are traded at large premiums over JGBs at present. In other words, despite the disappearance of the traditional Japan premium (on the three-month libor-based yen), Japanese banks are again paying a premium to borrow. See James Fiorillo, “Japan Premium Back with A Vengeance,” *Industry News*, ING Barings, February 20, 2002.

**Figure 5 Credit spread between 5-year industrial Bank of Japan bonds and 5-year Japanese government bonds**



Note: End of month data.  
Source: ING Barings.

**Figure 6 Credit spread on 10-year Japanese government bonds**



Note: Market (bid) price on credit spread derivatives available as an insurance protection on bond default (daily data).  
Source: ING Barings, UBS Warburg.

dollar. In the United States, the industries most heavily hit by import surges would be the usual suspects of auto parts, electronics, and steel; the latter has certainly demonstrated its protectionist clout. The affected industries would put enormous political pressure on the US Congress—so would Beijing, Seoul, and other East Asian capitals on the US government—to respond with trade threats at a minimum.<sup>16</sup> Of course, a financial crisis in Japan would also cause some direct disruption in the US markets, but the resulting economic effect would probably be limited—although US banks' exposure to Japan remains sizable (\$33 billion as of September 2001), Japan's share in those banks' total outstanding foreign exposure has declined (especially their exposure to banks) and US banks' ability to withstand shocks is higher now than in the 1980s or early 1990s.<sup>17</sup> The impact will also be felt in a political channel of transmission along with the trade channel (I discuss this in the section on "Possibilities for US Preemption and Responses," see page 9).

Looking to the longer term, Japan "hitting the wall" would ultimately be a two-part process, whenever it begins. The first part would be the realization of contingent liabilities, disintermediation, and capital flight, as described. The second part would come once a large part of the Japanese financial system (not just banks) would have to pass through public ownership, as a result of the crisis. This is standard in major financial crises, even those in developed economies (such as Sweden in the early 1990s). There could then be an avoidable but likely mishandling of the resale and privatization of those assets by the Japanese government, particularly with regard to foreign acquisition of those assets. Such mishandling in that situation would once again deprive Japan of capital and put off the day of recovery. However, this second decision point would only be faced a year or two after the first hit occurs because it would take that long to stabilize the financial system through nationalization. Over the medium term of 3-6 years, one could expect Japan to finally stabilize its financial system, converging on the US model, with large-scale foreign participation.<sup>18</sup>

16. For an assessment of the likely trade effects of a yen depreciation, see Marcus Noland, Sherman Robinson, and Zhi Wang (1999), "The Continuing Asian Financial Crisis: Global Adjustment and Trade," Institute for International Economics working paper No. 99-4; see <http://www.iie.com/catalog/wp/1999/99-4.htm>.

17. I am grateful to Ted Truman for this assessment.

18. The argument for a long-term convergence between US and Japanese financial sectors, and the implications of that for trans-pacific relations, is given in Adam S. Posen (2002), "Finance," in *U.S.-Japan Relations in a Changing World*, Steven Vogel, ed., Brookings Institution Press, forthcoming, <http://www.iie.com/catalog/wp/2001/01-8.pdf>.

### **Potential Triggers for the Crisis**

Recent market manipulation and good luck (with respect to the US recovery) has gotten the Japanese government through the March 31 fiscal year-end without incident. At some point in the near future, however, a negative shock can be expected to force the Japanese government to take on what is now a contingent liability as an explicit and large expenditure on the government's balance sheet. The most likely candidates are (1) insolvency of a regional or prefectural government, with collapse of the attending mid-sized bank; (2) government assumption of the pension fund obligations of a failed construction or retail company; or (3) loss of savings of a number of Japanese savers in a bankrupt life insurer. Alternatively, the government could be faced with such a claim and have to publicly renege upon it.

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Either way, when that shock occurs, there will be a sudden spike in JGB interest rates as well as increased scrutiny and fear of the rest of the contingent liabilities in that class (other local governments, other pension funds).<sup>19</sup> There will also be some combination of capital flight out of Japan, from the remaining liquid parts of the market, and further movement of domestic Japanese funds from the banking system into cash, gold, and postal savings. This will cause investment to contract. The crisis scenario spins out from there along the lines described in the section on "What a Crisis in Japan Would Look Like" (see page 6).

Even healthy economies have unexpected setbacks and the ability of policymakers to respond to them determines their ultimate impact on the economy. Consider the list of likely policy-driven shocks to the Japanese economy in coming months, which are also factors likely to lead to the mishandling and magnification of the effect of any exogenous negative shocks that will occur:

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19. Morris Goldstein, *The Asian Financial Crisis: Causes, Cures, and Systemic Implications*, Institute for International Economics, 1998, argues that a similar "wake up call" to investors regarding a class of potential financial problems contributed to the Asian crisis.



- Large movements of Japanese savings out of private banks (already underway) turning into runs before deposit insurance limits are imposed on remaining bank accounts in April 2003;<sup>20</sup>
- Continued declines in real estate prices driving overt *yakuza* (organized crime) activity because of the government's refusal to put distressed assets back on the market;
- Revelations of unexpected insolvencies throughout the banking and other sectors with mark-to-market accounting, despite the recent stock market gains;
- A rise in long-term interest rates when Moody and Standard & Poor's downgrade Japanese debt to borderline investment grade rating levels (which they have already announced intentions of doing);
- Tax revenues falling off a cliff due to the recession while Koizumi remains pledged to a cap on debt issuance of ¥30 trillion for FY2001;<sup>21</sup>
- Koizumi's public support continuing to decline, and Diet resistance to any initiatives by him increasing as a result;  
Escalation of the finger pointing between the BoJ, the FSA, the MoF, and the Cabinet Office;
- Further repetition of Finance Minister Masajuro Shiokawa and FSA Minister Hakuo Yanagisawa's unsupportable statements that the banking system does not require public capital injections unless a crisis hits, making it more difficult for them to credibly respond to a problem;
- Similar repetition by BoJ Governor Masaru Hayami and his deputies of (equally unsupportable) statements that deflation is a supply-side phenomenon and that more aggressive monetary expansion risks causing hyperinflation;
- Erosion of public confidence in the bureaucracy, of unity in the governing coalition, and perhaps creation of an accompanying criminal scandal, due to the very public mishandling of food safety and other health issues;<sup>22</sup>
- Scapegoating of China (for cheap labor) and of the United States (for trying to buy Japanese assets cheap) for Japanese economic decline, discouraging necessary FDI flows in and out of Japan, particularly from and to the financial sector;
- Increasing trade frictions with China and emerging Asia. As the yen declines against the dollar, Japanese companies cut orders from abroad, and antidumping is used on both sides;
- Increasing trade frictions with the United States, as the Japanese trade surplus rises, US export industries get hit further, and US unemployment lags the business cycle; and
- Vulnerability to demonstrations of aggression from North Korea (remember the missile overflight of 1999), as well as to general terrorism, in its role as US ally against the Axis of Evil.

This would not be an easy set of hurdles to clear, even for an economy and a government in peak condition. The assumption that nothing will go wrong—that not even an earthquake will occur—seems unduly rosy. In fact, Japan has been quite lucky in the past few years, thanks to a growing world economy,

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a relative lack of protectionist pressures against it, and, even by Japanese standards, an absence of direct political opposition to government initiatives. This is unlikely to last. And the underlying vulnerabilities of the Japanese economy from banking fragility, debt-deflation, and fiscal indebtedness make it ill-prepared to withstand even small setbacks.

#### **Possibilities for US Preemption and Responses**

Beyond the direct economic impact, the United States has a real national security interest in keeping Japan from financial crisis and/or engaging in competitive devaluation with no reform to show for it. China, in particular, would play any crisis in Japan opportunistically, seeking to demonstrate its leadership role in Asia (by maintaining its fixed exchange rate peg against the dollar) while criticizing Japan. Given the Japanese government's own nationalism and mounting insecurity vis-à-vis China,

20. Some ¥27 trillion (equivalent to over 5 percent of GDP) had left uninsured accounts in the year to January.

21. According to our rough estimates, if Koizumi's debt cap is maintained, and growth is 1.5 percent less than government forecasts in FY2001 (that is growth in line with most private sector forecasts), the needed public sector contraction will take nearly another 1 percent off of GDP over two years. See Kuttner and Posen (2002), cited in footnote 9.

22. On April 2, 2002, the *Nihon Keizai Shimbun* reported that the coalition member Komeito Party's president Takenori Kanzaki called for the resignation of Agriculture Minister Tsutomu Takebe, saying he should take responsibility for mishandling the mad cow outbreak. This allied Komeito with anti-Koizumi forces in the LDP.

at least initially Japan would be prone to escalate any trade or diplomatic conflict rather than negotiate. Middle classes and politicians elsewhere in emerging Asia will respond angrily to Japan for exporting adjustment when they view themselves (justifiably or not) as having suffered in order to reform.

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***The United States should use the now credible threat of "Japan passing" as the leverage... An ally should not be left unchallenged for endangering US foreign policy interests and global stability just because it is an ally and the source of the danger is economic rather than military.***

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This could destabilize some regimes, worsen trade conflicts with Japan, and shift additional exports to the United States (further complicating American attempts to build domestic support for the Doha trade round, particularly any efforts to put antidumping on the table). The Bush administration does not (and should not) want such an outcome.

Through President Bush's February 2002 visit to Japan, however, the administration appeared intent on treating Koizumi the way his father (George Bush senior) treated then Russian President Boris Yeltsin in the early 1990s—that is, the administration seemed to think: "There are not any obvious alternatives, we like the guy personally, he seems to be the best hope of reform, no point in publicly pressuring him, we will embrace him and hope that gives him the strength to get good policies through." There are reports that President Bush was much more firm in his private communications with Koizumi, including in a letter leaked to the press. As was the case with Yeltsin, however, such a tactic with Koizumi underestimates US leverage and overestimates his inclination to reform. The point is moot whether Koizumi cannot or just will not take decisive action; he becomes irrelevant, if not harmful, to US interests if he does not. Therefore a more explicit policy of US pressure is worth it for desired outcomes.

The idea that the United States has no choice but to take what it can get from Koizumi overestimates the strength of his bargaining position in two ways. First, it misreads Koizumi's priorities: his one policy accomplishment so far, and what he chose to spend his honeymoon political capital on, was expanding the scope for Japanese military involvement.

While the US defense establishment was very gratified by this initiative, this should emphasize to that establishment that Koizumi's desires for foreign and security policy would be frustrated were ongoing US support and encouragement to be withdrawn. He needs US backing for expression of his foremost priority.

Second, the idea that the United States is lacking leverage does not take into account that the bureaucrats and the LDP party backers are the ones who still really run Japan on economic issues, though their diminishing authority is creating something of a power vacuum. This could have been different if Koizumi had not squandered his initial popularity, but it is now clearly back to business as usual. For both these reasons, access to status and participation in world affairs, international organizations, and especially to discussions over security and economics in Asia (e.g., relations with North Korea), all of which the United States still controls, provides leverage over what Koizumi and his bureaucratic masters want.

The key is that the United States has to decide from a foreign policy perspective to demand from the Koizumi government the economically and symbolically important step of a real bank cleanup. This is rightly the only Japanese reform that will satisfy Asian capitals, as well as the US Congress, and it is one of the two key steps (along with ending deflation) needed to arrest Japan's economic decline. Given that Koizumi's fulfillment of the US Defense Department's wish list post-September 11 did not amount to much, even those who advocated that our security alliance should take precedence have to realize that Japan's main contribution to Asian stability must come through economic stability—especially when large middle-income countries such as Argentina and Korea perceive themselves as having lost ground under efforts to live up to painful reform demands in recent years, while Japan has gotten away with exporting its miseries.

It remains to be seen whether the Bush administration turns its until-now friendly advice into an effective demand. On the economics side of the relationship, US CEA Chair R. Glenn Hubbard and Treasury Secretary Paul O'Neill have pronounced in visits to Tokyo the substantively justified and clear public line that "yen depreciation will not solve Japan's bad debt and deflation problems." Being right on the economics is not enough, though—if the effects of self-destructive economic policies were a deterrent to Japan's leadership, we would not be in this mess in the first place. That is why the message has to be: "Yen depreciation without a bank cleanup and rising unemployment in Japan is inexcusable, and a Japan that lets that happen will not be relied upon in

future." There has to be a link made to something the United States and/or the world will do to Japan if Japan further damages world economic growth and US national security interests.

It would, of course, be best for this to be done multilaterally and through economic means. Given the World Trade Organization, trade threats are out.<sup>23</sup> The G-7 process could be one avenue. Yet, years of reportedly forceful behind-closed-doors criticism in the G-7 has not yielded results. It is time the rest of the G-7 declared publicly that, until Japan undertakes domestic financial reform and monetary reflation, there will be no exchange rate intervention to aid Japan should the yen strengthen, and that any unilateral efforts by Japan to weaken the yen without prior domestic reform will be opposed by coordinated intervention. Clearly, a yen depreciation that resulted from aggressive monetary expansion would help fight deflation in Japan, but the bulk of that battle has to be fought using domestic tools, and the banking problems must also be faced.<sup>24</sup> When Japan takes on both its debt and deflation problems, a

yen depreciation should be welcomed (perhaps managed) by the G-7.

Yet, exchange rate intervention and the G-7 have their obvious limitations, and therefore the pressing need to prevent crisis in Japan cannot be left to these means alone. It requires US unilateral action as well, particularly after September 11, precisely because this is a foreign policy matter and involves our most important ally in Asia. Once the foreign policy side of the US government does acknowledge this as priority and is willing to put the pressure on Japan, there will be viable options. The threats must be communicated that Japan will be downgraded or ignored by the United States in favor of China in various ways, and will be allowed to take the blame for economic destabilization in Asia, if it does not finally take responsible action.

In short, the United States should use the now credible threat of "Japan passing" as the leverage. This can be as simple as expanding bilateral discussions with China while pointedly not keeping the Japanese informed, or as provocative as making assenting murmurs to China on its efforts at free trade with its ASEAN neighbors while remonstrating with Japan on its agricultural protectionism, or as direct as letting the Japanese government know (through the press) that scenario planning is going on for an Asian policy with an unimportant Japan. An ally should not be left unchallenged for endangering US foreign policy interests and global stability just because it is an ally and the source of the danger is economic rather than military.

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23. For a more sophisticated argument about this point, see C. Fred Bergsten, Takatoshi Ito, and Marcus Noland, *No More Bashing: Building a New Japan-United States Economic Relationship*, Institute for International Economics, 2001.

24. See Posen (2002), cited in footnote 4, for a more detailed discussion of why domestic monetary expansion should be preferred to purchases of foreign assets as a means of reflation.

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