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Finance and Changing US-Japan Relations:
Convergence Without Leverage— *Until Now*

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FINANCE AND CHANGING US-JAPAN RELATIONS: CONVERGENCE WITHOUT LEVERAGE—*UNTIL NOW*

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In the postwar era, US-Japan economic relations have been characterized by substantial tensions, yet this has not damaged the underlying security relationship or critically harmed the multilateral economic framework. In fact, these two economies have become more integrated over time even as these tensions played out. These tensions, however, have required an enormous expenditure of political capital and officials' time on both sides of the Pacific and have led to foregone opportunities for institution building and policy coordination.[1] They have deepened since Japan "caught up" with the United States around 1980, and Japanese and US firms began increasingly to compete for profits and market share in the same sectors. Moreover, as both the US and Japanese economies continue to mature – both in terms of the age of their populations and their industrial mix – they will likely face even greater tensions between them over allocating the management and costs of industrial adjustment.

Financial liberalization and integration could change all this. At present, US and Japanese corporate governance and investment behavior appear to be converging towards the arms-length, market-based, US approach to financial markets. If this trend continues, it will not only reduce tensions in the near term by facilitating the resolution of specific disputes, but it could also forge common interests between domestic interest groups across the Pacific while giving those groups more power relative to their respective governments. Over the longer-term, convergence would also produce common US and Japanese policy goals in relation to international capital flows and investment. Finally, for a transitional period, convergence should simultaneously increase US influence <u>and</u> improve Japanese economic performance, a combination that has been difficult to attain since the first oil shock.

Convergence between the US and Japanese financial systems, however, is not a foregone conclusion. The general question of whether the decline of national models is inevitable remains open[2]—and the specific outcome of the interaction between Japanese political economy (arguably the most distinctive among industrial democracies) and financial liberalization (arguably the most

1. In the language of the introduction to this volume, the general picture is one of tension (instead of harmony), but more cooperation than conflict in terms of results, although there were mutual gains missed.
2. Suzanne Berger, "Introduction," in Suzanne Berger and Ronald Dore, eds., *National Diversity and Global Capitalism* (Cornell University Press, 1996), notes (skeptically) that convergence might occur because of economic opportunism and competitive deregulation, open borders and markets, belief in liberal ideas, or direct international pressures on countries and domestic demands. See also Adam S. Posen, *Restoring Japan's Economic Growth* (Institute for International Economics, 1998), chapter 6, for a different set of arguments why "national models" will fail to converge overall.

transformative aspect of globalization) already is unfolding as a critical case study.[3] Even if most would agree that some form of liberalization has taken place in Japanese as well as American financial markets, scholars disagree over whether the Japanese form of liberalization is distinct from the American, whether this liberalization is likely to be the victim of political backlash (in either country), or whether financial sector change is likely to transform the rest of Japan's economy.

This essay is focused on a related but more policy-oriented question: If we assume that the current trends toward liberalization in and convergence between the United States and Japanese financial system persist, how will this affect US-Japan relations? I will present evidence of convergence toward the increasingly deregulated US system over the past 15 years, and I will argue that this trend is likely to persist and probably accelerate. I assume as well that the case need not be made here on the pure economics why the more liberal model is likely to confer efficiency gains (at least in the short-run). I do not presume that the ongoing academic discussion of globalization and its effects has been settled. For purposes of policymaking, however, if this convergence assumption proves incorrect in the coming years, it almost certainly would mean that financial factors would be only a very minor factor in US-Japan relations (as it was until recently), or simply one of many sectoral disputes with dynamics with which we are familiar, having no special implications. Several hundred billion dollars have already been bet by Japanese and American investors on the belief that financial liberalization and convergence will occur, so it seems worth exploring the implications of this, I would argue, likely possibility.

The impact of financial convergence on US-Japan relations has been limited *to date*. Despite the breathless rhetoric about globalization, the concern with which some observers viewed the growth in Japanese holdings of US government debt, and the incidence of severe banking system problems in both countries, neither government has been able to extract much in the way of leverage over the other from financial sector developments. This may not come as a surprise to most observers, but it is worth documenting. I will argue, however, that many of the key deregulatory measures have only taken effect in Japan since the response to the 1997-98 recession, and that those, combined with the looming financial crisis awaiting Japan's undercapitalized banking system[4] will change matters.

3. See Frances McCall Rosenbluth, *Financial Politics in Contemporary Japan* (Cornell University Press, 1989), and Steven Vogel, *Freer Markets, More Rules: Regulatory Reforms in Advanced Industrial Countries* (Cornell University Press, 1996), for two somewhat opposing interpretations that agree this is a test case for globalization and for its effect on domestic political economy.
4. Adam S. Posen, "Japan 2001 – Decisive Action or Financial Panic," Policy Brief 01-4 (Institute for International Economics, 2001), explains why the banking system is likely to have an overt crisis in Japan in Fall 2001, though partial policy responses in the past have averted or delayed such an outcome.

Specifically, American FDI into and influence upon the Japanese financial sector is likely to mount in the coming years, and this will reinforce American "soft power" over the ideas driving international financial arrangements. This combination of financial flows and ideational factors has already radically shifted the setting of the US-Japan trade agenda, the willingness of both governments to engage in exchange rate intervention. While a future political backlash may raise tensions, the underlying economic forces will drive the United States and Japan into closer cooperation in terms of results on financial issues.[5]

These financial developments are unlikely to have much direct impact on US-Japan security relations, but they are likely to exemplify and feed many of the themes about the broader relationship identified in this project: economic issues growing less contentious between the two countries; military power becoming less important as a factor in determining bargaining power between the United States and Japan,[6] and non-governmental actors and international organizations continuing to increase their role in the relationship at the expense of the two states.

1. THE COURSE OF FINANCIAL LIBERALIZATION SO FAR IN THE UNITED STATES AND JAPAN

For this chapter, the independent variable influencing the US-Japan relationship is finance, both the state of finance within the two countries as well as financial flows between them. The source of variation is the long slow process of deregulation, first in the United States, second and more slowly in Japan. Up until 1980, there was little change of import on this front in either country. The size and turnover of international capital flows only significantly expanded beyond that necessary for trade in the mid-1980s.

Accordingly, this section gives a brief history of domestic financial deregulation and response in the United States and in Japan, and then an overview of the development of transpacific capital flows, emphasizing the last 15-20 years. Underlying developments in both countries are four facts: First, both financial systems started out with strict regulations separating banking and securities activities; second, both systems started out with limits on the returns that could be paid depositors and the vast majority of domestic savings in bank accounts; third, both systems faced fundamentally unprofitable banking systems once these barriers began to erode; and fourth, both systems suffered through banking crises caused by financial firms' reaction to partial deregulation and lax supervision. Even when we speak of "convergence," thereby

5. Schoppa's chapter illustrates how greater tensions in domestic politics over the Japanese or American government's stance on a given issue can still lead to increased cooperation as a result.
6. Though, in this issue area, financial developments still leave the United States relatively advantaged versus Japan.

acknowledging a gap between national forms of both corporate finance and savings behavior and regulatory practices, we should not lose sight of these basic similarities. It is these similarities, arising out of the economic logic of what financial systems can and cannot do that gives rise to the convergence.

1A. The United States

The United States financial system was characterized by decentralization of both financial institutions and regulators, with additional divisions between types of financial firms and between states' rules.[7] The response to the 1929 stock market crash and the Great Depression had led to the creation of many legal barriers between firms, most notably the Glass-Steagall Act of 1933 preventing both interstate banking and the conduct of investment and commercial banking under one roof. Additionally, the Bank Holding Company Act of 1956 plugged any holes in Glass-Steagall's rules preventing commercial banks from holding stock in nonfinancial firms. Interest rates paid on individual's deposit accounts were limited by Regulation Q. The S&Ls were required to invest only in long-term housing loans, and therefore were limited in their risk-taking and profit making, but received the right to offer a little more to their depositors in recompense. The Securities and Exchange Commission was one of several regulators of financial markets, including state-level regulators who controlled both the life and casualty insurance industries (and still do).

Deregulation began in earnest with the Garn-St. Germain Depository Institutions Act, effective September 1983. This act legalized interest-paying deposit accounts and money-market funds, products already well under way as the inflation of the 1970s had made Regulation Q interest rate limits untenable and the use of certificates of deposit (CDs) had been deregulated by 1973. Garn-St. Germain also removed all statutory limits on real estate lending, opening up the S&Ls' mortgage market to competition but in return allowing the S&Ls to engage in commercial and consumer lending. Unfortunately, this regulatory pandering—giving each piece of the banking sector something—rather than encouraging exit of some banks sowed the seeds of what became the S&L crisis. Losing their traditional high-margin business, and presented with the opportunities to make loans in areas where they were unprepared to evaluate credit risks, the S&Ls ramped up real estate lending as part of an early 1980s boom. Commercial banks also shifted into lending to small and medium enterprises collateralized by land as they lost their best clients to the rise of commercial paper (CP) as a low-cost short-term financing option.

Meanwhile, more depositors switched their assets into money market funds (MMFs), CDs, and mutual funds, which made banks and S&Ls have to compete harder for loanable funds.

The collapse of the market for real estate in the mid-1980s cut directly into the capital of most S&Ls and many banks. As a measure of the change in real estate prices, Friedman[8] notes that the vacancy rate for commercial offices was 4 percent at the height of a recession in 1980, but 18 percent despite a recovery by 1986. The affected banks and S&Ls behaved just as economic theory would predict: until supervisors enforced matters, they invested in higher risk/high return projects in hopes of restoring their capital, they rolled over outstanding bad loans to avoid writing them down, and they stopped lending to high quality borrowers with safe low returns. These financial firms also rapidly escalated deposit interest rates, figuring that any losses would be covered by deposit insurance.

US supervisors unfortunately did some gambling on resurrection of their own, waiting to shut down banks and S&Ls with insufficient capital in hopes that better economic times would allow them to recoup their losses. This only allowed the problem to grow until it was necessary for large-scale government action to consolidate, recapitalize, and/or close failed institutions, and to begin selling off foreclosed real estate assets.[9] In August 1987, the Competitive Equality Banking Act put $11 billion into recapitalizing the Federal Savings and Loan Insurance Corporation, but this ended up being just the start of what became an estimated $159 billion hit (about 3 percent of a year's US GDP) to taxpayers for cleaning up the mess with final legislation coming only in 1993.

One positive outcome of this sequence was an increase in the sophistication of US savers, including a rising awareness that the limits per account on deposit insurance really would be upheld, and might come into play, as well as a greater appreciation for risk and for self-allocation of funds. As can be seen in figure 1, the allocation of US household wealth has shifted significantly over this period. The share of transaction accounts and other once standard bank accounts has steadily declined, and even CDs are held by half as many savers as at their height. Retirement accounts, mutual funds, and individual equity ownership have risen to compensate, as life insurance's share in savings has remained stable. The rise in share of the equity portion

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7. Benjamin Friedman, "Japan Now and the United States Then: Lessons from the Parallels," in Ryoichi Mikitani and Adam S. Posen, eds., *Japan's Financial Crisis and Its Parallels to US Experience* (Institute for International Economics, 2000).
8. Friedman, "Japan Now and the United States Then."
9. Robert Glauber and Anil Kashyap, "Discussions of the Financial Crisis," in Ryoichi Mikitani and Adam S. Posen, eds., *Japan's Financial Crisis and Its Parallels to the US Experience* (Institute for International Economics, 2000).

appears to be less than one-for-one with the run-up in the US equity market of 1994-2000, again indicating a healthy sense of discounting by American savers.

On the corporate finance side, a similar process was underway. After CP became standard for the largest American corporations, displacing short-term bank loans, the high-yield (junk) bond market grew to provide securitized financing for riskier businesses. The minimum size for American companies to go directly to the markets for financing, either to issue a bond or to go public with an equity issue, declined throughout the period. This gave rise to the growth in the volume of the NASDAQ and to lower demand for long-term bank lending. To manage their risks, as well as to offer differentiated products, American financial firms including banks began to create derivative securities and to securitize an increasing share of loans. Investors and borrowers could go directly to financial markets for lower costs of intermediation, or even without intermediation, to an unprecedented degree.

The United States' reactive approach to financial deregulation extended beyond the response to the S&L crises. The largest commercial banks slowly took on more capabilities by sending petitions to the Federal Reserve, as, in an early example, Bankers' Trust did by engaging in some investment banking activities. Bank holding companies were allowed to merge across state lines or acquire out of state banks, as recognized in the Riegle-Neal Interstate Banking and Branching Efficiency Act of September 1995 (taking effect in June 1997). Throughout the 1990s, financial innovations including derivatives in November 1999, after two decades of lobbying, Congress passed the Graham-Leach-Billey Act, effectively repealing Glass-Steagall and the 1956 Bank Holding Company Act. The expected effect is the emergence of a number of financial "supermarkets," like Travelers/Citibank/Salomon Smith Barney, offering a complete range of services. Some critics remain concerned that the risks to financial stability that Glass-Steagall was meant to prevent will reappear. The Federal Reserve has announced that it has moved to the use of bank-reported Value-At-Risk (VAR) models to assess the soundness of banks' portfolios, instead of examining the portfolios themselves, in what it deems a necessary response to the complexity of banks' diversification and securitization. The question is open whether such self-regulation will be effective. US banks are still prohibited from having shares in nonfinancial companies directly on their balance sheets, though they now may be held by other parts of their holding companies.

1B. Japan

The Japanese financial system traditionally featured indirect financing of industry, with a concentrated banking sector and underdeveloped capital markets.[10] As in the United States, there was compartmentalization between securities and banking activities, because the postwar occupying authorities imposed a law modeled on Glass-Steagall.[11] The banks had competition for depositors from the Postal Savings System, which doubled in size over the last 50 years, and now takes in two-thirds as many deposits as the entire private banking sector. Since Postal Savings funds were made available to the government for use in the Fiscal Investment and Loan Program, and since the Postal Savings system was regulated by the Ministry of Posts and Telecommunications in de jure cooperation (de facto competition) with the Ministry of Finance (MOF), it offered a slightly higher rate of interest as well as an implicitly superior government guarantee. Also, like the United States, all interest rates on deposits were regulated, but they were capped at much lower levels relative to lending rates and to returns on capital, as a conscious effort to subsidize investment.

There were strong limits on corporate finance in return for the lower cost of funds. Much of capital was administratively allocated by MOF, MITI, and other agencies, through the banks, because demand exceeded supply.[12] Only NTT, the telephone monopoly, Japanese National Railways (government owned), and electric utilities were encouraged to issue corporate bonds. All other private firms had to put up private collateral with a trust bank and then pay a securities firm for the privilege of selling a bond. The long-term credit banks provided most of the long-term lending for industry. Unlike in the United States, where the separation between banking and securities businesses arguably was a spur to financial innovation, in Japan financial innovation was limited by the MOF.

The MOF's view of financial stability meant controlling exit as well as entry to the financial market, and in so doing the regulators took a limited view of disclosure in their perceived interest(s) of stability.[13] Steil and Vogel[14] paint very similar views of MOF regulators as proud of their power and prestige, protective of the firms under their supervision, even more

10. See Shijuro Ogata, "Financial Markets in Japan," in Suzanne Berger and Ronald Dore, eds., *National Diversity and Global Capitalism* (Cornell University Press, 1996). Takeo Hoshi and Anil Kashyap, *Corporate Financing and Governance in Japan: The Road to the Future* (Massachusetts Institute of Technology Press, 2001), give a provocative historical argument that many of these attributes, and the whole *keiretsu*-Main Bank system in Japan, was a recent partly American creation.
11. Benn Steil, *Illusions of Liberalization: Securities Regulation in Japan and the EC* (London: Royal Institute of International Affairs, 1995).
12. Vogel, *Freer Markets, More Rules.*
13. Friedman, "Japan Now and the United States Then", p. 41, notes that until 1995, on the official records, no Japanese bank had an operating loss, a patently unbelievable situation.
14. Steil, *Illusions of Liberalization,* and Vogel, *Freer Markets, More Rules.*

protective of their administrative discretion, and clearly associating market competition with unnecessary risk. As one example of this view, deposit insurance was kept informal, without any specified limits, because the real objective was not to ever have any banks fail, so no deterrent effect on savers was desired.

Yet the same economic forces working on US banks and securities houses were also increasing competitive pressures on the Japanese financial system. As Ogata[15] notes, since the mid-1960s, there were growing private capital markets worldwide, growing Japanese government bond markets, diversification of the savings instruments available to savers, gradual erosion of compartmentalization, and then phased deregulation of interest rates paid depositors starting in 1985. Japan's persistent balance of payments surplus made capital controls less relevant, forcing banks to make their own decisions on credit allocation. By the mid-1980s, the same process that had hit the American S&Ls and small banks had begun in Japan. Japan's small banks were at least as ill-prepared to adapt their credit assessment as their US counterparts, and they had even fewer options for shrinking or changing their business lines.

The best Japanese non-financial firms were going directly to capital markets, whether at home or abroad, and were driving down margins on banks' lending and demanding cheaper capital. The CP market, for example was created in 1988, when 2.2 trillion yen were issued in the first year, before going on to average around 9 trillion yen a year in the 1990s.[16] In 1989 and 1990, literally no domestic yen bonds were issued by any firms other than NTT or electric utilities, because all corporate borrowers had gone to the euroyen markets. Banks were also getting squeezed on the deposit side, at least in terms of interest rates. In 1985-86, 150 trillion yen went into high yielding 10-year time deposit accounts at Postal Savings (instead of banks).

So, just as their American counterparts did, Japanese banks ramped up lending to small- and medium-enterprises on the basis of real estate collateral, feeding into a property boom. As Shimizu[17] carefully documents, up until 1983, total lending to all SMEs in Japan was about equivalent to the total lending to large firms. SME lending then began to rise for the remainder of the decade, reaching a level three times that of lending to larger firms by 1990. With MOF committed to no exit from the financial markets and banks still holding a large amount of (decreasing margin) loanable funds, banks had to chase new areas for lending. The three long-

15. Ogata, "Financial Markets in Japan."
16. Steil, *Illusions of Liberalization.*
17. Yoshinori Shimizu, "Convoy Regulation, Bank Management, and the Financial Crisis in Japan," in Ryoichi Mikitani and Adam S. Posen, eds., *Japan's Financial Crisis and Its Parallels to US Experience* (Institute for International Economics, 2000).

term credit banks made the biggest shift in lending toward SMEs and real estate since they had the sharpest fall off in loan demand.

The collapse of the Japanese stock market in 1990 and again in 1992, followed by steady declines in land prices, triggered the financial crisis with which Japan is still coping today. Underlying it, however, was the inherent problem of partially deregulating financial markets, neither allowing banks to change their business lines or to close, while their old margins and their old methods of credit evaluation eroded. MOF bank supervisors waited to close banks in hopes that a pick-up in the economy would bail them out. Japanese bank regulators still believed that stability was defined as no failures. Meanwhile, Japanese banks responding to the moral hazard of having too little capital and too much deposit insurance rolled over outstanding bad loans rather than writing them off and continued to lend on real estate well into the 1990s.

The *jusen*, the real estate lending companies owned by consortia of banks to handle small-scale mortgages, were the first to visibly collapse under the cycle of bad loans, depreciating collateral values, and credit contraction feeding further local SME business collapses and bad loans. MOF inspectors admitted in 1991 that 40 percent of their outstanding loans were non-performing, but gave the *jusen* a 10-year regulatory window to deal with the problem. Four years later in 1995, the share of non-performing loans on the *jusen*'s only slightly smaller balance sheets had risen to 75 percent. Cargill, Hutchison, and Ito put it very well:

> The resolution of the jusen industry [in 1995] was fundamentally flawed and illustrated to the market the [Japanese] government's unwillingness to objectively assess and manage the financial crisis. It illustrated that the convoy system was still operational by imposing the greater part of the resolution burden on the banking system...The intense public negative reaction to the small amount of taxpayer funding included in the plan gave the regulatory authorities the rationale to continue a policy of forgiveness and forbearance...As a result, the government became very reluctant to propose the use of public funds to resolve the financial distress. This reluctance to use public funds further delayed resolution of the non-performing loan problem and thereby substantially increased the ultimate resolution costs.[18]

The difference between the American and Japanese regulators' initial response was only in degree, not in kind,[19] but the difference in degree was enormous. American regulators, with prompting from legislators, tackled their S&L problem within five years of beginning and at a cost of 3 percent of GDP, and the problem was limited to some regions and types of banks. Japan,

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18. Thomas Cargill, Michael Hutchison, and Taka Ito, *Financial Policy and Central Banking in Japan* (Massachusetts Institute of Technology Press, 2000), 53.

by contrast, is now into its eleventh year of system-wide financial fragility, and the expected cost to the taxpayer is on the order of 100 trillion yen or 20 percent of a year's GDP. Between the surprise failures in Fall 1997 of Yamaichi Securities, the number four Japanese securities firm, and Hokkaido Takushoku Bank, a major regional bank on the north island, and the passage of a package of bank reform legislation a year later, Japan teetered on the edge of outright financial crisis.[20]

With the coming of the government of Prime Minister Keizo Obuchi in July 1998, following an LDP election setback in an upper house election, some real financial reforms were put in place. In a bill passed in October 1998, the government began to address recapitalization of the Japanese banking system with public funds. In addition to a new commitment to stricter supervision (see below), the government arranged for all but one of the largest banks, and most of the second tier banks, to take strictly conditional capital injections by 1 April 1999, based on new balance sheet inspections. The Japanese government received in return preferred shares that would allow the regulators to take over the bank or vote out management if the mandated capital adequacy ratio was not met. The trend of financial disintermediation in Japan was stopped and partially reversed as a result.

The MOF, now very much discredited with the electorate, was held accountable for mismanagement as a bank supervisor. In June 1998, the ministry was reorganized, and the Financial Supervision Agency was spun off with responsibility for the banking system. Within the MOF, the banking and securities bureaus were combined into a "Financial Planning Bureau".[21] Combined with the granting of independence from the MOF to the Bank of Japan, effective February 1998, the MOF became a shadow of its former self. Nevertheless, the Japanese tendency towards centralized regulation remained, and the FSA became the Financial Services Agency in 2000 with the addition of the securities industry to its portfolio and the movement of the Financial Planning Bureau to it from MOF. The nationalizations of the bankrupt Long-Term Credit Bank and Nippon Credit Bank in fall 1998 demonstrated the new FSA's resolve.

As in the United States, much of the Japanese securities deregulation proceeded down an independent track, neither impeded nor hurried by the country's banking crisis. Steil[22] offers

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19. What is interesting and frustrating, naturally, is that Japanese regulators appeared to learn nothing from the mistakes made in the United States, despite explicit attempts to communicate those. I return to this point in the next section.
20. Posen, *Restoring Japan's Economic Growth*, chapter 4, describes the situation and its dynamics at the time.
21. Jennifer Holt Dwyer, "US-Japan Financial Market Relations in an Era of Global Finance," in Gerald Curtis, ed., *New Perspectives on US-Japan Relations* (New York: Japan Center for International Exchange, 2000).
22. Steil, *Illusions of Liberalization.*

ample evidence that through 1995, Japanese securities markets had offered only the "illusion of liberalization." In November 1996, then Prime Minister Ryutaro Hashimoto announced his plan for "Big Bang" deregulation of financial markets. This plan promised a series of deregulatory initiatives through the year 2001. These included allowing price competition on brokerage commissions and other financial fees, removal of limits on individuals holding bank accounts abroad or trading foreign currencies, removal of restrictions on the trading of derivatives, and allowing cross-sectoral competition between banks, securities houses and insurance companies. Given the implementation lags for any deregulation initiative, it is difficult to say as yet what the ultimate state of the Japanese financial system will be once the banking crisis is resolved.

Japanese savers have suffered some hard lessons in recent years, and perhaps as a result their savings behavior has if anything grown more conservative (see figure 2). Demand deposits at banks and in Postal Savings have continued to account for around 55 percent of Japanese household savings throughout the 1980s and 1990s. Holdings of equities and bonds, which did rise in the 1980s with the asset price boom, have been halved since then. In fact, security and investment trusts have not been growing, despite some deregulation measures meant to encourage their growth. As will be discussed in the next section, it is the Japanese savers' unwillingness to move their money to seek out higher returns, which allows Japan to withstand its financial problems, which explains the lack of political demand for resolution, and which is the major drag on the forces for convergence.

1C. Financial Flows between the United States and Japan

It is often observed that capital flows between nations, and the desire to control or maximize inflows, is a major concern of economic policy today. The United States-Japan relationship putatively is affected by the huge flows between the two countries. Yet, transpacific financial flows have developed fitfully against this backdrop of slow deregulation and temporary crisis in the US financial system, and slower deregulation and ongoing fragility in the Japanese financial system. Tokyo is one of the world's major financial centers, and financial firms there allocate vast quantities of savings, but it remains relatively underdeveloped versus London and New York. In both the United States and Japan, the banks and firms who hold savers' money are actually engaged in vast international transactions–securitized mortgages in the US, for example, are re-sold worldwide; CP and interbank markets run 24 hours globally to maintain liquidity for the largest corporate players–but domestic savers still invest domestically.

So the capital flows between the world's first and second largest economies, between the world's biggest net debtor and biggest net creditor have not shown the same growth as global finance overall. One would expect direct banking flows to decline in relative importance as better corporate borrowers seek out disintermediated finance via securities.[23] And, it is clear that US bank claims on (loans to) Japan have been steadily declining since the height of the bubble, from $1.7 trillion outstanding to $220 billion, one-eighth of where it started; as a percent of total US banks' claims on foreigners, the decline over the period is from 24 percent to 3.5 percent, one-seventh. This lack of direct exposure may explain the relative lack of concern in some American quarters about Japanese financial problems. US banks' liabilities to Japan, shows a more mixed picture since 1988–the amount outstanding has fluctuated between $1.05 trillion and $1.9 trillion, first declining from 1988 to 1991, then rising again from 1994 to 1998. This would seem to reflect changing borrowing costs, where the "carry trade" of borrowing from Japanese banks charging near zero nominal interest rates and reinvesting elsewhere is profitable. Even as the level of borrowing rose up to surpass old highs, however, the share of Japanese lending in US bank liabilities abroad remained largely steady in the 11-13 percent range.

Moving to the holdings of equities, a different pattern emerges. The total sales and total purchases of US corporate stocks by Japanese investors have both been growing strongly since mid-1995. Both spent the 1990-1995 period fluctuating between $10-25 billion per month.[24] Since then, equity flows have grown steadily to a little more than $100 billion per month in purchases by Japanese, a little less than $100 billion in sales. The net purchases (or sales) have been largely undisturbed by this five or six-fold increase in capital flow, remaining at essentially zero, though varying month-to-month from positive to negative. Even ten years of monthly flows in the billions do not add up to large quantities of American equities in Japanese portfolios if the net each month is plus-or-minus $5 billion or less.

Conversely, foreign direct investment (FDI) is a form of capital flow with implications beyond those implied by its small volume. It is a flow that tends to be lasting, it often involves corporate control and transfers of technology and management techniques, and it has a visible political symbolism that many more liquid financial flows lack. Countries often have mixed feelings about foreign direct investment. If inflows come, the country can fear being "taken over"; if inflows do not come, the country can ask what makes itself unattractive. Similarly, if FDI flows out, the country can worry about exporting jobs, but if no FDI goes out, it can worry about missing out on opportunities left to others. As discussed below, the Unites States and Japan have experienced all of these feelings.

23. Less good corporate borrowers are unlikely to have access to international capital markets, and likely to be dependent upon loans from their local bank.
24. This appears to be a tiny fraction of the outstanding bank liabilities, but the equity number is a monthly flow whereas the bank liabilities are an outstanding stock.

Figure 3 gives the picture of annual flows of FDI to the United States from Japan, and vice versa. FDI from Japan to the United States was very high in the late 1980s, as the yen was strong and Japanese assets were very expensive relative to American ones. Despite the apparent attractiveness of the US economy in the 1990s to foreign investors, the relative expensiveness of American companies and the relative lack of investment funds in Japan due to the recession there kept FDI below $2.5 billion a year. Meanwhile, American FDI into Japan remained a trickle throughout this period, though 1998 and 2000 were record years for the inflow. To put the numbers in perspective, Japanese FDI outflow to the United States in 2000 was five times the US FDI inflow to Japan in the record year.[25] If there is an asymmetry in US-Japan financial flows that might be exploited or politically sensitive, this would be one, especially since it is so persistent.

Another financial flow that is much remarked upon for its asymmetry is the vast Japanese holdings of American treasury bonds. Even as Japanese issuance of government debt grew enormously over the 1990s, less than 6 percent of Japanese Government Bonds (JGBs) were held outside of Japan.[26] Meanwhile, Japanese holdings of American treasury bills and notes during America's run-up of debt in the late-1980s reached over 40 percent of the total. Several people on the US side worried about American "dependence" upon Japanese capital, while some Japanese officials and politicians made vague threats at times of dumping T-bills in retaliation for American actions.[27] Net monthly sales of US Treasuries by Japanese investors (figure 4) rarely exceeded $50 billion, and only once exceeded $100 billion, since January 1988. This is hardly a prepossessing number for a national debt numbered in the trillions and, until recently, issuing billions of dollars of new treasuries every month. The only large net sales sustained for more than a month were in late 1995 and in 1997-98, which again makes sense as times of acute financial distress lead investors to meet cash calls by selling their most liquid assets. The economic fundamentals rather than any political agenda seem to be the main driver of Japanese net sales of US Treasuries, and they remain low versus the stock outstanding.

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25. American Chamber of Commerce in Japan, *US-Japan Business White Paper 2001* (Tokyo: 2001). Among the G-7, the next highest ratio of FDI outflow-to-inflow is 2.8 for Germany, while all the rest are below 1.5.
26. No figures are available on how many of these are held by Americans as opposed to other foreigners.
27. In a speech on 23 June 1997, at Columbia University then Prime Minister Ryutaro Hashimoto said Japan had been "tempted to sell US Treasuries and buy gold" on a number of occasions, mostly arising

2. THE EFFECT OF FINANCIAL DEVELOPMENTS ON US-JAPAN RELATIONS TO DATE

The American and Japanese financial systems have been going through much the same process of liberalization, but with the United States starting earlier and moving faster.[28] As outlined in the previous section, this process has included for both economies a banking crisis, and an abrupt rise in inwards FDI from the other country, again with the US experiencing them first, and Japan still in the throes of both transitions as of summer 2001. The Japanese Big Bang financial deregulation initiatives, if carried through, would tear down the walls separating investment from commercial banking, and smaller investors from the markets, much as the long-succession of legislation coming through the US Congress in the 1980s and 1990s eventually repealed Glass-Steagall. Cross-border equity flows, FDI, and sales of US Treasuries all grew over the 1990s, without clear secular trends, consistent with integrating financial markets.

Despite this tendency toward convergence, or at least staggered movements down the same path, there were two important divergences. First, Japanese savers' behavior changed less in line with financial deregulation than American savers' behavior, and if anything became more risk-averse over the 1990s. Second, and perhaps not unrelated, the American process of liberalization was accompanied by increasing confidence in the US financial "model" and its benefits as the process went on, while in Japan the opposite reaction was felt. Undoubtedly, these contrasting confidence effects were largely the result of the diverging growth and unemployment performance of the two economies over the period.[29] Nevertheless, the divergence in confidence also reflected the different starting points of the two financial systems, with the American adjustment to liberalization being more one of degree, while the Japanese adjustment definitely being one of kind.

These similarities and differences made themselves felt in US-Japan economic relations over the last twenty years, but primarily within their own realm. That is, there were examples of conflict and cooperation over the pace of deregulation in Japan in relation to US exports and direct investment, over the response to overt Japanese financial fragility in 1997-1998, and over

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when the United States failed to stabilize exchange rates. In an editorial in *The Financial Times* the next day, this remark was characterized as a "veiled threat."

28. Vogel, *Freer Markets, More Rules*, and Steil, *Illusions of Liberalization*, argue that through the mid-1990s the power and preferences of Japanese (mostly MOF) bureaucrats determined a uniquely Japanese form of financial liberalization which included persistent or re-regulation. For purposes of this paper, however, the broad similarities of pressures on both the Japanese and American banking systems, the similar rise of securitized corporate finance, the common experience of financial crisis and regulatory forbearance in response, and the enhancements in information and access available to investors constitute essentially the same process of liberalization.

29. Grimes' chapter in this volume describes this reversal on macroeconomic performance.

how changes in the market influenced the financial regulations and model that the two countries could advocate in Asian emerging markets. There was, however, little evidence of either financial flows (from Japan to the United States, in the form of Treasuries purchases) or financial confidence (waxing in the United States, waning in Japan) granting leverage by one country over the other in broader economic discussions, let alone in matters of national security. In general, even in the decade since the end of the Cold War, security aspects of US-Japan relations have run on a separate track.[30] The declining importance of G-7 summits and of macroeconomic policy coordination is evident over the 1980s and 1990s as well, but appears to be driven by the rise of markets and the decline of interventionist ideology across all the industrialized economies.[31]

2A. Relations over Financial Regulations and Financial Services Trade

In theory, banking regulators should form a relatively close fraternity, if not an "epistemic community," across national borders. They share a similarity of goals and pressures, a common sensibility, and often direct experience working together through numerous international fora, postings in each others' countries, and training efforts through the Bank for International Settlements and the International Monetary Fund.[32] In today's integrated financial markets, they have little choice but to exchange information – not only are subsidiaries of Japanese financial firms active in US markets (and to a lesser degree, vice versa), but loans between Japanese and American banks, and movements in asset prices in each country, tie financial stability within one country to the other. This is a classic example of interdependence, where openness and integration increases both capabilities and vulnerabilities. Since the creation of the Basle Capital Adequacy Standard for Banks in 1996, commercial banks active in international markets have been subjected to a clear common standard of evaluation for the asset side of their portfolios. This standard was created with the participation and assent of both American and (grudgingly) Japanese regulators.

When push came to shove in US and Japanese financial markets in the 1980s and 1990s, however, relations between regulators were not entirely smooth. As described in Steil,[33] Japanese financial regulators made entry for American financial firms extremely difficult, through use of discretionary power and their relationships with domestic incumbents. During the late 1980s, the

30. See Green and other chapters in this volume.
31. C. Randall Henning, "US-Japan Macroeconomic Relations in the Last Three Decades of the Twentieth Century," Mimeograph (Institute for International Economics, 2000).
32. Dwyer, "US-Japan Financial Market Relations in an Era of Global Finance," notes that Japanese financial regulators in New York have offices across the street from the Federal Reserve Bank of New York, implying that there is an easy neighborliness between the two.
33. Steil, *Illusions of Liberalization.*

major Japanese banks became the world's largest, due to their enormous deposit bases, but they also had some of the lowest returns on assets.[34] Japanese regulators would hear no warnings that consolidation was coming, however, being able to point to the simultaneous American difficulties during the S&L crisis. In a particularly notable example of lack of coordination in even day-to-day supervision, the MOF learned in August 1995 that one employee had caused and hidden huge losses in the New York operations of Daiwa Bank. Neither Daiwa's US operating officers nor the MOF regulators informed the Federal Reserve until six more weeks had passed, during which time Daiwa's counterpart banks were at risk. In the first half of 1998, when fragility in the Japanese banking system peaked, American regulators "ring-fenced" most Japanese banks in the New York markets, excluded them from the Fed's discount window, and asked them to have on-hand cash sufficient to cover their overnight balances.[35] While this was in no sense intended as a political or threatening act, it clearly conveyed the message that American bank regulators had a far different and more pessimistic view of Japan's banks than their own regulators.

The evident lack of learning by Japanese regulators from the policy mistakes of the American S&L crisis is particularly striking. Posen characterizes both the Japanese and American financial crises as following a similar dynamic, right down to the regulators' slow response:

> [T]he grounds for crisis are laid with protection of the banking system from competition (e.g., Japan's convoy regulations), followed by partial gradual deregulation. Turning to policy response, banking supervisors allow a credit boom for lower-quality borrowers to occur in hopes of restoring bank profitability when the large, good borrowers go directly to capital markets. Of course, this just adds to the potential trouble on bank balance sheets when things go south. Regulators observe the bad loans, but keep quiet due to the banks' implicit or explicit offers of direct benefits and future employment, as well as bureaucratic disincentives to delivering bad news, and simple lack of experience with accurately evaluating risky loan portfolios. When the bust comes, supervisors engage in forbearance, meaning that they allow banks time to carry non-performing loans rather than demanding write-downs...The interaction of moral hazard on the part of the banks and regulatory forbearance on the part of supervisors is what causes the spiraling accumulation of bad loans. This was the story in the United States in the 1980s...And despite this cautionary example, this was also the story in Japan in the 1990s...[36]

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34. Anil Kashyap, "Discussions of the Financial Crisis," in Ryoichi Mikitani and Adam S. Posen, eds., *Japan's Financial Crisis and Its Parallels to US Experience* (Institute for International Economics, 2000).
35. Ring-fencing means increasing supervisory scrutiny and discouraging other banks from having unreserved exposure to the banks under monitoring. Exclusion from the discount window forces the Bank of Japan (in this case) to provide upfront the extra liquidity for the US operations of these banks. Both of these measures significantly constrain the ability of banks to conduct business.
36. Posen, Adam S., "Introduction: Financial Similarities and Monetary Differences," in Ryoichi Mikitani and Adam S. Posen, eds., *Japan's Financial Crisis and Its Parallels to US Experience* (Insititute for International Economics, 2000), pp. 7-8. This is a mainstream view in economics. Cargill, Hutchison, and Ito, *Financial Policy and Central Banking in Japan*; Friedman, "Japan Now and the United States Then;" Glauber and Kashyap, "Discussions of the Financial Crisis;" Hoshi and Kashyap, *Corporate Financing and*

Given that US regulators already had been taken to task for the S&L crisis in a litany of congressional hearings, central bank sponsored conferences, and published policy analyses by 1992, it is impossible to claim that Japanese regulators and politicians were not warned against repeating American mistakes.[37] The warnings became only more public and specific as the 1990s progressed, and the size of the Japanese bad loan problem swelled.[38] Cynical observers will not be surprised, because there is no room in this standard financial crisis story for learning; rather the incentives to inaction are universal given the situation. Yet the inability of this knowledge to transfer successfully between regulatory peers is an important cautionary note about the limits of coordination and expertise as influences on policy.

The great size of the Japanese banking problem, taken against the background of Japan's economic stagnation in the 1990s and the Asian financial crisis of 1997-98, made it an issue of enormous salience in US-Japan macroeconomic policy discussions. In fact, there was little dispute on either side of the Pacific that both Japan's stagnation and Asia's crisis were in some part caused by the banking problem. Sakakibara[39] recalls that in the summer of 1998 "Washington demanded clear plans to dispose of banks' bad loans and additional stimulus measures. However, Tokyo could not immediately present practical measures in line with the request." The Diet session had closed, and an upper house election was due in July. The yen was in sharp decline against the dollar in this atmosphere, and on June 17, the US and Japan intervened jointly to support the yen at 137.60 per dollar. "As suspected by Rubin and others, the effects of joint [exchange rate] intervention did not last long. In August, the yen started to weaken again toward the high [dollar value] of ¥140 per dollar."[40] As noted in the previous section, partial bank reform and recapitalization had to wait until October 1998 to be passed by the new Japanese Diet.[41] The financial fragility in Japan had drawn in the US Treasury, normally removed

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Governance in Japan; and Shimizu, "Convoy Regulation, Bank Management, and the Financial Crisis in Japan," all make similar assessments.

37. See the references in Friedman, "Japan Now and the United States Then," and Glauber and Kashyap, "Discussions of the Financial Crisis," for some of the criticism of US mistakes.

38. The various annual publications of the American dominated IMF and the OECD were quite explicit on these points, including references to past US errors.

39. Sakakibara, "US-Japanese Economic Policy Conflicts and Coordination," p. 181.

40. Eisuke Sakakibara, "US-Japanese Economic Policy Conflicts and Coordination during the 1990s," in Ryoichi Mikitani and Adam S. Posen, eds., *Japan's Financial Crisis and Its Parallels to US Experience* (Institute for International Economics, 2000), p. 182. Interestingly, though Sakakibara is on record in numerous places as an advocate of exchange rate intervention as a policy tool, he admits that most of the interventions of the 1990s failed to have the desired or any lasting effect.

41. Sakakibara, "US-Japanese Economic Policy Conflicts and Coordination," claims that this reform was only possible because the US government became more "pragmatic" following the Russian bond default and LTCM collapse bringing the crisis home. He blames the US puritanism on bank reform for the

from banking issues, and the MOF's International Finance Division, also normally separated from such concerns; the situation had also provoked the one major concerted foreign exchange intervention of Robert Rubin's tenure as Treasury Secretary contrary to his declared skepticism for such measures and his "strong dollar" policy. This added to the sense that US foreign exchange intervention was a favor to elicit the October 1998 legislation.

The escalation of Japan's domestic financial problem into a matter for the highest levels of economic diplomacy was preceded and accompanied by a sharp decline in the civility, public and private, of US-Japan economic relations between 1996 and 1999. Japanese officials publicly complained of being lectured to by domineering and insensitive United States officials; American officials felt frustrated by Japanese government intransigence against using what appeared to be obvious remedies to a situation of even more obvious crisis.[42] Vice Minister of Finance Eisuke Sakakibara and Deputy Treasury Secretary Lawrence Summers became poster children in their opposite countries for the degree of tension. Notably, all of this escalating conflict occurred despite the relative lack of trade disputes at the time even with a widening bilateral US trade deficit, and therefore the absence from the discussion of the normally more conflictual US Trade Representative, Department of Commerce, and Congress.

Even more importantly, neither the public conflict nor the concerted intervention nor the common knowledge and transnational forums available to economic policymakers produced much in the way of policy change in Japan. While the American demands or suggestions did give the Obuchi government some of its agenda for fall 1998,[43] as well as add to its sense of urgency, what is striking is how partial and slow the response still was to the international attention paid to a domestic Japanese economic problem. This slowness persists despite the combination of resolution being in Japan's overall economic self-interest, having significant international spillovers on the United States and Japan's Asian neighbors, and (along with economic stimulus in Japan) being one of the foremost goals of overall US international economic policy.

Japanese public's reluctance to inject public capital into the banks. Jeffrey Shafer, "The International Aspects of Japanese Monetary Policy," in Ryoichi Mikitani and Adam S. Posen, eds., *Japan's Financial Crisis and Its Parallels to US Experience* (Institute for International Economics, 2000), strenuously contradicts this view of US government intentions.

42. Shafer, "International Aspects of Japanese Monetary Policy," among others, recalls the disappointment that American officials felt in 1996-97 having their private advice to the MOF not to raise the consumption tax ignored. This experience may have contributed to some of the public tack and tone emerging from the US Treasury for changes in Japanese policy in the late 1990s, though the pressures from the Asian crisis were obviously the main factor.

Trade in financial services has also in recent years emerged as an area of growing, though still limited, importance in bilateral US-Japan and multilateral trade negotiations. This is in part because the United States recognizes this as a sector where it has a clear competitive advantage.[44] There are also public policy motivations stemming from the belief that Japan's economic problems and its structural differences with the United States stem in large part from the low returns to capital and the low rank of shareholders in the Japanese economy.[45] At present, these discussions have not really differed much from other trade negotiations, and in fact the deals in this sector have attracted less attention than such matters as steel, auto parts, and plate glass did in the United States.

The most significant negotiation to date was over access of American insurers to the Japanese market. Japanese insurance had long been cartelized, with three sectors, traditional life, traditional non-life, and a third sector for smaller or more innovative products.[46] In July 1993, insurance was named as a priority sector under the US-Japan Framework Talks, and, in October 1994, a "Framework Agreement on Insurance Sector Measures" was agreed. There were clear differences between the MOF's implementation of the agreement and what American negotiators believed they had signed, so negotiations resumed in 1995. In April 1996, a new Insurance Business law was passed in Japan, along with a number of supplementary measures, and then additional deregulation and access was granted as part of the WTO Financial Services Agreement of December 1997. The main result has been to get American firms access to the Japanese auto insurance market, along with the right to differentiate policy rates on the basis of age, and to have the policies sold independently rated for soundness. American firms also gained control of most of the third sector where new products are offered. Still, as of FY1998, foreign insurers held only 4.6 percent of the total market versus a usual foreign firm market share of 10-33 percent in the rest of the G-7.[47]

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43. Council on Foreign Relations, 2000, *Task Force Report: Future Direction for US Economic Policy Toward Japan* (www.cfr.org/p/pubs/Japan_TaskForce.html [date of access]), Appendix.
44. Catherine Mann, *Is the US Trade Deficit Sustainable?* (Institute for International Economics, 1999), goes so far as to suggest that liberalization of financial and other business services, allowing for more exports from the United States, would significantly reduce the overall US trade deficit.
45. This was clearly recognized as a possibility as early as the 1983 yen-dollar talks. See Henning, "US-Japan Macroeconomic Relations in the Last Three Decades of the Twentieth Century," among others, for more recent discussions emphasizing the low returns to capital.
46. A concentration ratio of market share among the top 5 companies would be 60 percent in both life and non-life.
47. This summary draws on the "Insurance" entry in ACCJ (2001). Steven Vogel notes that once US firms did dominate the third insurance sector, the US government argued that Japan should not liberalize that sector before liberalizing the rest of the insurance market. This had some economic logic, but politically was viewed in Japan as an instance of hypocrisy by the United States (with some justification).

2B. Relations over Capital Flows

The largest swing in capital flowing between the United States and Japan in the last twenty years has involved US Treasuries and Japanese government bonds. During the 1980s, the United States government accumulated an unprecedented amount of public debt in peacetime as a result of the Reagan fiscal policies, while the Japanese government slowly but steadily paid off the expanded public debt it issued in 1975 after the first oil shock. The picture reversed completely in the 1990s, with the US federal government steadily reducing its deficits and then its stock of outstanding debt through annual surpluses. The Japanese government ran up an even larger debt-to-GDP ratio over the course of the 1990s, though more through tax revenue shortfalls than through intentional deficit spending to counter the recession. These vast movements in the *stocks* of government debt available to the market, however, conceal a major asymmetry in the *flow* of capital between the two countries.

Put simply, Japanese and other foreign investors purchase a great deal of US Treasury bills and notes, while US and other foreign investors purchase only a small fraction (currently, about 5 percent) of JGBs issued. Figure 5 displays the Japanese share of total foreign purchases and sales of US Treasury bonds and notes since 1988. Interestingly, Japanese shares and purchases seem to move in tandem, which is consistent with the view in figure 4 of small net sales of Treasuries by Japanese investors without multi-month trends. Nevertheless, when the US public debt was at its height in 1988-1990, Japanese purchasers made up 50 percent of total foreign buyers, and they already held upwards of 40 percent of the outstanding debt. In 1990-92, Japanese investors hit hard by the bubble's burst no longer had spare cash to put into Treasuries, and dropped out of the market. Since 1992, as cash continued to be tight, strong availability has led to JGBs replacing Treasuries as the main inflow into Japanese investors' portfolios.

As previously noted, the perception that Japanese holdings of US public debt gave Japanese officials a means of threatening US policymakers – that Japan could "dump" Treasuries, and thereby roil US markets and drive up US interest rates – was widely held in both Japan and the United States, though more so in the former. The facts that the US economy was importing a great deal of capital annually, that this capital inflow allowed US investment and consumption to exceed domestic production and savings, and that Japanese savers hold a lot of the assets that were sold to gain the capital are undeniable. The interpretation that links these as something controllable by conscious policy, however, is flawed analytically and unsupported by the historical record. The basic problem is that capital flows are the result of thousands of decentralized individual decisions to buy and sell, and those decisions are largely driven by economic fundamentals. At the margin that moves markets, and beyond, they are not up to the discretion of policymakers on either side of the Pacific.

Japanese savers hold their assets overwhelmingly in low-risk, low-return demand deposits and life insurance, with a large portion of those assets automatically invested in JGBs. Japanese banks and other financial firms on their own accounts are the major owners of US Treasuries in Japan. In their portfolios, these highly liquid bonds play a key role in the settlement of payments, as well as being a store of value. While it is true that a depreciation of the dollar would lead to capital losses on Treasuries holdings in yen terms, a rise in interest rates on JGBs would have similar effects, so there is no truly “risk-free” asset available to these firms, and it therefore pays to diversify. To claim that these investment decisions would be subject to government direction is mistaken, even in Japan. Were the Treasuries to be somehow dumped in large measure at once by Japanese banks, they would have to replace the safe assets in their capital with something of equivalent security. Japanese regulators would also have to somehow come up with a justification for telling financial firms to shed the world’s most liquid security, one without credit risk.

Of course, the United States government could do something to cause rational individual investors to sell off Treasuries. It is perfectly sensible that the policies of a debt-issuing government could have a direct effect on the perceptions of investors, and that the perceptual shift would be widely shared. It is this threat of losing the faith of international capital markets that disciplines the monetary and fiscal policies of many emerging markets.

Yet, there are two related reasons why this theoretical possibility is unlikely to be a factor in US-Japan relations today and in the future. First, there is nothing distinctive about the Treasuries owned by Japanese as opposed other foreign, or for that matter American, investors. A policy which is likely to bring about sales of US debt is going to a first approximation to be perceived similarly by *all* holders of that debt. European or even American capital can leave the United States just as easily as Japanese capital can, so the issue becomes one of the general economic effects of a policy shift, not one of *bilateral* foreign relations. Second, the fact that a large amount of Japanese savings are invested in US Treasuries does not mean that the United States is in any sense dependent upon Japan to fund its debt. Just as the sustainability of the US current account deficit depends upon its overall level and not any particular bilateral trade balance, the inflation and currency risks of Treasuries determine their demand and the particular composition of who holds them is largely irrelevant. Were Japanese savings for foreign policy reasons to go *en masse* into another safe asset to substitute for US Treasuries, such as JGBs or

German *Bunds*, this would drive down the returns on that substitute asset for those already holding it, and would induce those people to increase their holdings of US Treasuries.

This lack of leverage from capital flows in and out of the US Treasuries market can be seen in the historical record. The Japanese share of Treasuries purchases has been steadily declining, with a sharp fall in 1990-92, and large net sales in 1996-1998 (as can be seen in Figures 4-5), and there is no evidence of the United States being more accommodative of Japanese demands on policy as a result during those periods. There is also no sign of any particular Japanese policy decisions being the source of the sales, while the economic events in Japan raising investors' need for cash explains these movements easily. Meanwhile, total American public debt has been declining markedly over the second half of the 1990s, and there is no evidence of a secular decline in Japanese influence over US economic policy. The same logic held in the opposite direction when the US public debt rose over the 1980s; the Plaza Accord of 1985 and the Louvre Accord of 1987, and the macroeconomic coordination associated with them, would seem to indicate that mounting US debt did not bolster Japanese resistance to American economic demands, let alone increase the ability to force changes in US policy.[48]

The other main type of capital flow to merit discussion as a potential influence on US-Japan relations is that of foreign direct investment. As discussed in the previous section, cross-border portfolio equity flows remain small between the United States and Japan, and movements in transpacific bank loans seem to be driven by medium-term economic factors. In 1986-91, the declining dollar and the rise in Japanese asset values led to the first large inflow of Japanese investment into the United States.[49] Coming at a time of unemployment, historically large trade deficits, and perceived lack of competitiveness, there were numerous episodes of popular backlash against "foreign takeovers." Despite various debates in the US Congress, however, no legislation was passed to counter the inward investment, and no efforts were exerted in bilateral US-Japan talks to curtail the flow.

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48. In fact, it is another widely held myth that the American call for Japanese macroeconomic expansion at the time of the Louvre Accord led to the Japanese asset price bubble. Leaving aside the contradiction between these two myths about which nation had influence as US public debt rose, this blaming of the bubble on US pressure is unjustified. Suffice it to say that it is far from obvious that US pressure produced the specific BOJ monetary policies held responsible for the bubble (given the timing), that those scapegoated monetary policies actually caused the bubble (given the fundamentals), and that the bubble had to have the impact it did on the Japanese economy (given transmission mechanisms). See Henning, "US-Japan Macroeconomic Relations"; Toshiki Jinushi, Yoshihiro Kuroki, and Ryuzo Miyao, "Monetary Policy in Japan Since the Late 1980s: Delayed Policy Actions and Some Explanations," in Ryoichi Mikitani and Adam S. Posen, eds., *Japan's Financial Crisis and Its Parallels to US Experience* (Institute for International Economics, 2000); and Kashyap, "Discussions of the Financial Crisis."
49. Edward Graham and Paul Krugman, *Foreign Direct Investment in the Unites States* (Third Edition, Institute for International Economics, 1997).

It is incredible to think of the transformation in attitudes. Ten years later, there is hardly a stir when recent FDI flows into the United States have dwarfed the previous record annual inflows of 1989-90.[50] When Senator Ernest Hollings tried in summer 2000 to make the takeover of Voicestream by Deutsche Telekom a national security issue, he lost a Senate vote 99-1. Honda had an advertising campaign in the late 1990s showing a red, white, and blue Civic automobile, declaring how much of the car was made in US plants they owned.

In Japan, significant FDI inflows began only in 1998, and public attention was drawn to such notable acquisitions as Renault taking over Nissan, and Ripplewood Holdings purchasing the nationalized LTCB (later Shinsei Bank). There was some publicly vocalized discontent, especially when both firms quickly and visibly engaged in non-Japanese corporate behaviors: laying off workers, and refusing to rollover Sogo department store's loans, respectively. There has also been some greater resistance from parts of the Japanese government than seen in their counterparts in the United States,[51] but METI is on record wanting to encourage more inward FDI. Whether this resistance to FDI will be transitional on the part of Japanese citizens and officials (as it was in the United States), or whether the opening for inwards FDI is a temporary one created by the weakness and insecurity of the current Japanese economic situation, remains to be seen. As will be argued in the concluding section, that sort of weakness is likely to increase in Japan in the near future, particularly in the financial sector, which will probably increase the acceptance and inflow of FDI.

2C. Relations over the Financial Model for Emulation

US-Japan relations take place at a number of levels, and in economic matters, the ideational issue of who has the "better model" has at times played a critical role. There is the matter of relative self-confidence in bilateral relations on the part of the policymakers in light of their nation's economic performance, and therefore their support or perceived competence at home.[52] While important, this factor alone is too narrow a consideration of the economic model debate's impact. Such assessments encompass a richer range of ideas than just pointing to the most recent national growth and trade statistics, and influence a broader range of specific issues besides general bargaining confidence or popular tensions. The relative merits of financial systems, with the arms-length, market-based, securitized model on the US (or U.K.) side versus relationship-based,

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50. Matthew Higgins and Clive Walcott, "Global Capital Flows: Capital Appears Ready to Flow Back into Japanese Equities," Mimeograph (Merrill Lynch: 21 May 2001).
51. The FSA made sure to sell off the other nationalized major Japanese bank, the former NCB, to a domestic purchaser, for example, even though there was a valid foreign bid.
52. Grimes in this volume ties lagged perceptions of macroeconomic performance to broader US-Japan relations.

mixed claims, bank dominant model on the Japanese (or German) side, have been heatedly discussed by academics, businesspeople, policymakers, and pundits over the entire period this chapter analyzes. As will be described, the running state of this debate has directly influenced such aspects of US-Japan relations as the frequency of coordinated exchange rate intervention, the composition of capital flows between the US and Japan, and the bilateral economic agenda in terms of respective national wish lists.[53] Examination reveals that the underlying economic and political factors driving convergence have led to lasting effects of the American dominance in these financial ideas in recent years, whereas the earlier ascendance of the Japanese financial model in the discussion had negligible long-term impact.[54]

Exchange rate levels and volatility have been a major source of frustration for governments since the end of Bretton Woods – rarely is an economy's exchange rate at the desired level, and it never stays put if it gets there. For government officials accustomed to allocating credit and controlling domestic interest rates, like those of the Japanese MOF, intervention to stabilize exchange rates is consistent with a general distrust of markets and a belief that they can be controlled. For government officials who have experience with the financial markets and are more accustomed to rules-based rather than results-oriented government action, like those of the US Treasury, intervention to stabilize exchange rates is deemed likely to be ineffectual or counter-productive.[55] Ideology appears to matter more than trade exposure in determining this outlook, as the United States some time ago became a more open (as measured by [imports+exports]/GDP) economy than Japan, and some US export industries have to compete as much or more on price than some high-value-added Japanese manufactures.

The liberalization of international financial markets, starting with the lifting of capital controls in the United States in 1980 and running through deregulation of individuals' foreign exchange holdings in Japan in 1998, has prompted an explosion in the volume of daily foreign exchange transactions. The objective question of whether, under what conditions, sterilized foreign exchange rate intervention will be effective, given the size of the market, is still under

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53. The economic recommendations proffered to emerging markets by the IMF and the World Bank, and the course of Asian monetary cooperation, are also affected by the relative perceived benefits of the American and Japanese financial systems. Searight in this volume addresses these two points from an international institutions perspective, emphasizing the institutions' independent role in forming these outcomes.

54. This is quite clearly the opposite outcome of the debate over the means of industrial production, where the Japanese model has largely remained triumphant, even as Japanese growth has receded.

55. Though even some American officials will be sympathetic to the view that exchange rate levels and volatility can (damagingly) diverge from values justified by "fundamentals," they are less likely to believe anything can be done about it. See Clarida (1999) and C. Randall Henning, *Currencies and Politics in the United States, Germany, and Japan* (Institute for International Economics, 1994).

debate, though most contemporary macroeconomists are skeptical.[56] For the US-Japan relationship, however, the emerging American view that intervention is unlikely to produce desirable results has clearly not only limited the frequency of concerted intervention in the 1990s, it has eroded some support for exchange rate targeting in Japan.

Sakakibara[57] describes wistfully how a series of concerted and then unilateral exchange rate interventions to weaken the yen against the dollar in 1995 and 1996 failed to have noticeable effects, and how the US Treasury was reluctant to intervene even once to slow the yen's fall in June 1998. Keidanren, the Japanese association of large businesses, has dedicated a diminishing amount of space and effort to the exchange rate issue in recent statements about desired policy. This decreasing emphasis occurred even against a backdrop of the Japanese and American governments (but not the BOJ) seeming to agree that a weaker yen would be desirable, if linked to bank reforms. On April 5 2001, Haruhiko Kuroda, Japan's Vice Minister of International Finance, wrote an op-ed in *The Asian Wall Street Journal* tying the yen's decline that month to fundamentals, and indicating that intervention would not be forthcoming. Though political pressures from Asian neighbors opposed to yen weakness made him back off that position the next day, it was a leading indicator that the incoming Koizumi government would not be making currency moves a major part of its economic agenda.

Beliefs about financial systems also influenced the form of capital flows between the two countries over the last two decades, but asymmetrically. The core issue was over corporate governance. Japan's "main bank system" was one of mixed claims by stakeholders over corporate enterprises – lenders sat on corporate boards, held stock in the firm, intermediated relationships with other companies, and stepped in to change strategy or management during times of corporate distress.[58] In contrast, US corporate governance by outsiders had many divisions between investors and management, an absence of cross-shareholdings, an emphasis on shareholder rights and dividends to the exclusion of other stakeholders, and a combination of bankruptcy and hostile takeovers to deal with corporate distress. Amidst concerns for American competitiveness, the well- known business strategist Michael Porter, writing in the *Harvard Business Review* in 1992, was one of many to decry the "short-termism" of American management due to the emphasis on

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56. Taylor (2000) is a recent, econometrically, sophisticated argument that sterilized intervention does work for the most part. Kathryn Dominguez and Jeffrey Frankel, *Does Foreign Exchange Intervention Work?* (Institute for International Economics, 1993) is the standard work indicating that only unsterilized intervention, i.e. backed by the promise of domestic monetary policy changes, will succeed.
57. Sakakibara, "US-Japanese Economic Policy Conflicts and Coordination."
58. The literature on this subject is vast. For reasonably balanced economic treatments, see Hoshi and Kashyap, *Corporate Financing and Governance in Japan*, and Fukao and Kester (1992).

financial markets and share prices in decision-making. As late as 1995, Fukao could write:

> As Japanese manufacturers began to show their strength in international markets, potential problems in the governance of US corporations were brought to light [e.g., executive compensation, lack of monitoring]...In addition, the short time-horizons of US managers, the possible deleterious effects of mergers and acquisitions on the long-term viability of US companies, and the massive layoffs of white-collar workers in the recession of 1991-92 all draw public attention to problems in US corporate governance.[59]

One practical upshot of this state of the debate in the late 1980s and early 1990s was a generally held belief that there was little point in US foreign direct investment into Japan as there was almost no possibility of American firms or partial owners successfully integrating into the web of relationships that made the Japanese economy go.

In hindsight, it appears obvious that the disadvantages of American short-termism were at a minimum exaggerated, as were the advantages of Japanese relationship financing. W. Carl Kester was ahead of the curve among academic contributors to the debate (albeit unintentionally now sounding ironic), writing in 1996 that "over-investment in declining core industries, excess manpower, excess product differentiation, and speculative uses of excess cash, among other problems, appear to be at least as problematic in Japan as in the United States."[60] Today in 2001, after more than a decade of Japanese bad loans, low returns on capital, and collapsing asset values, this is a commonplace view.[61] Yet, this view should not be dismissed as merely a matter of bandwagoning on good American economic performance relative to Japan.

The assessment of the relative advantages of various financial systems was always ultimately an empirical question, and one regarding specific predictions about the behavior of banks, securities, and nonfinancial firms–not just aggregate economic performance. The weight of analysis in recent years has been to argue that the Japanese financial system never quite performed the way it was supposed to do in theory, while American finance did function pretty much as expected once deregulation began.[62] The exodus of Japan's best businesses from bank

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59. Mitsuhiro Fukao, *Financial Integration, Corporate Governance, and the Performance of Multinational Companies* (Brookings Institution, 1995), p. 3.
60. W. Carl Kester, "American and Japanese Corporate Governance: Convergence to Best Practice?" in Suzanne Berger and Ronald Dore, eds., *National Diversity and Global Capitalism* (Cornell University Press, 1996), p. 123. To be fair to Fukao, in *Financial Integration, Corporate Governance, and the Performance of Multinational Companies*, predicted (p. 69) as well that reallocation of capital and labor to new opportunities from declining industries, for example, would be more efficient under American-style corporate governance than under the Japanese system.
61. Among many others, see McKinsey (2000), Richard Katz, *Japan: The System that Soured* (New York: ME Sharpe, 1998), and Asher and Dugger (2000).
62. Again, Hoshi and Kashyap, *Corporate Financing and Governance in Japan*, collects much of the research to date. Recently, some authors have begun to speak of Japan's economic success in the entire postwar period as coming *despite* its financial system, and the US financial system making up for other

relationships to direct financing on capital markets, and the sudden entry of questionable Japanese SME's into ample access to loans, described in the last section, should not have taken place if the Japanese financial system did offer in practice the benefits it was supposed to in theory.

The comparison with what occurred in the "economic models" debate on the side of manufacturing, as opposed to financial systems, is enlightening. At the time that US businesspeople and policymakers were suffering from concerns about "international competitiveness" in the second half of the 1980s and the first half of the 1990s, American management practices, particularly in manufacturing, came at least as much under scrutiny as financial practices.[63] Such ideas from Japan and continental Europe as just-in-time inventory, quality circles, and team and lean production techniques, were widely adopted in American companies; both Japanese home country plants and factories under Japanese ownership or management in the United States were visited and studied in detail as models. Unlike with regards to the widespread calls for change in American financial practices, which were largely ignored in terms of policy or business decisions, at least as difficult and costly changes were made to implement these "high-performance work organizations." Also unlike on the financial side, these changes in American manufacturing and work organization have persisted and spread in the last decade, even as overall US economic performance began to exceed that of Japan.[64] It would be too much of a Whig interpretation of history to suggest that the more economically sensible idea always eventually wins out in the market of decision making. Nevertheless, this comparative spread of the Japanese manufacturing model and the American financial model, affected but not determined by relative macroeconomic performance in the two countries, does give credence to the presumption that learning does take place among both business practitioners and economic researchers.

The real-world upshot for US-Japan relations of this intellectual victory by the end of the 1990s for arms-length, market-based finance has been profound, and is still gaining momentum.

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weaknesses in education and labor markets. See Posen, *Restoring Japan's Economic Growth*, chapter 6, for references, particularly to the work of David Weinstein and his co-authors.

63. See, e.g., Stephen Cohen and John Zysman, *Manufacturing Matters: The Myth of the Post-Industrial Economy* (Basic Books, 1987); Michael Dertouzos, Richard Lester, and Robert Solow, *Made in America: Regaining the Productive Edge* (Massachusetts Institute of Technology Press, 1989); Eileen Appelbaum and Rosemary Batt, *The New American Workplace: Transforming Work Systems in the United States* (Cornell University Press, 1994).

64. Sandra Black and Lisa Lynch, "What's Driving the New Economy: The Benefits of Workplace Innovation," Working Paper 7479 (Cambridge, Mass.: National Bureau of Economic Research, 2000); Jessica Cohen, William Dickens, and Adam S. Posen, "Have New Human Resource Management Practices Lowered the Sustainable Employment Rate?" in Alan Drueger and Robert Solow, eds., *Sustainable Employment* (New York: Russell Sage, 2001); and Paul Osterman, "Work Reorganization in an Era of Destruction: Trends in Diffusion and Effects on Employee Welfare," *Industrial and Labor Relations Review*, vol. 53(2) (1998), pp. 179-96.

One aspect has been the growth in recent years of FDI into Japan, even as the overall world market has been betting on American domestic production and investing accordingly. This has been matched by policies proposed by METI, and calls from domestic interest groups in Japan, to make further changes in corporate governance to encourage and accommodate inwards investment, including mergers and acquisitions. In the early 1990s, Japanese multinationals set up foreign subsidiaries to deal with matching US accounting rules and insider trading constraints, until Japanese regulations on consolidated accounting caught up with US practice in 1998. Cross-shareholdings have begun to be unwound, following a METI-sponsored law in 1999 to make it easier for both banks and non-banks to sell-off reciprocal equity without running into prohibitive capital gains. And American investors have come to believe that they can in some instances discern the value and connections of Japanese businesses and acquire effective control, and venture funds in Japan have grown as a result.[65]

This increased flow in FDI and convergence in approaches to corporate governance has had two related effects. First, it has created new domestic private-sector lobbies in each country, as well as splits within the Japanese and US governments, that can form trans-national alliances for particular policies. "So on the Japanese side, the leadership of Sony Corporation has publicly pushed for the addition of outside directors to Japanese corporate boards and the pursuit of shareholder value, and Keidanren has called repeatedly for changes in the 100-year-old commercial code to allow share repurchases by companies, both of which would also increase the friendliness of Japanese financial markets to American M&A activity. These efforts have been backed by METI, while the MOF has been silent or opposed. On the American side, there has begun to be a meaningful version of the "China lobby" on Japanese trade issues, i.e., American firms with enough investment over the wall in Japan to have an interest in directly opposing protectionist tendencies in Congress or the US administration. For example, American insurance companies have taken a significant share of the Japanese auto insurance market, and American auto firms have extensive stakes in Japanese producers,[66] and these new interests have changed the tone and terms of the current auto parts negotiations.

The second impact has been on the bilateral trade agenda between the United States and Japan, particularly in terms of American agenda setting. With the rising credibility of inwards FDI as a factor, the American priorities have shifted since the mid-1990s in terms of types of goals, and sectors pursued, to holding negotiations on sectors such as finance and

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65. New venture capital funds include investments by Chase, GE Capital (on its own and in conjunction with Sumitomo Bank), Goldman Sachs, Soros, and Warburg Pincus. I am grateful to Bowman Cutter for discussion of the changing American investors' perspective to amplify the quantitative data.
66. American Chamber of Commerce in Japan, *US-Japan Business White Paper 2001* (Tokyo, 2001).

telecommunications that will leverage structural change in Japan. This is to be distinguished from sectors for negotiation being chosen because of either their perceived "strategic significance" to the American economy[67] or because of their politically charged visibility as constituting a sizable share of the bilateral trade imbalance.[68] The ultimate goal of the policy is to increase sustainable Japanese growth for the sake of international financial stability and broad foreign policy goals from the US-Japan alliance, not to reduce the bilateral trade deficit *per se*.

This recent policy shift reflects a fundamental change in ideational and interest group factors likely to last, driven by financial factors, and so far seeming to transcend parties.[69] Current Bush Administration US Trade Representative Robert Zoellick has pointed to the negotiations conducted over NTT access charges by former Clinton Administration Deputy US Trade Representative Richard Fisher in late 2000 as an example of what should be done in the future. This was clearly an instance where the change bargained for was likely to help Japan grow, help Japanese businesses become more competitive, and not going to cause an immediate large-scale boost in Japanese imports of American goods. Keidanren and METI both publicly supported reductions in access charges as the negotiations went on, despite the Japanese Ministry of Posts and Telecommunications' strong opposition. The Laura Tyson-chaired Council on Foreign Relations Task Force on US-Japan Economic Relations, which, though bipartisan, was popularly seen as a blueprint for Japan policy should there have been a Gore administration, conveyed much the same message:

> Two broad areas of reform should be a major focus of economic dialogue between the American and Japanese governments during the next several years – reforms that improve the [Japanese] climate for direct investment and financial market reforms affecting how capital is raised and allocated [by Japanese businesses]. [70]

NDU (2000), known as the "Armitage Report,"[71] also bipartisan but popularly seen as a blueprint for Japan policy in the Bush administration, shared the fundamental message that what

67. The chapter on technology by Vogel and Zysman in this volume details how such sectors as semiconductors became points of conflict because the United States wanted to keep them alive domestically.
68. None of this denies that some trade disputes, anti-dumping cases, and political tensions between the United States and Japan will be driven by traditional protectionist lobbies. The main concern here is what is the desired and likely agenda among trade policymakers on both sides of the Pacific within the realm of their discretion that remains after legislators' constituent interests are met.
69. Undiscussed here is the learning (and frustration) felt by many American participants in previous US-Japan trade negotiations, such as the SII talks, which also has fed this shift.
70. Council on Foreign Relations, 2000, *Task Force Report: Future Direction for US Economic Policy Toward Japan,* www.cfr.org/p/pubs/Japan_TaskForce.html. In the spirit of full disclosure, I was a signatory to the Task Force Report, and contributed to the drafting of the document.
71. National Defense University, 2000, *Armitage Report.*

was good for Japanese economic growth would be in American national interests, without the trade balance being a major factor to take into account. Bush administration Treasury Secretary Paul O'Neill picked up on the pro-growth rhetoric for Japan in his first months in office, and emphasized cross-national outreach to private-sector leaders in Japanese business as another source for convergence. Going forward, this finance and FDI driven agenda is one with a more clearly "win-win" economic attitude, with much less likelihood for trade tension between the United States and Japan, with a much larger role hoped for from non-state actors, and with much different priorities for what changes in Japanese economic structure would be considered desirable by the United States.

3. THE COMING TRANSFORMATION OF JAPANESE FINANCE AND ITS IMPACT ON US-JAPAN RELATIONS

Looking at the time since financial deregulation began in the United States, the effect of financial liberalization and convergence in the United States and Japan on the two countries' relationship has been a mixed bag. In the last twenty years, there has been extensive financial deregulation in both countries, enormous growth of international capital markets, and of overall financial flows between the United States and Japan, as well as an increase in investors and corporations on both sides of the Pacific taking advantage of market liberalization. Yet, there were many areas where financial change had little impact. Instances of Japan or the United States exerting direct leverage on the basis of financial advantage upon the other on overall economic policy, let alone on broader security issues, are unavailable. The much watched sizable Japanese holdings of US Treasury bills and notes proved to have little influence on US behavior, or even on US-Japan tensions, as they waxed and waned. Considering the more cooperative aspects of the relationship, banking and other financial regulators failed to learn from each others' mistakes, and often failed to communicate with each other, despite the existence of an international framework for so doing. Exchange rate management became far less frequent and concerted since the late 1980s, even as the volatility of the yen-dollar exchange rate increased (though the causality may have run from the latter to the former).

Still, the increasing intellectual consensus that convergence on the US financial system does reflect beneficial (if disruptive) economic forces has caused a marked shift in the agenda for US-Japan economic relations more narrowly defined. This shift can be dated from when Japan's banking system breakdown became publicly apparent, in the *jusen* mini-crisis of 1995, through the present day. Underlying this intellectual flow has been a significant increase in the willingness of both countries' multinational corporations and banks, as well as of American (if not Japanese) savers, to bear market risks for the sake of large efficiency gains. A key marker of this development has been the expansion of American FDI into Japan, particularly in the financial sector, after decades of Japan taking in little or no FDI, and the MOF precluding any entry, domestic or foreign, into the Japanese financial system. Japan's inability to resolve its financial difficulties–such that they visibly exceeded the cost and duration of the 1980s US S&L collapse, and that they were allowed to persist during and impede resolution of the Asian financial crisis–underscored the partial nature of its financial liberalization and the cost to Japanese national interests of leaving matters unfinished.

This dating of a surge in the importance and acceptance of financial convergence is essentially coincident with the emergence of the American "New Economy" of the late 1990s, and the paying down of the United States public debt. One could claim that the shift in behavior toward inward FDI by Japanese companies, or in agenda from trade opening to growth and financial stability among American officials, really is just another reflection of changing relative growth perceptions overall. Yet, as discussed in section 2C, the persistence in the United States of Japanese models for manufacturing long after the relative decline in Japanese growth, indicates that the specific case for financial convergence rather than some general American triumphalism is at work here, as does the apparent irrelevance of Japanese Treasuries holdings.

The intellectual battle is likely to be as settled as such battles ever are over the course of the next year or two. As can be seen in figure 6, plotting the Nikkei and Dow Jones stock averages, the United States ran up arguably as much of a "bubble" in stock prices in the late 1990s as Japan did in the late 1980s. It has been a repeated question from Japanese press and politicians, what will happen to the US economy when their bubble bursts? We are already seeing that a securitized, less-bank-dependent, more liquid and risk-taking financial system does not transmit financial shocks with the same persistence to the real economy that a less diversified, collateral-based, less liquid system does. Instead of feedback from asset prices on lending and credit in a never ending cycle as Japan has experienced, the United States is having rapid sell-offs and reallocation of capital.

The substantive impact on the US-Japan relationship to date of this recent acceleration of financial convergence is clear. On the Japanese side, the support for financial convergence grew: private-sector lobbying for changes in the laws affecting corporate governance increased; receptivity to American FDI expanded; and nongovernmental allies for American advocates of financial change gained strength. On the American side, this convergence encouraged a new prioritization of economic policies toward Japan: bilateral negotiations for trade and regulatory liberalization shifted focus toward areas relevant to Japan's investment climate from those traditionally seen as more linked to the bilateral trade deficit; the US Treasury displayed an increased willingness to put on pressure, and if necessary, accept higher tensions for restoring financial stability in Japan, even as trade disputes receded; and American financial firms suddenly became an important lobby on US-Japan issues, largely in favor of reducing tensions where possible. In general, for both countries, traditional trade disputes receded in importance even as the bilateral trade deficit expanded, and on the financial side efforts moved toward setting rules of the game for domestic actors rather than negotiating numerical outcomes.[72]

Is this change likely to persist, or will some form of political backlash turn it around despite the intellectual momentum behind the trend?[73] There certainly is resistance in some powerful parts of Japan to further financial liberalization, especially as it would compel closures of some politically connected businesses and rising unemployment transitionally. The pace of implementing agreed upon liberalization is also up for grabs, and the reluctance to decisively deal with the current banking crisis is widespread, even among advocates of banking reform. With regards to the US and IMF response to the Asian financial crisis of 1997-98, Japan and many of its neighbors feel abused or ignored by American policymakers and by financial markets. To the extent that advocacy of financial liberalization is seen as American triumphalism, disregarding the earlier success stories of Asian growth, and is conflated with acknowledged IMF mistakes in the handling of specific structural adjustment programs or in sequencing capital account liberalization, there is the potential for intellectual counterarguments. In the United States, there are critics as well. Some "public interest" NGOs are committed to opposing globalization, for ideological or cynical reasons. "Japan-bashers" are alive and well in the US Congress, very concerned about the bilateral trade deficit, about US market access in specific industries, and about the protection of constituent businesses and workers. Between these two is the potential for an alliance against exporting the American financial model and American FDI to Japan.

Yet I believe that these forces for backlash are unlikely to win out over the basic economic factors at work. As analyzed in Posen,[74] the Japanese government faces an imminent choice between managing a controlled implosion of its financial system or outright financial crisis. A controlled implosion would entail announcing and enforcing a write-off of the 15-20

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72. When financial matters were first made a significant part of the US-Japan trade agenda, they were either specified in terms of American market share like other sectors, or they were seen as instrumental to getting Japanese imports up and the trade deficit down. Looking forward, the financial issues will be largely specified in terms of changes in Japanese domestic regulation as instrumental to increasing Japanese growth, without explicit trade targets. Such a move towards rule making is itself consistent with the general thrust of deregulation in the American style (see Vogel, *Freer Markets, More Rules*) and therefore with convergence.
73. I am grateful to Daniel Tarullo for forcing my consideration of this possibility.
74. Posen, "Japan 2001 – Decisive Action or Financial Panic."

percent of GDP in bad loans currently held by the Japanese banking system; recognizing that numerous bankruptcies of SMEs will result; shutting down or consolidating undercapitalized banks; recapitalizing those that remain; and selling off the accumulated collateral (mostly real estate) from defaulted borrowers[75] — in short, a radical shrinking of the Japanese banking system with convergence on the US model. As described above, the primary problem with Japanese banking has been the inability to force banks to exit as most good borrowers and some savers have left the system. Until exit is forced, the bad loans problem and the low returns to capital throughout the Japanese economy, as well as the drag on consumption from uncertainties about asset prices and job security, will persist.[76] Alternatively, an outright financial crisis in Japan would mean noticeable capital flight, a sharp decline in the value of the yen and of Japanese financial assets, the removal of savings and capital from the Japanese banking system, and spiral downwards in Japanese investment and growth difficult to arrest.[77]

The alternative of muddling through is no longer available to the Japanese government precisely because of the partial financial deregulation and international capital market integration they have already undertaken. There simply is too much American and liquid Japanese capital ready to leave Japan quickly should returns collapse or financial transparency be reversed. In fact, the Japanese government has set up its own deadline by its commitment to enforcing mark-to-market accounting on the banks for the half-fiscal year ending September 30, 2001. This will conclusively reveal the extent of the banks' capital losses and weak loan portfolios. Of course, the regulators could renege on this commitment, but such a renege would be so obvious and clearly motivated by fear that it might prompt the very crisis they are trying to avoid. It is possible that through extreme creativity by Japanese policymakers, or more likely through the extreme passivity of Japanese savers, the time might be pushed back another few months. Still, that would only open up further the gap between returns accruing to Japanese savers and the higher returns with lower risks in the United States and elsewhere. Somehow this would be arbitraged, unless the Japanese government further ramps up its public debt to make up the difference, but that too would likely provoke a financial crisis through a fiscal channel.

75. This would of course have a short-term contradictory effect on the Japanese economy, but it also is necessary to return to sustainable growth, and is better than the alternative. Fiscal and monetary policy can be used to offset the deflationary impact. See Posen, "Japan 2001 – Decisive Action of Financial Panic."
76. Kashyap, "Discussions of the Financial Crisis," p. 109: "Throughout the 1990s, the major Japanese banks were simultaneously among the largest banks in the world, and the least profitable. This situation cannot continue much longer...at this point, the banks have virtually no competitive advantage vis-a-vis the other global banks; put differently, it is hard to think of a product or service line in which the Japanese banks could compete head-to-head with the world leaders and win much business."
77. Posen, *Restoring Japan's Economic Growth*, Chapter 4, sets out the economic logic of such a crisis in detail, and how 1997-98 teetered on the brink of such an occurrence.

No matter how and when exactly such a financial crisis hits Japan in the next couple years, it will force the inward FDI, if not the outright leveraged buyout, of the Japanese financial sector by American capital and financial management. There will be no one else with the money, the skills, or the appetite for risk to salvage the system – and the assets of Japan will be available in a fire sale. So either by choice, or by crisis, Japan will complete its financial convergence upon the US model, with all the long-term effects to ease tensions and decentralize foreign policy decisions in the US-Japan economic arena discussed here. Unfortunately, if the transition to that situation of congruence is made through a Japanese financial crisis, the spillovers on the security relationship from US-Japan financial convergence as well as on the world economy will likely be quite large.

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Figure 1: Allocation of US household wealth

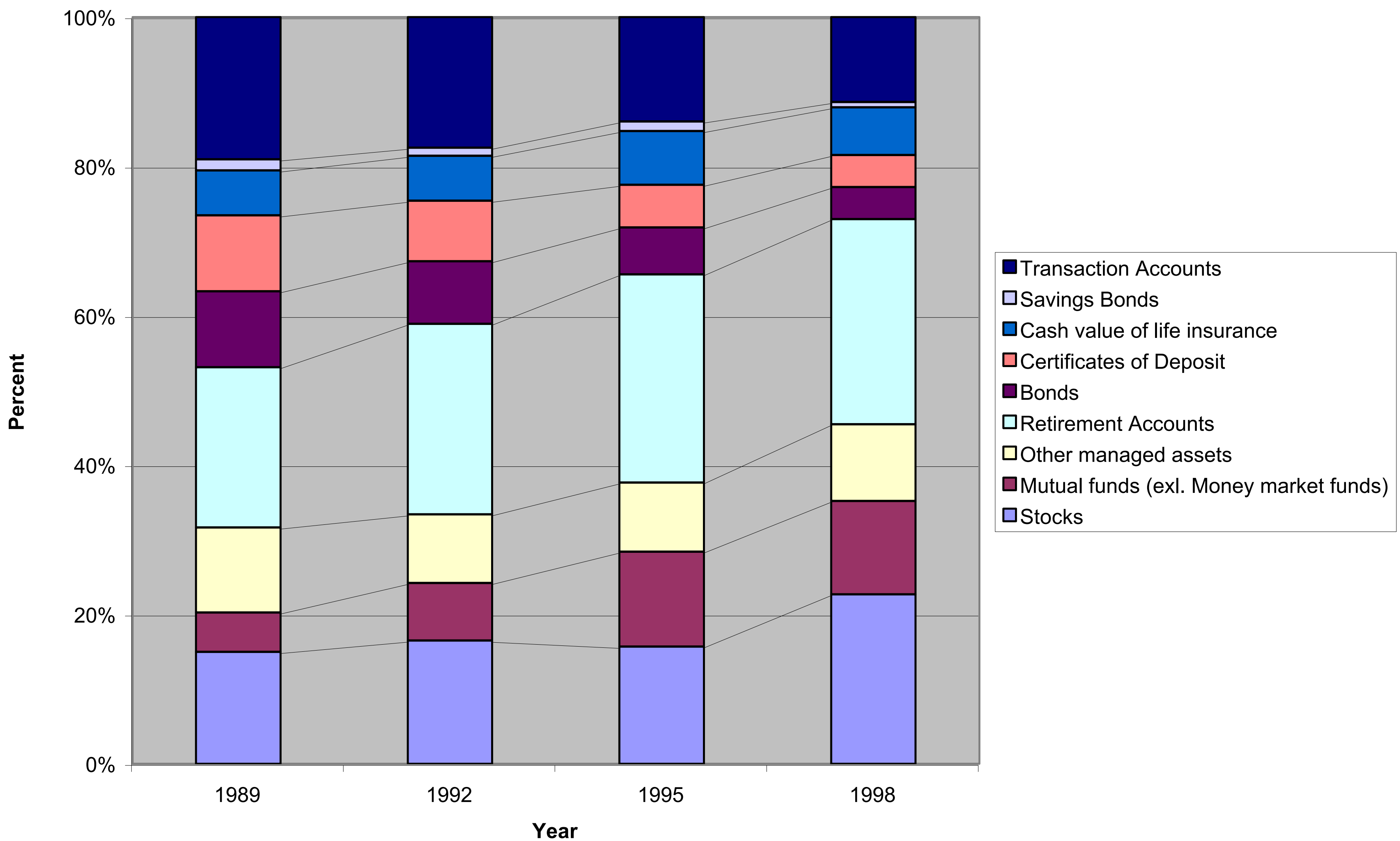

Figure 2: Allocation of personal savings in Japan

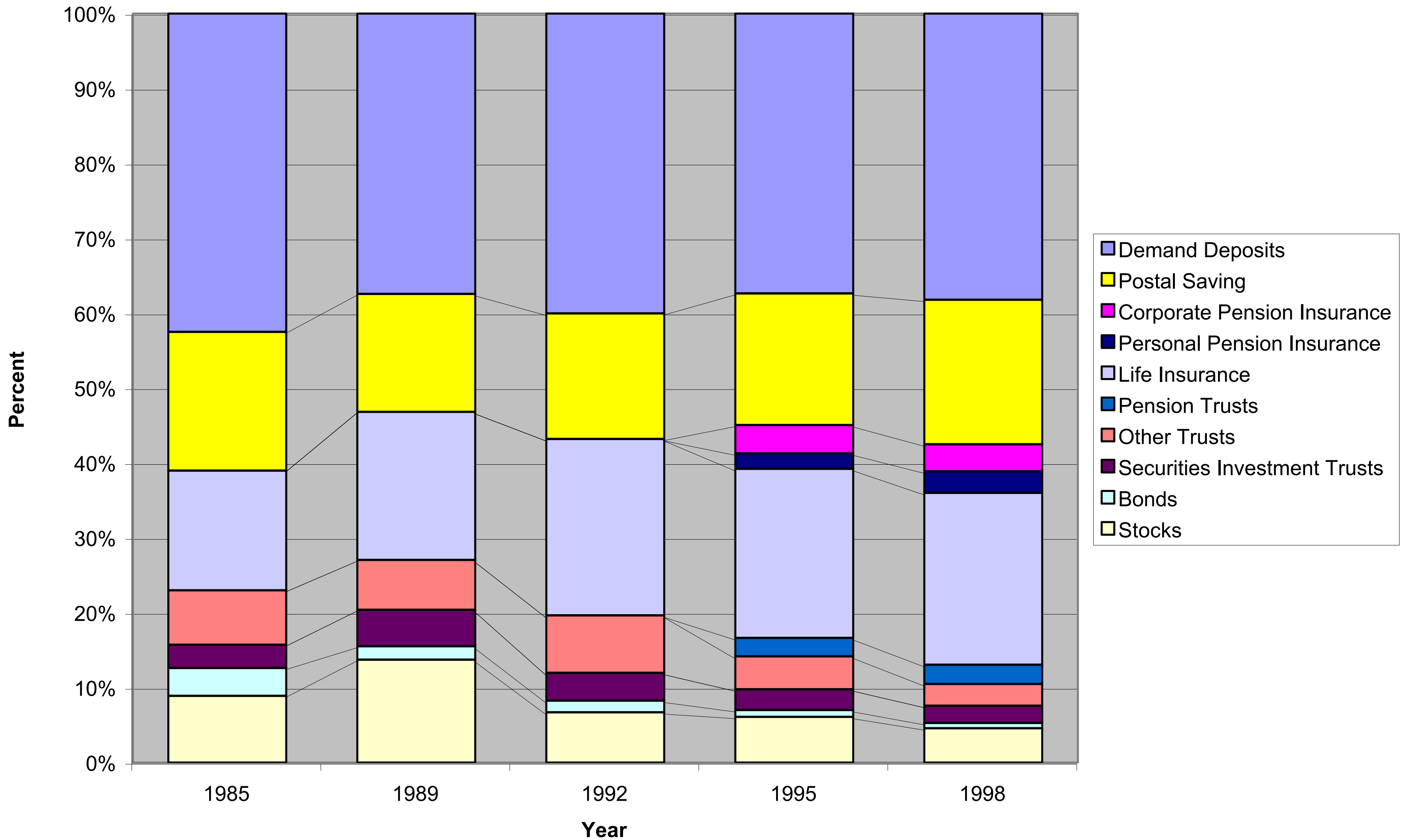

Figure 3: Foreign direct investment

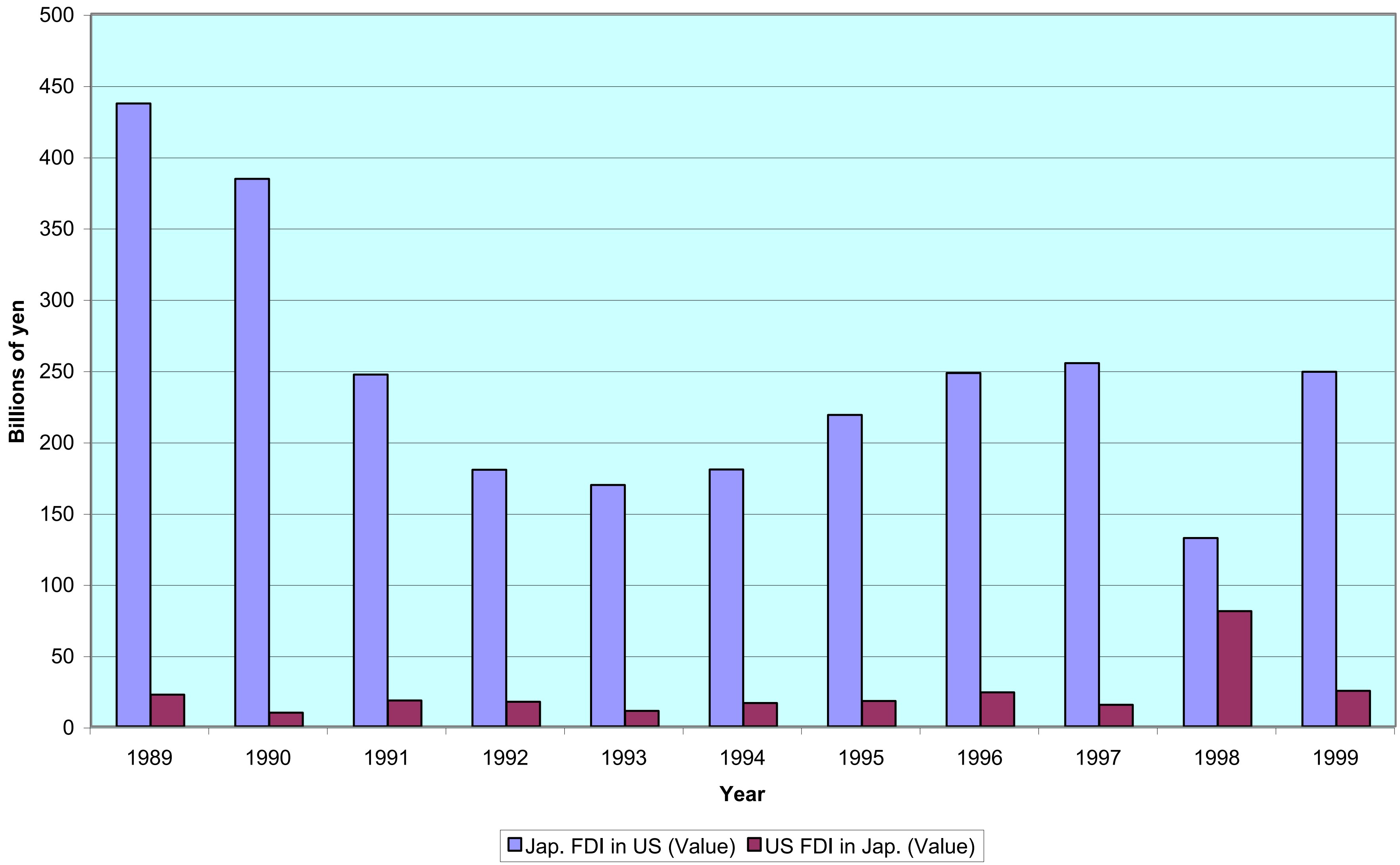

Figure 4: Net sale of US Treasuries by Japan

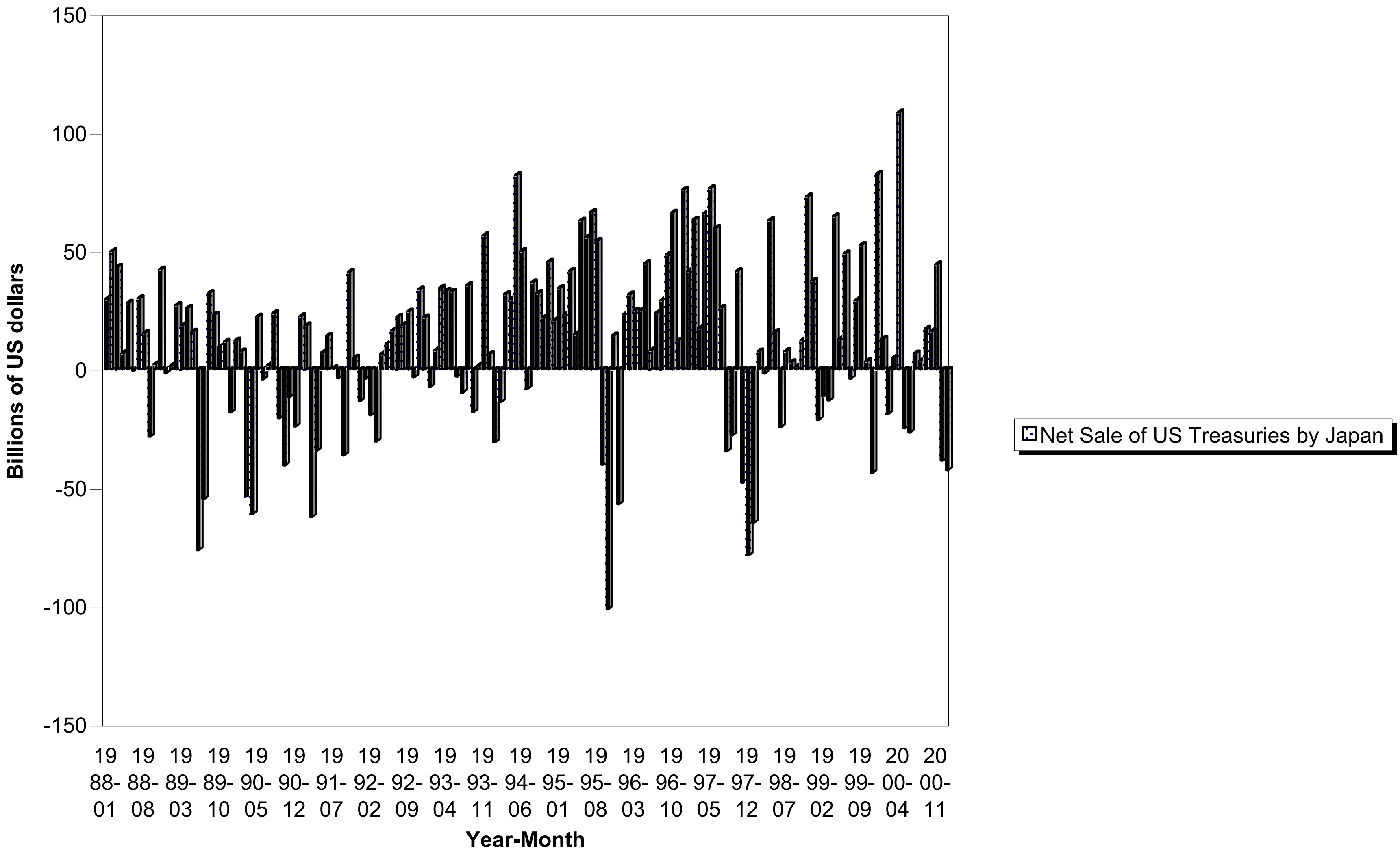


Figure 5: Japanese share of total foreign sales and purchases of US Treasury bonds, notes
60
50
40
30
20
10
0
Percent
1988-01
1988-08
1989-03
1989-10
1990-05
1990-12
1991-07
1992-02
1992-09
1993-04
1993-11
1994-06
1995-01
1995-08
1996-03
1996-10
1997-05
1997-12
1998-07
1999-02
1999-09
2000-04
2000-11
Year-Month
Japanese Share of Total Sales
Japanese Share of Total Purchases

Figure 6: Performance of Dow Jones and Nikkei