CHAPTER 2

Japan's Economic Integration

Developing Regions and the United States

Japan's politico-economic relations with the Pacific Rim countries, especially with the United States, have influenced the country's behavior in the management of financial crises in the 1980s and 1990s. On one hand, Japan has become a major provider of financial resources supporting the economic growth and recovery of developing countries in recent years. On the other hand, Japan's interaction with the United States influenced the behavior of Japanese actors as they engaged in financial crisis management. The shifting balance and intensity of Japan's economic integration with these countries over the past two decades corroborates the variance with which the Japanese actors reacted to different crises.

Japan's capital exporting status and initiatives for recycling current account surplus during the 1980s led developing countries with balance-of-payments problems to expect the Japanese government to act as one of their major sources of economic support. This was a vital way in which Japan contributed to the maintenance of international financial stability (considered an international public good) during financial crises as the Japanese financial sector and government engaged themselves in collective crisis management with other creditors. The financial contribution has become a significant component for the resolution of financial crises, because Japan, in general, has not been a generous importer of goods produced in developing countries, except for oil, certain natural resources, and agricultural products.[1] This is quite different from the U.S. case, where its import capacity has helped many Latin American and other middle-income developing countries improve their balance-of-payments positions.

U.S.-Japanese economic relations constitute the other important aspect of Japan's role in international financial crisis management. Throughout post-1945 history, the United States has been Japan's most important economic partner, with the United States acting as the structural power and Japan as its beneficiary. In the past two decades, moreover, there has been a further increase in the deep economic integration of the two countries, as well as a shift in the power balance.

This chapter does not examine Japan as a hegemonic power, though some scholars raised this discussion in the late 1980s.[2] The limited scope of this chapter precludes it from providing a comprehensive overview of Japan's economic relationship with the rest of the world. Data presented herein on the evolution of Japan's economic relations with developing countries and with the United States aim to illustrate the point that Japan's behavior toward Pacific Rim developing countries in financial turmoil derives from Japan's economic integration with developing countries as well as with the United States.

The first half of this chapter summarizes the history of the rise of Japan as a large economy after World War II and as a major source of global funding since the late 1970s, with reference to the changes in these trends in the 1990s. This half focuses particularly on Japan's economic relationship with Latin America and Asia. The second half focuses on the increasing economic integration and interdependence between the United States and Japan and on the tension associated with that changing relationship in the 1980s and 1990s. The organization of this chapter reflects how Japan's economic position represents a juncture between two different worlds, both of which Japan values significantly. On one hand, as the economic leader of the region, Japan has become a major investment and trade partner to developing countries in Asia. On the other hand, with its capital abundance and high technology, Japan is a member of the group of "rich countries," and it has relied and continues to rely heavily on its economic interdependence with the United States.

Japan as a Major Source of Development Finance

An important aspect of Japan's economic relations with developing countries in the past few decades is an increase in the flow of goods and money.[3] Fifty years have passed since Japan's failure of its imperial quest and since its devastating defeat in World War II, conditions that left Japan with very limited access to the developing world in the 1940s. Now more than half of Japan's trade is with developing countries (see fig. 2.1), and it has become the largest official aid donor to developing countries in absolute dollar amounts (see table 2.1). Japan has also become a major provider of private investment. Its role as a source of financial resources and technology has raised many expectations among developing countries.

The following data on trade and finance demonstrate the story of Japan's economic relations with developing countries: Japan's financial flows, both from public and private sources, have constituted an essential component of these relationships. With the major exception of Japan's ultimate reliance on

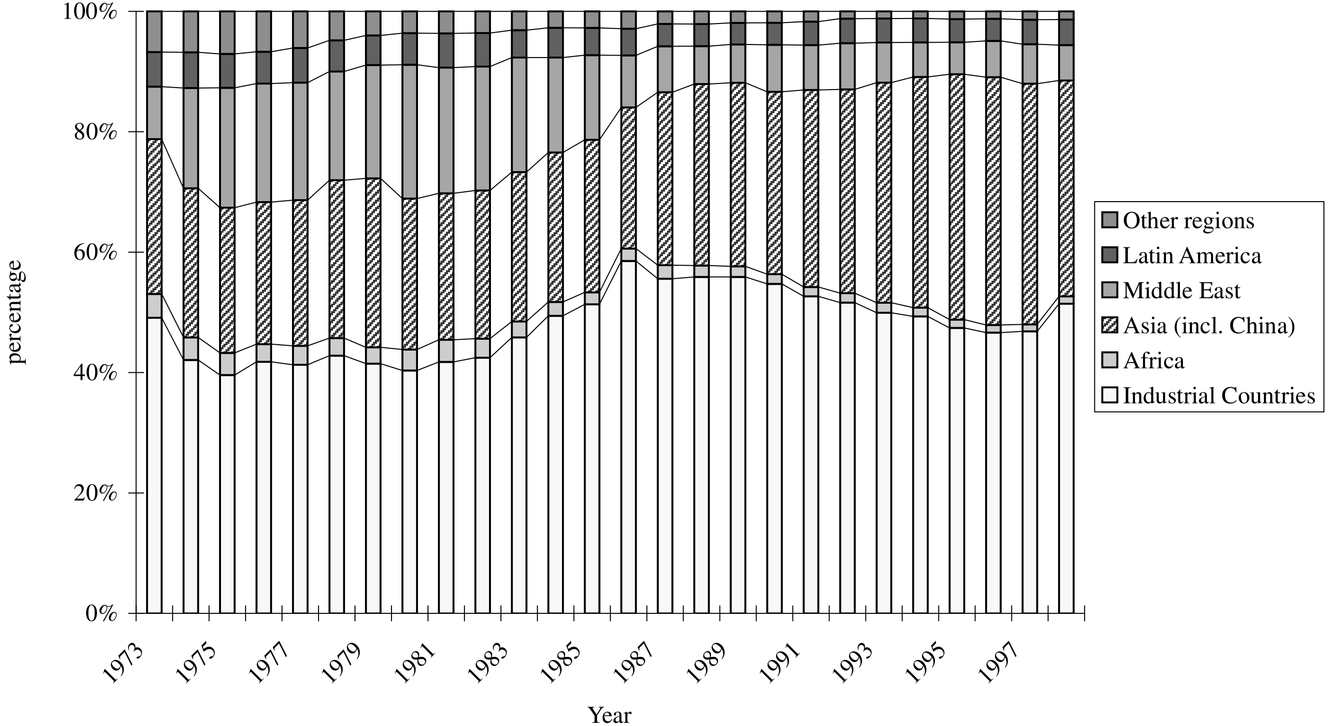

Fig. 2.1. Regional distribution of Japan's total trade, 1973–98. (From IMF, *Direction of Trade Statistics Yearbook*.)

TABLE 2.1. Top Ten ODA Donors, 1980–1998 (in millions of US dollars)

	1980		1985		1989		1990		1998	
1	**US**	**7,138**	**US**	**9,403**	**Japan**	**8,965**	**US**	**11,394**	**Japan**	**10,640**
2	Germany	3,567	**Japan**	**3,797**	**US**	**7,677**	**Japan**	**9,069**	**US**	**8,786**
3	**Japan**	**3,353**	France	3,134	France	5,802	France	7,163	France	5,742
4	France	2,8 89	Germany	2,942	Germany	4,948	Germany	6,320	Germany	5,581
5	UK	1,854	Canada	1,631	Italy	3,613	Italy	3,395	UK	3,864
6	Netherlands	1,630	UK	1,530	UK	2,587	UK	2,638	Netherlands	3,042
7	Canada	1,075	Netherlands	1,136	Canada	2,320	Netherlands	2,538	Italy	2,278
8	Sweden	962	Italy	1,098	Netherlands	2,094	Canada	2,470	Denmark	1,704
9	Italy	683	Sweden	840	Sweden	1,799	Sweden	2,007	Canada	1,691
10	Australia	667	Australia	749	Australia	1,020	Norway	1,205	Sweden	1,573

Source: OECD, *Development Report,* various issues; OECD Web site <http://www.oecd.org/dac/htm/dacstats.htm/> (July 5, 2000).

natural resource imports, particularly oil, it seems to have been difficult for developing countries to increase their exports to Japan. In compensation for the lack of imports from these countries, Japanese capital outflows have begun to constitute a major element of Japan's economic relationship, particularly since the mid-1980s.

Trade

Regional allocation of Japan's total trade indicates that about 50 percent of Japan's total trade (imports plus exports) has been conducted with developing countries over the past twenty years (see fig. 2.1). Two notable aspects of these trade patterns during this time are Japan's quest for natural resource imports and the expansion of its export market. The significant impact of the 1973 oil crisis, appearing on Japan's trade balance between 1974 and 1976, underlines the first feature. This event increased the value of Japan's imports from oil-producing countries, located mostly in the Middle East (plus Indonesia). The period between 1980 and 1982 reveals some of the same responses to the second oil shock of 1979–80, but this event was not as dramatic as the previous one.

The second feature of Japan's expanding trade relationship is the large increase in Japan's trade with industrial countries during the 1986–88 period, when the yen rapidly appreciated. One may interpret this increase as a very sticky J-curve effect (the volume of exports and imports responded slowly to the change in relative prices that the devaluation introduced). The period from 1990 through 1996 was characterized by the Asianization of Japanese trade relations, where the ratio of Japan-Asian trade against its total world trade increased from around 25 percent (in the mid-1980s) to above 35 percent. Both Africa and Latin America maintained their stable but declining shares of trade with Japan, with their shares falling from 4 to 2 percent and 6 to 3 percent, respectively.

Japan's trade balance (see fig. 2.2) shows that these increases in Japan's total trade with industrial countries (1986–88) and with Asia (1990–97) arose from increases in the amount of Japan's exports to these regions. The Japanese trade balance has been notoriously in surplus, causing criticism and retaliation by its industrial trading partners, including the United States, even before the 1973 oil crisis.[4] Asia is the only region with which Japan developed a significant and increasing trade surplus after the mid-1980s.[5] Japanese trade has been quite balanced with Africa and Latin America, and Japan consistently accrues trade deficits with the Middle East due to Japan's oil imports (see fig. 2.2). For the level of its economic development, Japan imports a relatively small amount of manufacturing goods from industrial countries and the

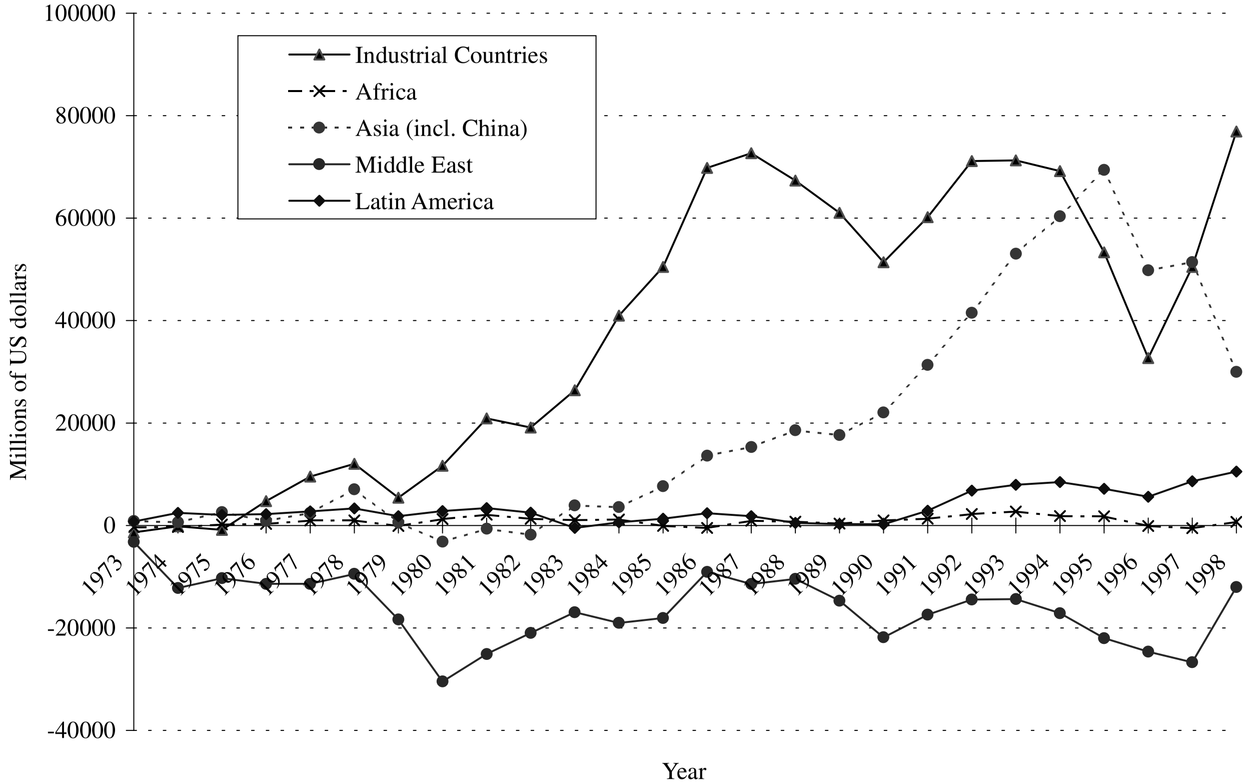

Fig. 2.2. Japan's trade balance with regions, 1973–98. (From IMF, *Direction of Trade Statistics Yearbook*.)

middle-income developing countries of Asia and Latin America, representing lack of intra-industrial trade (exports and imports of products falling within the same industry classification). The tensions arising from this trade practice are often cited as a bigger problem than the level of the imbalance itself.[6]

Easier access to Japan's domestic market for manufactured goods from developing countries is an important contribution that Japan could and should provide as a leading economic power. The stickiness of institutions and political arrangements created under what is labeled the "Yoshida Doctrine"[7] and the "catch-up process"[8] still exists in the Japanese economy. In addition, its need for heavy imports of natural resources has made the Japanese government quite cautious in opening Japan to a large amount of foreign imports that could drain its foreign exchange reserve. Finally, the nationalistic or mercantilist nature of Japan's economy has long hindered new or foreign entrants into the market. Whatever the motivation, long after the end of the Japanese economy's rapid growth period in the early 1970s, Japanese economic actors still promote exports and minimize "market-threatening" imports from abroad. The amount of primary goods Japan has imported from many developing countries has not apparently contributed much to the exporting countries' industrialization or to those countries' establishment of stable export income. Japan revisionists, who captured the spotlight in the late 1980s, have argued that Japan's unique domestic structure is maintained in such a way that it is difficult for foreign goods to penetrate and reach its consumers.[9]

This limitation of Japan's capacity to import from developing countries makes their alternative contributions to the stability and prosperity of developing countries even more important. Particularly with Japan's current account surplus (mostly against the United States and some other industrial countries) and its high savings rate, along with the strengthening yen since the early 1970s, investment and capital outflows from Japan became an essential component of the country's economic interaction with the developing world. Because such financial exchanges are conducted by private entities (e.g., foreign direct investment and bank lending) as well as by the government (official development assistance [ODA]), it is important to discuss them separately.

Financial Flows from Public Sources: Foreign Aid and Other Official Flows

Financial flows from public sources have been important components of Japan's economic relations with developing countries, particularly with countries where and during times when Japan's private sector was not ready to invest or had major reservations regarding country risk.[10] This foreign economic assistance has also constituted a major foreign policy instrument for the Japanese government as it increases ties with developing countries. During the financial crises of middle-income countries, the Japanese government employed these funds to facilitate crisis solution. Japan's ODA policy has attracted the interest of students of Japanese foreign policy due to a dramatic increase of its commitment in the 1980s and to its status as number one aid donor in the 1990s.[11]

Japan's foreign aid program started in the form of reparation agreements with independent developing countries in Asia in the aftermath of World War II, along with Japan's joining of the Colombo Plan.[12] Reparation agreements opened the doors for Japanese businesses to interact with developing countries in Asia.[13] This was particularly important for Japan in the 1950s, after the 1949 "loss of China" to communism. Although Japan continued to have economic relations with the People's Republic of China even after it severed diplomatic relations by recognizing Taiwan, a lack of stable economic ties with China led the Japanese government to turn to the rest of Asia and beyond for stable supplies of raw material imports and for export markets. The period between reparations and the 1973 oil crisis is characterized as the time when mercantilistic aid was used to promote Japan's economic development, in particular its exports. After joining the Organization for Economic Cooperation and Development (OECD) in 1964, Japan was expected to assume increasing global responsibilities as a member of this "rich countries' club." Japan, however, was not quite ready for the task. With the strong commercial orientation of the JEXIM Bank inherited by the Overseas Economic Cooperation Fund (OECF) in the form of heavily tied aid, Japanese aid policies appeared to have been solely for the purpose of export promotion.[14] As the voice of developing countries in the international arena rose through the collective power of the Group of Seventy-Seven (G-77)—the group of developing countries that constituted the UNCTAD (United Nations Conference on Trade and Development) in 1964—criticisms of Japan's foreign aid, in terms of both its strong commercial orientation and its high concentration in Asia, were repeated.[15] All through this early phase, Japanese foreign aid was very highly concentrated in Asia (see fig. 2.3). Even during the late years of this phase (1971–72), 99 percent of foreign aid was disbursed to Asian countries.

No doubt, 1973 was a defining year for the Japanese economy and for Japan's foreign relations with developing countries, when Japan's dire needs for natural resource imports played a large role. The quadrupling of oil prices and the increase in the developing world's power over resources represented a threat to Japan because it consistently imported over 90 percent of its energy supply. Japan then started to utilize its foreign aid to establish better relations with resource-rich countries, such as Indonesia, and with countries in the Middle East and Latin America. Some large-scale resource development proj-

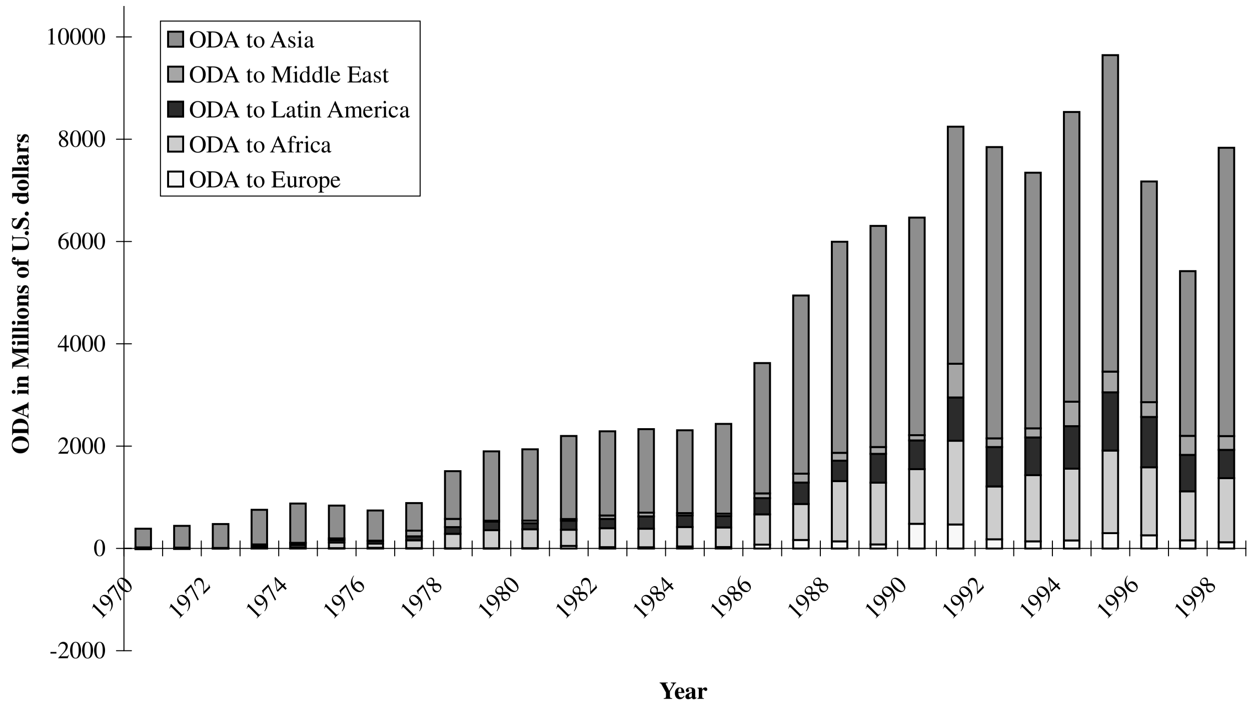

Fig. 2.3. Japan's foreign aid to various regions, 1970–98. (From OECD, *Geographical Distribution of Financial Flows to Developing Countries.*)

ects were financed by ODA.[16] During this phase, one observes some geographical diversification, out of necessity, of Japan's ODA. An average of 7 percent of ODA went to the Middle East during 1975–78, up from 0.1 percent in 1973, while aid to Asia declined from 90 percent (1973) to 70 percent (1975–78) (see fig. 2.3).

In the midst of this temporary regional reallocation of aid caused by the resource threat, the Japanese government launched a new phase of Japanese foreign aid policy by announcing, in May 1977, its first "Five-Year Aid-Doubling Plan." From this year on, various aid-doubling plans were implemented.[17] These plans, boosted by the rapid appreciation of the Japanese yen, made Japan the world's largest provider of ODA in 1989, for the first time in terms of absolute amounts.[18] Japan maintained its status as number one aid donor from 1992 to 1998 (see table 2.1). Accompanying the aid-doubling plans, aid pledges were made to increase the amount of foreign aid to certain countries or regions. Starting with Prime Minister Fukuda's visit to the countries of the Association of Southeast Asian Nations (ASEAN) in 1977, aid pledges promised many developing countries a boost in Japan's ODA disbursement.[19] Furthermore, since the signing of the Sino-Japanese Peace and Friendship Treaty with China in 1978, Japanese foreign aid to China has increased dramatically, particularly since 1982.

As the quantity of Japan's ODA increased, supporting Japan's economic integration with developing countries, there were also apparent improvements in the quality of Japan's foreign aid. At this time, the Japanese government began showing more sensitivity to humanitarian need, and it decreased the use of tied aid.[20] The publication *Keizai Kyoryku no Genjo to Mondaiten* (The current status and problems of Japanese Economic Cooperation) by the Ministry of International Trade and Industry (MITI) explains the rationale for this more active aid commitment on the part of the Japanese government since 1977.

> Due to the oil shock, the need for foreign aid by developing countries diversified rapidly, and at the same time "aid fatigue" of industrial democracies has become a prominent feature. . . . Under these circumstances, the expectation has risen that Japan would take a greater role in economic cooperation because of its current account surplus and strong yen.[21]

The Japanese government began to use a substantial amount of ODA to support Japan's emerging security agenda in the 1980s, and the agenda has related very closely to Japan's relationship with the United States. Playing an important role in the "comprehensive security" of Japan's foreign policy, Japan's foreign aid began to encompass "strategic as well as economic objectives."[22] The phrase *strategic aid* circulated in the Japanese media in the early 1980s. The programs so described aimed to strengthen Japan's assistance to "those areas which are important to the maintenance of peace and stability of the world."[23] Pakistan, Egypt, Sudan, and some Central American countries received increased amounts of Japan's foreign aid during this period. Inada argues that the phrase *strategic aid* largely meant that Japan's aid was "conducted in accordance with U.S. strategy."[24] This claim is empirically verified by the correlation between the recipients of U.S. Security Supporting Assistance and Japan's major aid recipients.[25]

In these contexts, the Japanese government began channeling its ODA in support of countries suffering from the consequences of the debt crisis triggered by the Mexican crisis in 1982. The Japanese government had increased its ODA steadily from the 1980s into the 1990s. In 1988, during the Toronto Summit, Prime Minister Takeshita of Japan announced a fourth medium-term ODA target (1988–92) of $50 billion. In addition to the increased quantities (of course, aided by a strong yen at the time), the characteristics of Japan's ODA transformed in various ways during the latter part of the 1980s. These changes appeared to have been designed to help not only debtor countries but also creditor countries in need of loan payments from those debtors.

First, the OECF began implementing policy-based lending (PBL) to some developing countries. PBL is a type of structural adjustment loan (not Japan's usual project loans) whose disbursement is based on the progress of the recipient country's economic adjustment. The Japanese government had traditionally avoided such loans. The shift was ostensibly prompted by the urgent need for quick loan disbursements to countries requiring new money for both economic growth and balance-of-payments purposes. Nevertheless, because of the increased fungibility of these funds, the recipient countries were able to channel funds to more politically important purposes, such as repaying the interest on their commercial loans. The second shift in Japanese ODA was a rapid decline in tied aid as a portion of Japan's concessional loans. According to an OECF report, the rate of aid tied to home country procurement dropped from almost 50 percent in 1986 to 9.6 percent in 1991.[26]

Japan has been one of the two largest aid donors since the late 1980s (see table 2.1).[27] Japan continued providing the most ODA to the developing world (directly and indirectly through international organizations) into the mid-1990s.[28] The United States, meanwhile, due to its budget austerity and the loss of the cold war rationale, retreated to a lower position, ranking as the second largest (1992–94 and 1996) or fourth largest (1995) aid donor. The increase in

Japan's aid donor status is reflected in the top donor profile of aid recipient countries. Japan provided more than 50 percent of the aid received by six countries in 1985–86 (averaged). However, in 1993–94, Japan was the majority aid provider to forty-six countries, including many non-Asian countries, such as Syria and Paraguay, although Japan's aid is still concentrated in Asia. The Japanese government, facing a highly strained central budget in the late 1990s, discussed a cutback in its ODA budget from fiscal year 1998. However, the onset of the Asian economic crisis in the latter half of 1997 and the dire need for increased funding to support Japan's initiatives in financial crisis management halted this process. Japan remained the largest ODA donor in 1998.

Other official flows (OOF) from Japan (see fig. 2.4) include overseas investment loans and untied direct loans implemented by the JEXIM Bank. Compared to ODA, with higher-than-market concessionality (a more than 25 percent grant element), OOF has lower concessionality and stronger commercial orientation. While the OECD governments are keen to advertise their contribution to economic development and concessional capital transfer through ODA, OOF is viewed as a financial instrument used by governments to promote their economic interests in both trade and investment.

In the case of Japan, OOF undertaken by the JEXIM Bank has two major purposes. The first, often stated purpose of JEXIM loans is to support and promote Japan's private industries in their expansion overseas. By the mid-1980s, the MITI reported that as much as 55 percent of Japan's foreign direct investment undertaken by small and medium-size firms was funded by public sources.[29] This is an indirect channel through which OOF enhances private flows. The official loans and guarantees provided by the JEXIM Bank to developing country projects have often contributed to increasing financial flows from Japan to the developing world.

OOF's second function is as a source of additional capital flow from Japan, which has been essential to developing countries, particularly since the mid-1980s. The OECF faced constraints when it tried to extend yen loans (ODA) to some middle-income Latin American debtor countries, for example, because the basic laws of the OECF did not allow any concessional yen loans to countries with a relatively high gross national product (GNP) per capita.[30] Under these constraints, the JEXIM Bank adopted an especially important function when it encouraged the extension of untied loans after the Japanese government announced its Capital Recycling Program in 1986 (further discussed in chap. 5). The JEXIM Bank disbursed a total of $23.7 billion by the end of June 1992.[31] The effort to recycle Japan's current account surplus through JEXIM Bank untied loans continued until the end of 1998 (see table 2.2), and it provided a total of $52.3 billion to developing regions in Asia/Oceania (48.4 percent) and Latin America (24.2 percent) and to IFIs (12.7 percent).

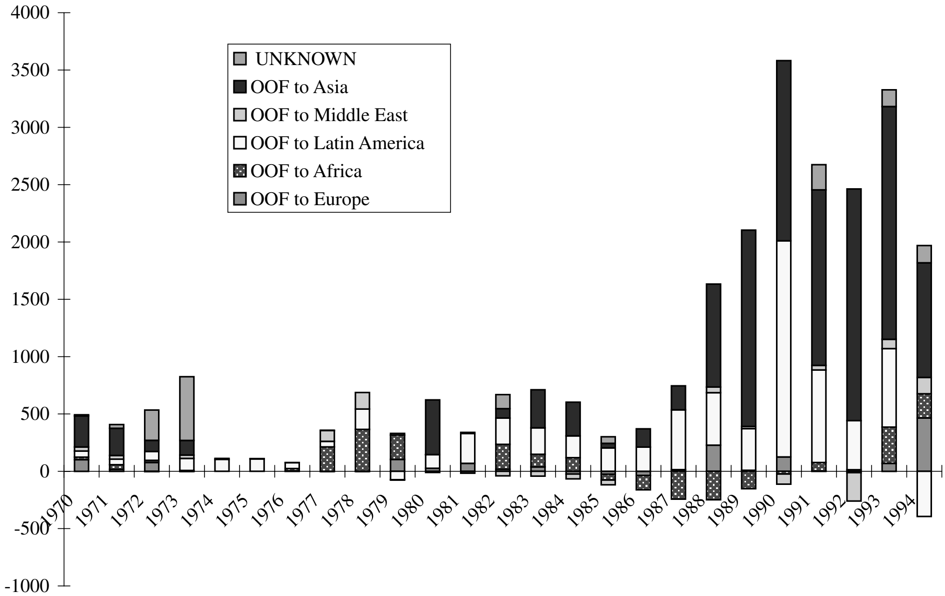

Fig. 2.4. Japan's other official flows (OOFs) to various regions, 1970–94. (From OECD, *Geographical Distribution of Financial Flows to Developing Countries.*)

Japan's financial flows from public sources, ODA and OOF, have established a strong quasi-economic link between Japan and developing countries. Japan's official financial flows have proven to be essential, particularly for middle-income emerging market countries in the 1980s and 1990s that faced financial crunch as they underwent financial crises.

TABLE 2.2. The Progress of JEXIM Bank Untied Loan Commitments by Region (as of December 4, 1998)

Region	Number of loans	Amount (millions of US dollars)	Percentage
Asia and Oceania	78	25,312	48.4
Europe, Africa, and the Middle East	63	7,642	14.6
Latin America and the Caribbean	64	12,665	24.2
IFIs	9	6,663	12.7
Total	214	52,282	100.0

Source: JEXIM Bank Web site <www.japanexim.go.jp/UntiedLoan/Index.html> (December 4, 1998).

Private Financial Activities: Foreign Direct Investment, Bank Lending, and Beyond

The Japanese private sector has been an important actor in Japan's economic integration with developing countries in the past three decades. Foreign direct investment (FDI) has constituted a substantial part of long-term financial flows, which have provided steady and productive sources of capital. Japanese bank loans, first prompted by the abundance of petrodollars in the mid-1970s, also provided long-term flows to creditworthy countries in the South. Finally, with the emergence of new avenues of investments in middle-income and rapidly industrializing developing countries (most of them otherwise called "emerging market countries"), portfolio capital flows into bonds and equities have surged since the first half of the 1990s. Although many consider these investment links largely market-driven or business-driven, Japan's domestic politico-economic structure makes these links an inevitable part of Japan's foreign (economic) policy.[32]

Examining the overall picture of Japan's FDI in the past few decades reveals a dramatic increase and changes in allocation. Until the 1980s, a relatively large portion of Japan's FDI went to developing countries in Asia and Latin America. Then, since the 1980s, as the overall amount of Japan's FDI drastically increased, the share of FDI to North America began to dominate, occupying more than 40 percent of Japan's FDI (discussed later in this chapter), until Asia made a substantial comeback in the mid-1990s (see table 2.3).[33] The sector disaggregation of Japan's FDI in developing regions demonstrates that the proportion of Japan's investment in the manufacturing sector decreased from 42.5 percent in 1980 to 23.1 percent between 1981 and 1985 and 22.8 percent between 1986 and 1990. The nonmanufacturing sector, dominated by natural resource extraction, which used to capture 52.8 percent, increased its share to over 75 percent in the 1980s.[34] Among developing regions, Asia and Latin America have been by far the largest recipients of Japanese FDI. While Asian countries began receiving more FDI in the manufacturing sector since the 1980s (30–40 percent), Japanese investment in Latin America went to nonmanufacturing sectors (80 to 90 percent), particularly in finance, insurance, and transportation.[35] Such a contrast suggests the clear differentiation of Japanese private sector activities in the two respective regions.

Japan's FDI in developing countries seems to be driven by three factors. First is securing the source of natural resources, which has been one of the most important and overreaching foreign policy objectives for Japan throughout its modern history. Accordingly, Japan's FDI behavior in resource-rich developing countries has long reflected this national preoccupation, particularly after the 1973 oil shock. In many resource-rich Latin American countries, Japan's FDI then took part in so-called national projects. *National project* was the unofficial name for a development project defined by the following criteria: (1) the project was directly related to Japan's national interests, particularly in natural resources; (2) Japanese companies participated as a group in the project; and (3) government organizations supported the effort directly or indirectly. Support from the government came mostly in the form of public cofinancing for the Japanese private financial sector. The projects were usually developed by Japanese trading companies and discussed with the host governments, which requested financial support from the Japanese government. An arrangement to finance the project was then engineered between Japanese public financial organizations, such as the OECF or the JEXIM Bank, and Japanese commercial banks.[36]

The second factor driving FDI is a concern for Japan's economic competitiveness. Classic studies of Japanese FDI in the 1970s suggest economic rationales for Japan's investment in the manufacturing sector. Following the pre–World War II literature on FDI by Akamatsu,[37] Kojima argued in 1978 that Japanese FDI followed the principle of comparative advantage and that FDI supplemented Japan's trade. That is to say that Japanese manufacturing firms shifted their production overseas via FDI as they lost their comparative advantage in producing certain goods under Japan's factor endowments. In this case, most of Japan's FDI went to countries with cheap labor, to capture

TABLE 2.3. Japan's Foreign Direct Investment by Region, 1965–1997 (in millions of current US dollars)

Region	FY 1965	FY 1970	FY 1975	FY 1980	FY 1985	FY 1990	FY 1995[a]	FY 1997[a]
North America	44	192	905	1,596	5,495	27,192	23,221	21,694
percentage	27.7	21.2	27.6	34.0	45.0	47.8	45.2	39.6
Europe	5	335	333	578	1,930	14,294	8,587	11,364
percentage	3.1	37.1	10.2	12.3	15.8	25.1	16.7	20.8
Latin America	62	46	371	588	2,616	3,628	3,879	6,424
percentage	39.0	5.1	11.3	12.5	21.4	6.4	7.5	11.7
Asia	35	167	1,101	1,186	1,435	7,054	12,361	12,355
percentage	22.0	18.5	33.6	25.3	11.7	12.4	24.0	22.6
Middle East	11	28	196	158	45	27	153	478
percentage	6.9	3.1	6.0	3.4	0.4	0.0	0.3	0.9
Africa	2	14	192	139	172	551	381	336
percentage	1.3	1.5	5.9	3.0	1.4	1.0	0.7	0.6
Oceania	0	123	182	448	525	4,166	2,816	2,087
percentage	0.0	13.6	5.5	9.5	4.3	7.3	5.5	3.8
Total	159	905	3,280	4,693	12,218	56,912	51,398	54,738

Source: MOF, *Kokusai Kinyukyoku Nenpo,* various issues. On notification basis.
Note: The Japanese fiscal year starts in April and ends in March.
[a]Beginning with FY 1995, Japan's FDI figures are published in yen rather than dollars. The average exchange rates used for converting yen figures into dollars are for FY 1995 ¥96.44 and for FY 1997 ¥120.99.

their comparative advantage. This characteristic of Japanese FDI has allegedly contributed to a "flying geese pattern" of industrialization within the Asian region, where "countries . . . follow one another in a developmental trajectory in which the latecomers replicate the developmental experience of the countries ahead of them in the formation."[38] In addition, Ozawa argued in the late 1970s that Japanese FDI supported the transformation of Japanese industries from low-technology and labor-intensive status to a high-technology position by enabling some companies to shift their production sites abroad.[39]

The strong need for Japan's manufacturing sector to export created a shift in Japanese FDI to developing countries as the Japanese government fully liberalized the majority of its capital controls in 1972. That was the year after the Japanese currency began to appreciate as the United States removed the dollar from its fixed rate to gold in 1971, a policy that ended the fixed exchange rate regime. To cope with a higher yen, Japanese manufacturing companies looked to invest and produce abroad. Thus, 1972 was considered the inaugural year for Japan's "real" FDI activities.[40] In the 1980s, Japan became more aggressive in using FDI to establish export platforms in developing countries with lower labor costs and more competitive exchange rates. This aggressive phase was further facilitated by the liberalization of Japanese finance from 1980 and was also forced by the rapid appreciation of the yen after 1985. In addition, facing strong import restrictions imposed by major industrial countries like the United States in the 1980s, Japanese exporters had to resort to overseas production to circumvent trade barriers.[41]

The third factor driving Japanese FDI in developing countries in the latter half of the 1980s was an increasing amount of investment in the financial and insurance sectors, particularly in Latin America. Aside from pursuit of tax-exempt status in some tax-haven countries in Latin America and the Caribbean, this development arose from Japanese manufacturing firms' reliance on foreign branches of Japanese banks for funding, a trend that forced the Japanese financial sector to follow the firms' rapid expansion overseas.[42] This leads us to the next major component of Japanese financial interaction with developing countries: bank lending.

Japan's bank lending to developing countries is a newer phenomenon compared to the history of Japan's FDI in developing countries. Although this phenomenon is less known (partly due to limited data), the presence of Japanese money became prominent in many developing countries by the second half of the 1970s.[43] Both the Japanese balance of payments recovered from the import shock of the 1973 oil crisis and the vast inflow of petrodollars into the country led to the relaxation of rules against capital outflow in the fall of 1976. Governmental restrictions on external lending activities by Japanese banks were lifted. A policy encouraging free outflows of capital followed during the next several years, with a temporary and short reversal after a second oil shock, in 1979–80. With limited investment opportunities in industrial countries due to the recession of the early 1980s, an increasing amount of Japanese capital was directed to developing countries. Many middle-income developing countries were undergoing "indebted industrialization" in the 1970s by taking advantage of the abundance of petrodollars floating throughout the international financial world.[44] Japan's MOF explained that such capital recycling contributed to an easing of balance-of-payments difficulties in the developing world.[45]

In a collection of his speeches from the late 1970s, an MOF senior official, Masao Fujioka, discussed the banks' important role in transferring funds from Japan to developing countries.

> Now Japan wishes to transfer incoming funds to the countries in distress and thereby to facilitate a proper international recycling of money. To this end, we are encouraging flotation of yen-dominated foreign bonds, and since last autumn [1976], we have resumed a *policy of encouraging the Japanese banks to provide medium- and long-term financing abroad.*[46]

The "policy of encouraging the banks" to lend abroad was comprised of various instruments to influence the Japanese private sector to allocate financial resources abroad. The instruments at the government's disposal included the JEXIM Bank's highly focused lending policies, the MITI's export insurance program, the ability to designate overseas "national projects," and the occasional provision of official foreign currency reserves to fund commercial transactions.[47] Semiprivatized or quasi-public "hybrid flows" were a form of surplus fund recycling employed by the Japanese government. These financial flows consisted of JEXIM Bank and OECF loans. These flows also served as inducements designed to redirect some of the profit-motivated private flows into a policy-guided, publicly desirable direction.[48] The political problems resulting from Japan's trade surplus with the United States had increased since the mid-1970s, leading the Japanese government to realize the important role of the major banks in offsetting external marcroeconomic pressures (e.g., rising yen) and political pressures (e.g., Japan bashing).

The outflow of Japanese long-term capital to developing countries was further facilitated by the gradual liberalization of the Japanese financial sector in the 1980s. In December 1980, a new Foreign Exchange and Trade Control Law was adopted, transforming foreign capital transactions from "closed in principle" to "free unless prohibited." In addition, the report by the Joint Japan-U.S. ad hoc Group on the Yen-Dollar Exchange Rate pushed for internationalization of the yen by opening up the Euroyen bond market between

April and December 1984. Many financial liberalization efforts followed in the latter half of the 1980s, increasing the importance of Japanese money in the world of finance by enabling outflows of Japan's net savings and current account surplus and by making its capital market accessible to foreigners.[49]

The use of the yen for Japanese financial operations abroad, however, never became significant, despite the internationalization efforts. The reliance of the Japanese financial sector on U.S. dollar-denominated transactions, along with the rapid fall of the U.S. dollar exchange rate in the second half of the 1980s (see fig. 2.13) accentuated the borrowing and lending behavior of the Japanese banks (i.e., borrowing short-term and lending long-term). Nakao writes:

> Although Japan had become the world's largest lender in the 1980s, the foreign exchange banks were heavy borrowers on another level. In contrast to the overwhelming accumulation of assets in the long-term capital account, therefore, there was an overwhelming accumulation of liabilities in the short-term account. As a nation, Japan was borrowing short-term and lending long-term.[50]

This behavior of the Japanese banks—borrowing short-term to cover outward long-term flows, otherwise called maturity transformation—has been quite invaluable for developing countries whose access to long-term capital is limited.[51]

Obviously, after the 1982 Mexican announcement of payment suspension on loan interests, and as many developing country debtors faced increased balance-of-payments problems in the early 1980s, long-term capital flows were allocated away from the heavy debtors, concentrated particularly in Latin America. Such capital then flowed into less risky borrowers, first and foremost to the United States, which had substantially high interest rates at the time (see fig. 2.14), and then to the developing countries of East Asia. Nevertheless, even during the height of the Third World debt crisis, outstanding Japanese loans (including capitalization of interests) to the developing world steadily increased until the Brady Plan reduced Japan's Mexican exposure in 1990. The same arrangement also reduced Japan's exposure to other countries, mostly Latin American ones, such as Argentina, Venezuela, the Philippines, and Costa Rica. In the second half of the 1980s, the nature of bank lending to developing countries also shifted away from syndicated loans and sovereign lending to project finance.[52]

In the early 1990s, as most middle-income developing countries reemerged from the debt crisis and privatized their government holdings in the process, they began to regain access to international capital markets, particularly through bonds and equities. The so-called emerging markets in Latin

America and Asia (and in other parts of the world, such as Turkey and Hungary) attracted capital from industrial countries during this period, when these industrial countries were experiencing very low interest rates under recession.[53] In these emerging market countries, country funds and regional funds set up to attract foreign investors to their stock markets also facilitated capital inflow to these regions, particularly in the first half of the 1990s (see fig. 2.5).

Developing countries from various regions have raised money in Japanese capital markets (see table 2.4),[54] and Japanese financial institutions, including institutional investors, have invested in these emerging markets. Japanese investors have shown a clear regional preference for Asian countries over Latin American ones. Financial institutions in Japan, especially major banks, have not yet gone through institutional rearrangements or a psychological destigmatization of the Latin American debt crisis, and economic difficulties at home and booming Asian markets nearby kept these institutions from venturing across the Pacific.[55]

Japan and the United States in the World Economy

I have thus far presented a historical evolution of Japanese economic interaction with developing countries in the period since the end of World War II, during which Japan has increasingly been integrated to these economies. I have also demonstrated how Japan has become a major contributor of financial resources to the developing world. Throughout this process, both the Japanese government and its private sector have been active and mutually dependent participants in their efforts to extend Japan's economic linkages with the developing world. This public-private interaction has influenced the level of Japan's presence in Asia and Latin America. Furthermore, Japanese economic expansion abroad has been closely linked to Japan's relationship and interaction with the United States.

For the past half a century at least, the economic relationship with the United States has been the most important dimension of Japan's economic exchanges with the outside world, and this relationship has also shaped, to varying degrees, Japanese foreign policy even toward other parts of the world. But while some Americans have emphasized the importance of the U.S.-Japanese relationship,[56] Japan is merely one of many important economic partners for the United States. Nevertheless, because the Japanese and U.S. economies are the two largest in the world, the economic and political dynamics between the United States and Japan and their respective economic interactions with the rest of the world constitute influential factors that shape the world economy.[57] Japanese actors, both governmental and private, have high stakes in their re-

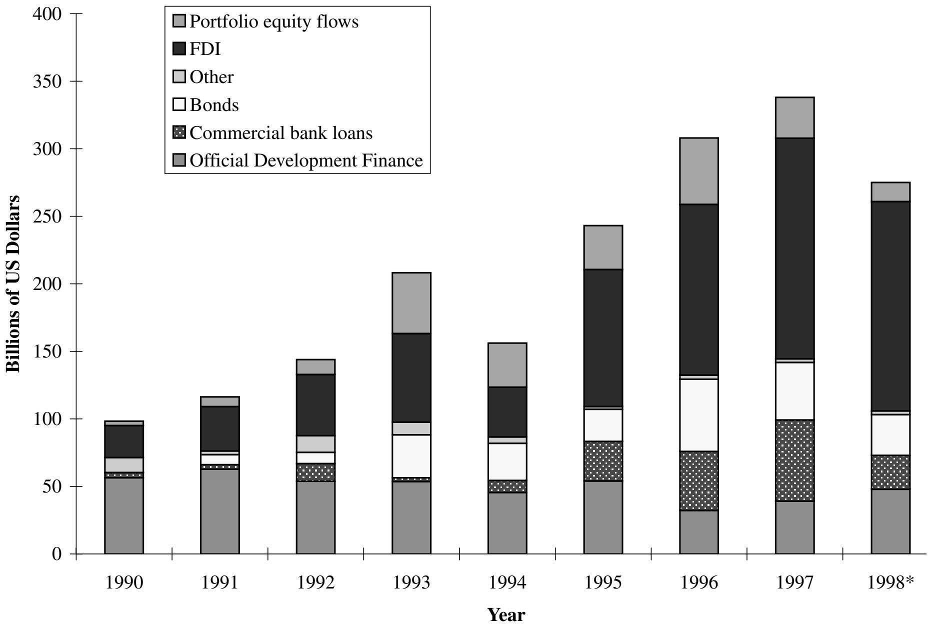

Fig. 2.5. Composition of capital flows to developing countries in the 1990s. (From World Bank, *Global Development Finance,* 1998 and 1999. *1998 World Bank staff estimate.)

lations with the United States, which makes their vested interests in the United States an influential factor as they interact with developing countries, particularly those in the Pacific Rim.

Appreciating the importance of U.S.-Japanese dynamics, scholars have exerted significant efforts to understand this relationship.[58] The U.S.-Japanese economic relationship endured and strengthened during the decade of the 1980s, when Japan began to compete with the United States in various aspects of economic life, including trade and technology. Despite political backlash in the United States against Japan's aggressive economic expansion, the economies of these two countries actually became increasingly interdependent during this period. The changes in U.S.-Japanese relations also have the potential to affect the well-being of other countries, particularly those dependent on both or either of these two powers for trade and sources of finance.[59] The interaction and interdependence of these two countries could potentially be the determining factor of economic stability in the world, which would benefit the economies of all interrelated countries. I therefore argue that Japan's role in maintaining international economic stability (considered an international public good) would be better examined by resorting to a trilateral perspective that takes into

TABLE 2.4. Samurai Bond Issuance, 1990–1998 (in billions of US dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998[a]
Supranational body	1.9	0.7	2.0	0.6	0	1.4	1.7	0.7	0
US and Canada	0.7	0.3	0	0.6	0.8	1.7	6.8	3.4	0.1
Europe	4.6	2.6	4.5	8.7	5.1	6.5	14.3	6.0	1.0
East and Southeast Asia	0.3	0.9	1.2	2.2	3.4	4.1	4.8	2.4	0.1
Middle East	0	0	1.8	2.0	0.7	0	0.7	0.2	0
South Asia	0.2	0.2	0	0	0	0	0	0	0
Oceania	0.6	0.4	0	0.2	0.7	2.6	2.9	1.7	0
Latin America	0	0	0	0.5	0.4	0.1	3.5	1.5	0
Other	0	0	0	0	0.3	1.3	0.3	0.5	0
Total	**8.2**	**5.0**	**9.4**	**14.8**	**11.4**	**17.8**	**35.1**	**16.4**	**1.2**

Source: Euromoney and World Bank.

[a]Up to November 1998.

consideration Japan's bilateral relations with developing countries (particularly those of the Pacific Rim), Japan's relations with the United States, and U.S. relations with and U.S. interests in those developing countries, all of which influence each other.[60]

The main objective of this book is to analyze collective financial crisis management; it does not pretend to provide a fully developed or original analysis of the U.S.-Japan bilateral relationship. Nevertheless, it is worthwhile to highlight important aspects of U.S.-Japan dynamics that are essential to the analysis of the respective leadership roles of these two major powers in the world economy.[61] Both the changing relative power between the United States and Japan and their interdependence in the last two decades have affected the behavior of these respective superpowers, and these changes should have affected the shape of financial crisis management.

The Early Stage of U.S.-Japanese Relations: From 1945 to the 1970s

Japan and the United States started out from very different economic conditions in the aftermath of World War II. The United States, on one hand, was the victorious hegemon that dominated the world in all respects and that became, along with the Soviet Union, the major force shaping the postwar world, a period when many developing countries gradually became independent. Japan, on the other hand, was destroyed in the war physically, economically, and psychologically. It was also subjected to occupation by the United States for several years, and it experienced many institutional changes until formally regaining sovereignty in 1952. During the period of Japan's economic reconstruction and recovery, Japan lived under a long "free-riding" phase when economic self-interest allegedly drove Japan's external relations, with very little regard to its contribution to common international concerns, such as Third World development. From the 1950s through the 1970s, the country concentrated on its economic development particularly through upgrading its industry and expanding its overseas markets.[62]

Throughout this period, Japan enjoyed U.S. protection in the area of security as well as in external economic activities, such as access to foreign markets and long-term capital. The United States was quite generous to Japan's aggressive economic expansion. Cold war security concerns and Japan's important role in rebuilding the regional economy of Asia Pacific were perceived as important political priorities for the United States.[63] Japan, at that point, did not present a substantial economic threat. Japan ran a chronic trade deficit with the United States until 1965, and the U.S. administration at that time tried its best to increase Japanese exports to the United States. Nevertheless, there was some uneasiness regarding Japan's "free-rider problem" and its lack of burden sharing. The closed nature of Japan's market against imports (apart from raw materials and some primary goods) through restrictions and quotas, as well as Japan's limited financial contribution to developing countries via foreign aid and other preferential access channels, made it apparent that Japan was pursuing narrow, economic self-interests.

Somewhere between the late 1970s and the early 1980s, Japan shifted from acting as a complete free rider to being an active participant in the maintenance and structuring of international economic stability, along with the United States.[64] Beginning in the late 1960s, the Japanese economy experienced a strong boom due to favorable international economic conditions and to its successful industrial transformation. Japan's balance of payments turned to a surplus during this period, and with only a few temporary reversals at times of oil crises, this surplus has been maintained ever since. The trade balance with the United States registered a surplus for Japan in 1966, for the first time since its independence, and has never reversed since. In fact, this trend began to create political tensions between the two countries. Moreover, Japanese capital and technology became a source of admiration and envy for many developing countries.

In contrast, the decline of U.S. hegemony became the topic of debate during this period. According to Kindleberger,

> after about 1971, the United States has shrunk in economic might relative to the world as a whole, and more importantly, it has lost the appetite for providing international economic public goods—open markets in times of glut, supplies in times of acute shortage, steady flows of capital to developing countries, international money, coordination of macroeconomic policy and last-resort lending.[65]

Some scholars argue that the degree of American decline in the world varies from one issue area to another and that we cannot, on the basis of one case or sector, conclude that the American economy is in decline.[66] A great deal of macroeconomic data, however, indicate that during the 1980s, Japan caught up with the United States in terms of its economic capacity (though not necessarily in terms of its will) to be one of the leading powers in the world economy.[67]

Increased Competition and Integration between the United States and Japan: The 1980s

Assisted by the strong yen after the 1985 Plaza Accord, Japan's economic presence in the world seems to have expanded dramatically.[68] Japanese government publications from this period clearly demonstrate that by the second half of the 1980s, the Japanese government was well aware of the importance of Japan's role as a "contributing member of the international community."[69]

A few basic data, such as growth in gross domestic product (GDP) (see fig. 2.6), real gross fixed capital formation (see fig. 2.7), and world export shares (see fig. 2.8) indicate relative U.S. stagnation in the second half of the 1980s and dramatic growth of the Japanese economy during the same period. The figures in both GDP growth and fixed capital formation indicate that with an exception of 1983 and 1984—when the U.S. economy was boosted by the stimulus policies of the Reagan administration—Japan consistently outperformed the United States in the 1980s, until 1991. This picture changes dramatically after 1991, as I discuss in the next section.

The gradual closing of the gap between the United States and Japan in terms of world export shares in the 1980s (see fig. 2.8) indicates the dramatic increase in Japan's economic weight in the world. In 1973, Japan's export share in the world was less than half that of the United States, with more than a 7 percent difference between the two. However, by 1986, the gap narrowed to a mere 1.3 percent. This narrowing of the gap is even more impressive if one accounts for the fact that the size of the U.S. economy was about twice that of Japan's at the time.

More importantly, as Japan's trade power began to overwhelm the world trade system in the 1980s, the very lopsided trade balance in Japan's favor became the hot topic of discussion in the United States and elsewhere. Actually, throughout the fairly long history of the U.S.-Japanese trade imbalance, the United States has consistently complained about Japan's "unfair" trade practices. The dominant U.S. strategy for dealing with the Japanese threat in the earlier phase (1950s–1970s and somewhat in the 1980s) included measures to restrict imports into the U.S. market, such as voluntary export restraints (VERs) and orderly marketing agreements (OMAs) that covered products ranging from cotton textiles, steel, and color TVs to, in a well-known case, automobiles. During the 1980s, new pressures characterized the second phase of the U.S.-Japan trade conflict, with the United States pressuring Japan to open its closed market and for its selective concessions. Various market access measures were negotiated under the Market-Oriented Sector Selective (MOSS) talks, which targeted various products (e.g., electronic communication products, pharmaceuticals, medical equipment, electronics, and lumber), and the SII talks, which aimed to change the structure of Japan's market to increase its imports. Finally, from the late 1980s into the first half of the 1990s, empowered by the 301 provision of the 1988 Omnibus Trade and Competitiveness Act, the U.S. government began to put more retaliatory pressure on Japan than ever before, setting

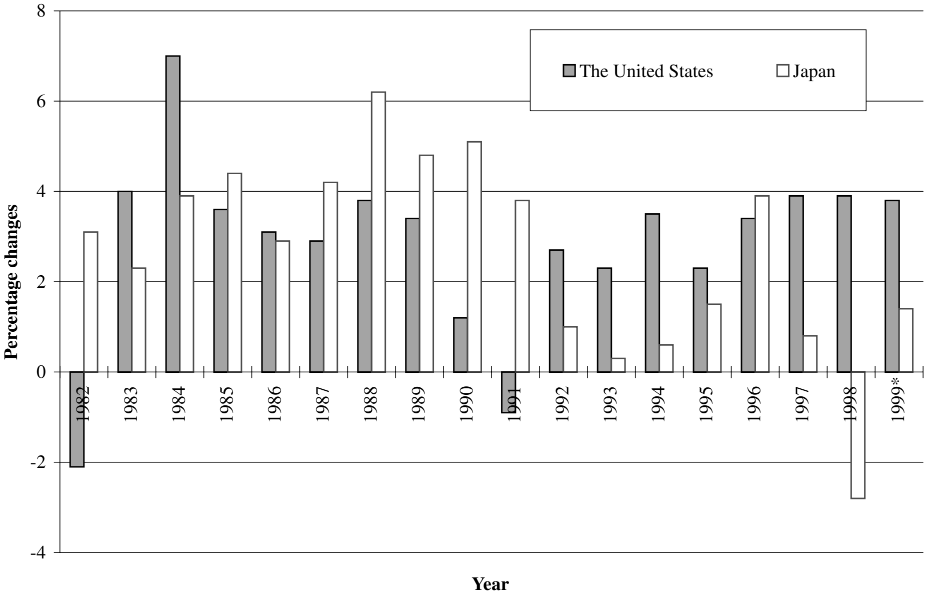

Fig. 2.6. GDP growth of the United States and Japan, 1982–99. (From OECD, *Economic Outlook*. *An estimate figure for 1999.)

"result-oriented" negotiations with quantifiable targets. The best example of this was the semiconductor negotiation of the late 1980s and the 1990s.[70]

The overall U.S. trade balance demonstrates the magnitude of the "Japan problem," which began to worsen in the early 1980s. The absolute level of the U.S. trade imbalance with Japan jumped from $21 billion in 1983 to almost $50 billion in 1986, and it has stayed that high ever since. The trade deficit with Japan has accounted for 30 to 40 percent of the overall U.S. trade deficit during this period. The deficit position of the U.S. trade balance has not improved in the 1990s. As the U.S. trade balance with the world improved due to the U.S. recession in 1992, the Japanese trade surplus captured 69 percent of the U.S. overall trade deficit (see fig. 2.9). Such data create an image of Japan as a free rider taking advantage of the American open market and of its security umbrella. In addition, the very limited intra-industrial trade between the two countries creates a bilateral trade panorama in which Japan exports high value-added and job-creating manufacturing products to the United States—a trend against which U.S. manufacturers have to compete—while the United States merely exports agricultural goods and raw materials to Japan.[71] These factors and the American perception of Japan's unfairness have angered the

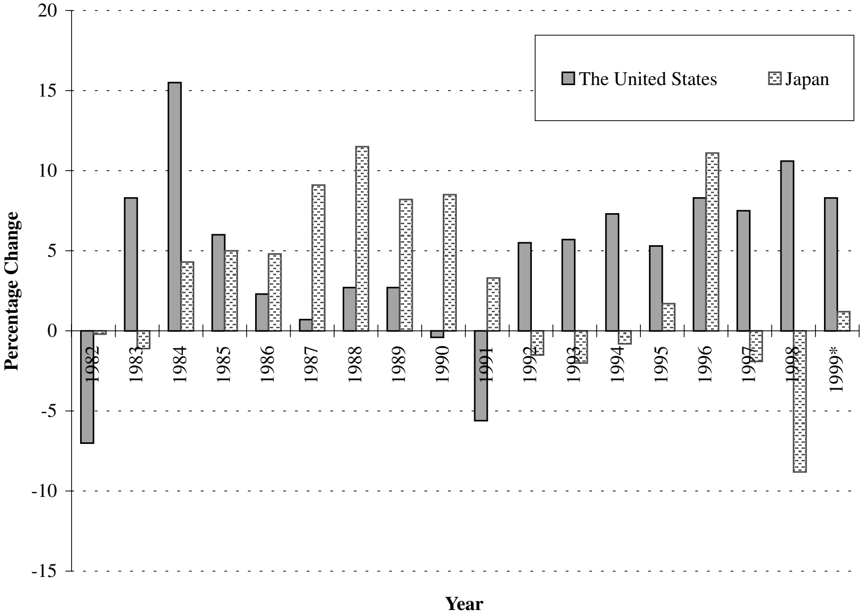

Fig. 2.7. Real gross fixed capital formation, 1982–99. (From OECD, *Economic Outlook.* *An estimate figure for 1999.)

American public and have led to increased protectionist sentiments and to discussions on strategic trade policies in the United States.[72]

Presentation of trade relations between the United States and Japan as dominated by competition and unfairness masked the increasing interdependence that characterized their trade and general economic relationships in the 1980s.[73] The weight of Japan's trade within total U.S. trade increased in the 1980s, peaking in 1986 when the Japanese trade share captured 19 percent (see fig. 2.10). The picture is the same and more impressive for Japan's trade relationship with the world. The share of trade with the United States soared to 29 percent of Japan's total trade with the world in 1984 and stayed at this level until 1989, after which it declined slightly. Around the mid-1980s, between 35 to 40 percent of Japanese exports ended up in the United States, thus accumulating the Japanese trade surplus vis-à-vis the United States.

Trade is not the only economic interaction that defines U.S.-Japanese relations. Japan's capital and financial power under the post-1985 strong yen was another critical factor in its relationship with the United States. Japanese banks occupied six of the top ten ranking positions of the world's largest (but not most profitable) banks in 1990 (see table 2.5).[74] Japan also acquired huge net

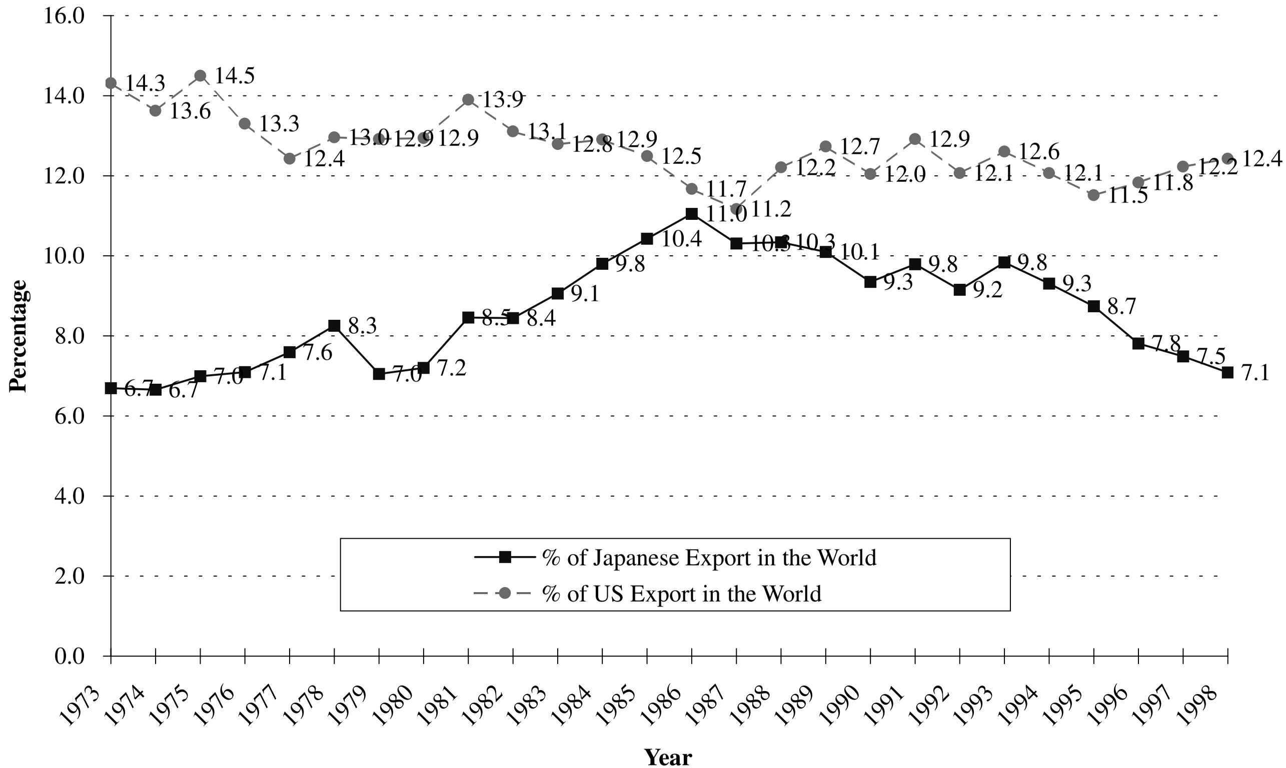

Fig. 2.8. Share in world exports: The United States and Japan, 1973–98. (From IMF, *Direction of Trade Statistics Yearbook.*)

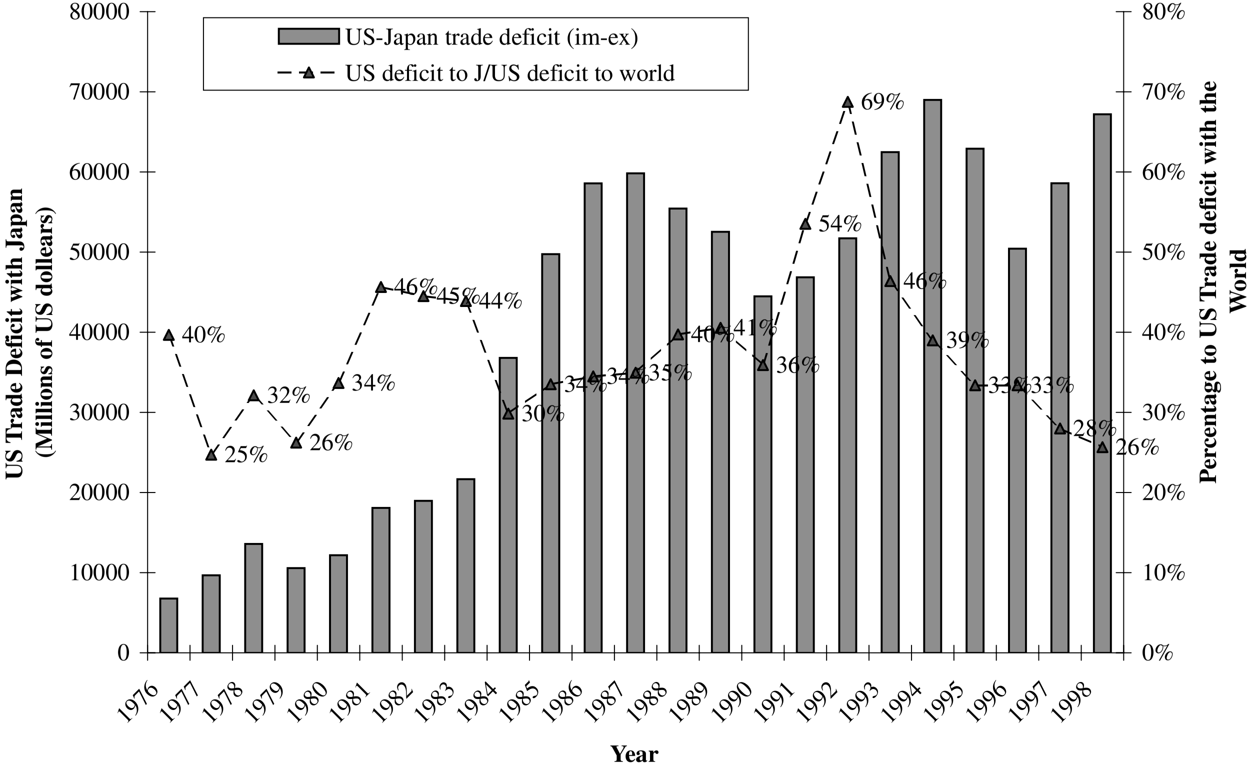

Fig. 2.9. US trade deficit with Japan and with the world, 1976–98. (From IMF, *Direction of Trade Statistics Yearbook.)*

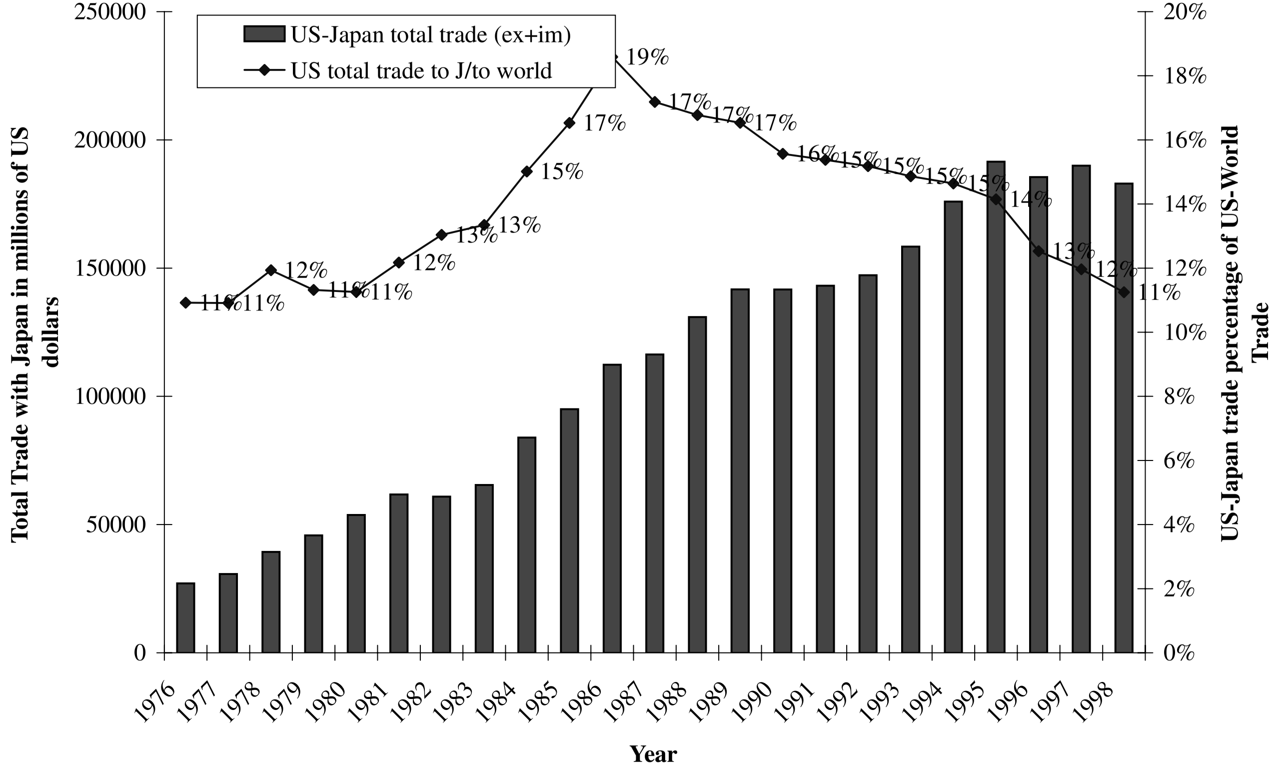

Fig. 2.10. US total trade with Japan and with the world, 1976–98. (From IMF, *Direction of Trade Statistics Yearbook.*)

TABLE 2.5. World's Top Ten Banks in Terms of Their Capital (measurement of strength)

	1984[a]	1986[a]	1988	1990	1992	1994	1996
1	Citicorp	Citicorp	National Westminster	**Sumitomo Bank**	**Sumitomo Bank**	**Sanwa Bank**	HSBC Holdings
2	Bank of America	National Westminster	Barclays Bank	**Dai-Ichi Kangyo Bank**	**Dai-Ichi Kangyo Bank**	**Dai-Ichi Kangyo Bank**	**Bank of Tokyo-Mitsubishi**
3	Chase Manhattan	Credit Agricole	Citicorp	**Fuji Bank**	**Sanwa Bank**	**Fuji Bank**	Credit Agricole
4	Banco do Brasil	**Fuji Bank**	**Fuji Bank**	**Sanwa Bank**	**Fuji Bank**	**Sumitomo Bank**	Chase Manhattan
5	Credit Agricole	**Mitsubishi Bank**	Credit Agricole	Union Bank of Switzerland	**Mitsubishi Bank**	**Sakura Bank**	Citicorp
6	J. P. Morgan	**Sumitomo Bank**	**Sumitomo Bank**	Credit Agricole	**Sakura Bank**	**Mitsubishi Bank**	Deutsche Bank
7	Manufacturers Hanover	**Dai-Ichi Kangyo Bank**	**Dai-Ichi Kangyo Bank**	**Mitsui Taiyo Kobe Bank**	Credit Agricole	HSBC Holdings	Bank of America Corp
8	**Fuji Bank**	Barclays Bank	**Mitsubishi Bank**	Barclays Bank	Union Bank of Switzerland	Credit Agricole	ABN AMRO Bank
9	**Mitsubishi Bank**	Banco do Brasil	**Industrial Bank of Japan**	**Mitsubishi Bank**	**Industrial Bank of Japan**	Citicorp	**Sumitomo Bank**
10	National Westminster	Union Bank of Switzerland	**Sanwa Bank**	National Westminster	HSBC Holdings	Union Bank of Switzerland	Union Bank of Switzerland

Source: The Banker, July issues.
Note: Starting with its 1999 issues (1998 numbers), *The Banker* stopped publishing the size of capital as the measurement of strength.
[a]Strength measured in terms of capital and reserve.

assets abroad, particularly in the United States (see fig. 2.11). In some cases, Japan's rapidly emerging financial power was considered a "hegemonistic threat."[75] Nakao writes,

> there was a danger of the Federal Reserve Board's losing its ability to influence events in a financial crisis and a risk of the U.S. national security as high-technology firms become increasingly reliant on foreign banks for loans.[76]

Indeed, Japan's financial power in the 1980s provides a key to understanding how the United States managed to accrue such a large trade deficit and still maintain an internationally acceptable balance of payments. The United States has managed to live under huge trade and federal budget deficits through substantial reliance on the inflow of capital. After suffering from high inflation and a stagnant domestic economy in the late 1970s, the Reagan administration resorted to an economic policy that has been labeled "Reaganomics." This policy consisted of tight monetary policy (high interest rates after 1979) and a lax fiscal policy (tax cuts and increased government expenditure, particularly on defense, since 1981). As a result, inflation stabilized (though the stabilization of inflation began during the last years of the Carter administration, when Paul Volcker was named as the Federal Reserve chairman), and the U.S. economy seemed to have slowly come back on track by the mid-1980s. However, this economic policy led to various unwanted, but expected, outcomes—namely, large current account and budget deficits.

The recovery of the U.S. economy and its expansion exacerbated the trade imbalance between Japan and the United States in Japan's favor, as I noted earlier; simultaneously, Japanese investors, under deregulation at home, were attracted by high U.S. interest rates. Japanese investors supported the expansion of the U.S. economy, in both the private and the public spheres. Possibly prematurely, Yamamura characterizes what happened in the United States throughout the 1980s as "the hegemon's last hurrah." He adds,

> by pursuing a tight monetary policy and financing absorption by debt instead of inflation, a necessary result was a rapid increase in borrowing from foreigners, especially from the Japanese, who found the high interest rates in the United States attractive.[77]

The rush of long-term capital outflows between 1986 and 1989 illustrates Japan's overseas investment boom. More than $130 billion in capital flowed out of Japan each year during these four years, and nearly half of this outflow was invested in the United States (see table 2.6). In addition to the FDI that set

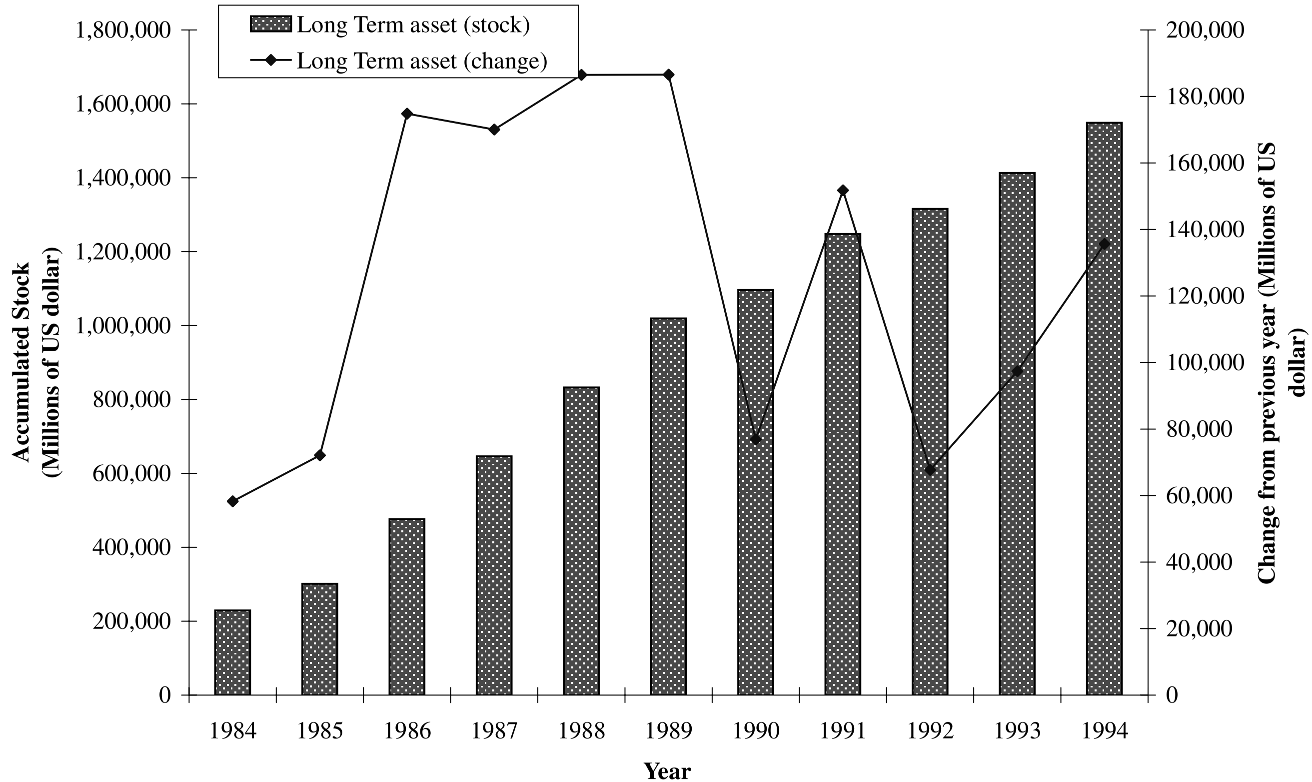

Fig. 2.11. Japan's long-term external asset: Stock and change, 1984–94. (From Bank of Japan, *Balance of Payments Monthly,* April 1995.)

TABLE 2.6. Composition and Geographical Distribution of Japan's Long-Term Net Capital Outflows, 1985–1991

	1985	1986	1987	1988	1989	1990	1991
World Total							
Direct investment	5,810	14,254	18,354	34,695	45,184	46,271	29,358
Security investment	43,032	101,432	93,838	66,651	28,034	5,028	−40,978
Trade credits	2,788	1,876	536	6,957	4,011	−671	−3,926
Loans	10,502	9,315	16,309	15,293	4,682	−16,930	−25,027
Other	2,410	4,584	7,495	7,334	7,335	9,888	3,516
Total	64,542	131,461	136,532	130,930	89,246	43,586	−37,057
United States							
Direct investment	2,043	7,774	9,018	19,568	22,768	24,986	15,302
Security investment	29,874	55,944	48,223	33,320	22,074	−19,849	−1,045
Trade credits	587	334	489	1,024	1,255	633	−314
Loans	716	690	1,663	2,830	4,761	2,783	2,569
Other	−57	908	1,637	2,518	3,003	3,166	1,846
Total	33,163	65,650	61,030	59,260	53,861	11,719	18,358
Twelve European Community countries							
Direct investment	1,480	2,694	3,476	5,693	9,419	9,921	7,344
Security investment	6,639	29,013	26,434	21,229	−24,562	9,409	−45,273
Trade credits	482	1,087	1,066	4,507	1,625	494	−843
Loans	835	1,038	2,091	1,768	−1,431	582	−1,876
Other	192	554	1,260	917	1,713	1,812	1,441
Total	9,628	34,386	34,327	34,114	−13,236	22,218	−39,207
Non-OECD/noncommunist countries							
Direct investment	1,913	3,055	3,972	5,842	7,802	6,864	4,627
Security investment	3,576	6,489	8,855	4,909	10,992	247	−10,436
Trade credits	1,447	1,111	−668	−741	−1,363	−2,246	−2,475
Loans	4,825	5,151	7,304	8,125	−3,406	−24,738	−26,389
Other	624	425	544	752	1,573	2,894	1,392
Total	12,385	16,231	20,007	18,887	15,598	−16,979	−33,281

Source: Kawai 1994, 96–98, table 5.8. Originally from Bank of Japan, *Balance of Payments Monthly,* April issues.

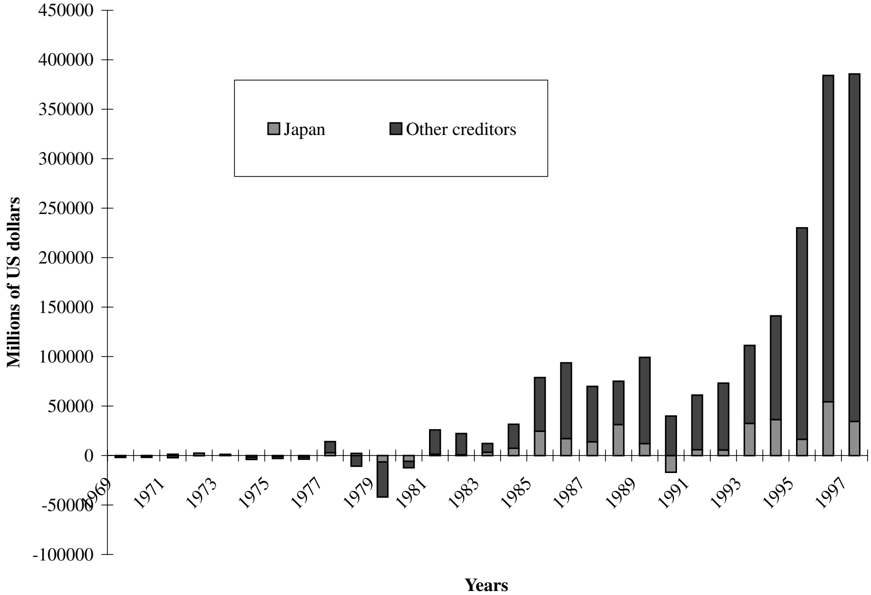

Fig. 2.12. US long-term net liabilities to Japan and other foreign countries, 1969–97. (From U.S. Treasury, *Treasury Bulletin.*)

up Japanese manufacturing firms and financial institutions in the United States, Japanese money, through purchases of U.S. long-term bonds and securities, financed not only American private firms but also U.S. government activities. From 1985 to 1987, large Japanese securities firms were among the principal investors in U.S. Treasury bonds, and they are said to have financed as much as 30 percent of the American government's budget deficit. The increasing trend in this area suffered a drastic decline in 1990 (see fig. 2.12).

The U.S. and Japanese economies became much more closely linked during this period, establishing the basis for the solid economic linkages discussed in chapter 1. Politically speaking, the two countries were living under a conflictive trade relationship, on one hand, and a symbiotic financial relationship, on the other. The United States became a net debtor in 1985 and the world's largest debtor in 1987. Japan became the major financier of U.S. debt throughout the 1980s. The Japanese private financial sector and other Japanese firms became heavily invested in the United States, as the strong yen and Japan's low interest rates made the purchase of U.S. stocks and bonds relatively profitable, and as exporting to the United States seemed more difficult due to exchange rates and strong protectionism in the United States. Economic interdependence, as well as economic linkages associated with these activities, led the

Japanese government to behave in support of the U.S. economy during this period. When Black Monday hit the U.S. stock market in 1987, for example, the Japanese government (the MOF) loosened (instead of tightened) regulations on Japanese investment in the United States in the aftermath of the market crash, so that the Japanese financial institutions could still invest in the country.[78]

As I noted earlier in this chapter, the bilateral dynamics of the foreign exchange rate between the United States and Japan have critically influenced both trade and capital flow issues. The Japanese government and its private sector have always preferred stability in Japan's exchange rate against the U.S. dollar, a preference tied to Japan's high dependence on the U.S. market and to the increasing importance of Japan's investment in the United States. In addition, many countries in Asia to which Japan exports have their currencies pegged to the U.S. dollar (or to the U.S. dollar-dominated currency basket). Such stability became harder to attain as the Bretton Woods fixed exchange rate system ended in the early 1970s. The exchange volatility further worsened in the 1980s (see fig. 2.13). A strong U.S. dollar and an accumulation of trade deficits in the United States in the early 1980s led to the 1984 Yen-Dollar Agreement, which liberalized Japanese capital markets for foreign capital inflow and internationalized the yen to correct the "artificially weak" yen. Although the exchange rate correction had to wait until the 1985 Plaza Accord, the agreement produced a fundamental transformation in Japan's external macroeconomic relations by increasing international capital mobility for Japan.[79] Despite various multilateral coordinating efforts through G-7 meetings and through bilateral negotiations and unilateral interventions, the yen strengthened (1978–81, 1985–89, and 1991–96) and weakened (1982–85, 1990, and 1997–98), influencing Japan's external economic activities.[80]

Finally, in the field of international development, in addition to its status as top ODA donor in the 1990s, Japan's influence has gradually augmented thanks to its own experience of economic success and its outstanding role in financing the economic development of many countries (as discussed earlier in this chapter). The Japanese government began to voice its reservations about prevailing development prescriptions through the forum of the IFIs, where the U.S. perspective traditionally dominated (i.e., the United States is considered a structural power here). The most prominent example of Japan's increasing initiative in that area is the World Bank's publication of *The East Asian Miracle* in 1993. This document gives more credence than usual to the idea that public policy and government intervention in the economy could play positive roles in economic development. In the publication, the World Bank and the United States, which wielded the greatest voting power in the institution, uncharacteristically compromise their "market-friendly approach."[81]

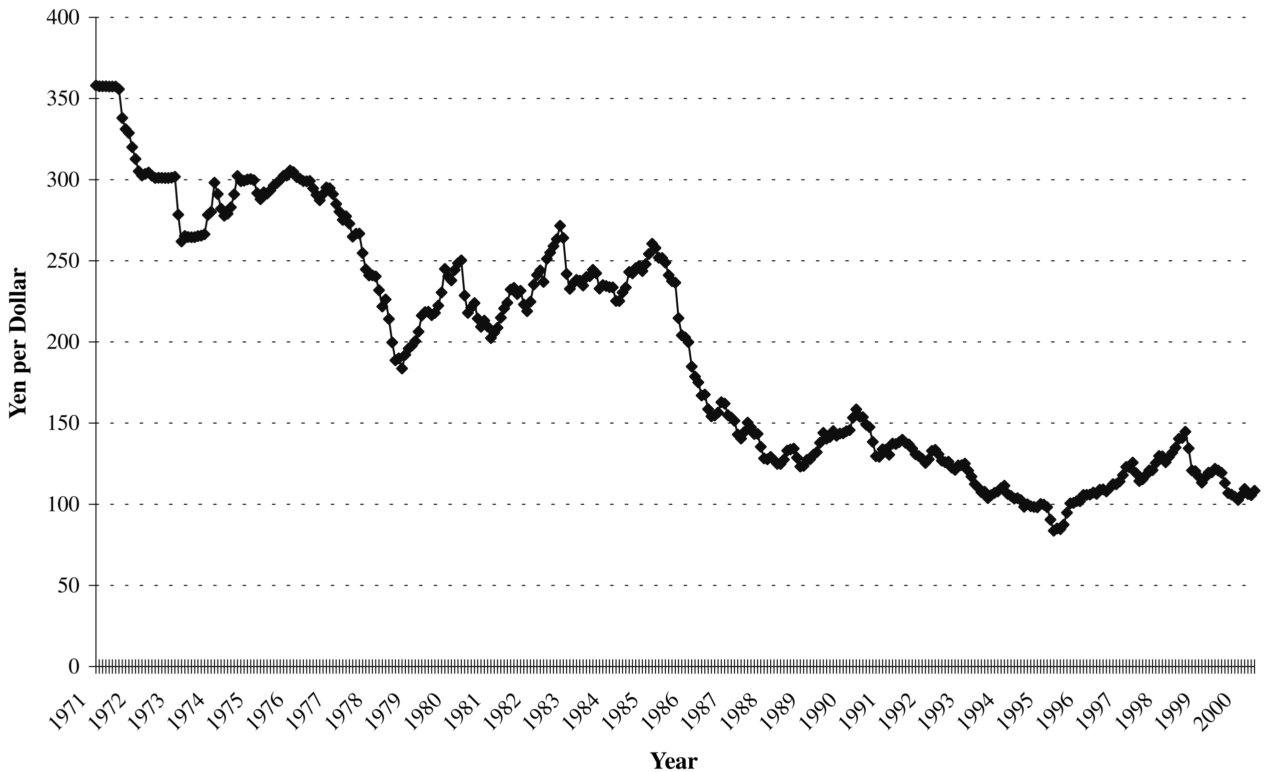

Fig. 2.13. Yen-dollar exchange rate fluctuation, 1971–2000. (From IMF, *International Financial Statistics.*)

Under the dramatic surge of Japan's economic power in the 1980s, some scholars saw something more than just an intensifying bilateral rivalry between the United States and Japan: they perceived a structural and hegemonic shift. Japan began to take on the function of a provider of international public goods as its relative economic size increased, with even the United States becoming dependent on Japanese financial resources. Rosecrance and Taw wrote in 1990:

> There are good reasons for Japan's present behavior: the leading economic power cannot escape the dangers of a possible collapse in the world trading and financial system. Today Japan sits atop the world financial pyramid; it must fall the farthest if the pyramid topples.[82]

Furthermore, Helleiner argued that given the way the Japanese government and business sector operate together to weather the adverse international economic environment and to guide, to some extent, the country's overseas business activities, Japan appears to be developing into an international (and structural) power.[83] This has led to a temporary surge in arguments that these developments are part of a power transition. The theory asserts that "international conflict is most likely to occur when the rate of development of the previous leading country is slowing down and when the rate of development of the previous lagging country is accelerating."[84] As the overriding power of cold war tension waned in the late 1980s, the Japanese "threat" was highlighted.[85]

As the 1990s clearly demonstrates, however, Japan never displaced the United States, while during the 1980s, economic interdependence between the United States and Japan strengthened. The Japanese government and its private sector became increasingly vulnerable to U.S. criticism and political pressure. Furthermore, under the structural power of the United States, discussion on Japan as a "reactive state" and on the country's responsiveness to *gaiatsu* (foreign pressure) gained wide recognition in the United States.[86] As Japan's recession in the 1990s lingered, it stemmed Japan's further rise in power. As the U.S. economy rebounded in the mid-1990s, the threat of Japan's overwhelming economic power waned. But concomitantly, given the widespread impact of Japan's economic problems in Asia and in the world, U.S. critics of Japan began to shift their focus from Japan's aggressive economic expansion to its apparent incapacity to put its own economic house in order.

Japan's Recession and U.S. Prosperity: The 1990s

International concern over the "rise of Japan" has waned slowly but definitely in the 1990s. From 1990 to 1991, Japan's "bubble economy" burst, revealing many negative effects; the economic performance of the United States, meanwhile, began to surpass that of Japan (see figs. 2.6, 2.7, and 2.8). Asher notes, "By 1992, it had become apparent to most observers that Japan faced a potentially comprehensive financial crisis, where problems in one area could migrate across the whole system."[87] Assessors of Japan's economic downturn in the 1990s may be divided into two groups, optimists and pessimists. The former group argues that slowdown of the Japanese economy is only a temporary phenomenon and that Japanese real economic power has not yet waned.[88] The latter group claims that the Japanese economic miracle is over and that the country requires a fundamental economic overhaul to get back on its feet.[89] The pessimistic view of the Japanese economic recovery gained more support both with the rise of criticism of the Japanese government's "too little, too late" approach in stimulating economic recovery during the past several years and with the ill-timed sales tax hike in 1997.[90]

Japan's economic problems are not limited to domestic problems. After the bursting of its economic bubble in 1990, Japan's external financial position also shifted. Although Japan has retained its large creditor status in the world (similar to the case of the late 1980s), the Japanese financial sector has become slowly incapacitated. The collapse of land and stock prices in Japan negatively affected the business performance of Japanese financial institutions and also caused them to accumulate bad loans. In addition, changes in the rules of international finance also impacted Japanese financial activities overseas. The most important change was the 1987 decision adopted by central bankers from the Group of Ten (G-10) countries who met at the Bank for International Settlements (BIS) to establish for all banks operating internationally a minimum ratio (8 percent) of self-capital to bank assets. The central bankers proposed to enforce this standard worldwide by the end of 1992. The fundamental purpose of introducing such a standard was to protect financial sectors from overexposing themselves to foreign lending. Often called the BIS capital adequacy (or bank capital adequacy) standard, the international rule has limited Japanese banks' overseas activities. The rule was particularly constraining to Japanese banks in regard to their future overseas lending activities, because the level of their capital to their assets was relatively low. Prior to the adaptation of the rule, such a low level of capital had given Japanese banks added risk and more competitiveness. In the 1990s, the introduction of the standard and the collapse of Japanese stock prices, which further lowered the Japanese banks' self-capital, hampered their overseas lending activities.[91]

Japanese investment in the U.S. securities market declined suddenly in 1990, and the net flow in this investment category became negative ($19.8 billion outflow from the United States, as illustrated in table 2.6). The reversal was partly the result of a temporary shift in Japan's monetary policy from a relatively

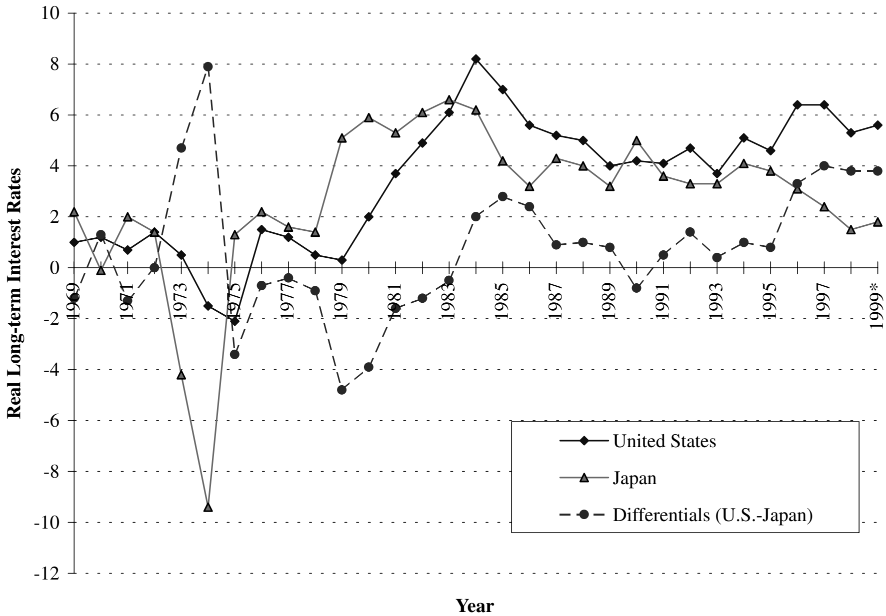

Fig. 2.14. Real long-term interest rates of the United States and Japan, 1969–99. (From OECD, *Historical Statistics.* *Long-term interest rates for 1999 are measured by the rate of central government bonds.)

loose policy to a tight one, a change that pushed Japanese long-term real interest rates to higher levels than those of the United States in 1990 (see fig. 2.14). The temporary weakening of the yen also threatened the profitability of Japanese investments in the United States (see fig. 2.13). In addition, an abrupt decline in the Japanese stock market decreased the capitalization of the Japanese banks and led some other financial institutions to withdraw investments from the United States to compensate for the domestic losses. Furthermore, there was a trend of regional concentration of Japan's lending and investment in Asia in the early 1990s, while the profitability of investment in the United States declined due to the U.S. recession and concomitant low interest rates until 1994.[92] Nevertheless, the financial ties between the United States and Japan remained solid (see fig. 2.12).[93]

During this time and despite Japan's financial problems, Asia kept attracting Japanese investment in the 1990s. After a moderate decline in capital outflow from Japan in the early 1990s, Japanese portfolio flows regained their strength, pushed by unprecedentedly low domestic interest rates at home and good investment and lending opportunities abroad. This outflow accounted for $84 billion by 1994, slightly down from its highest level of $113 billion in

1989. Not until the onset of the Asian financial crisis in 1997 did Japanese financial institutions curtail their financial exposure to the Asian economies.

Despite suffering a decade of recession, Japan is still the second largest economy and maintains its status as a major creditor in the world. However, it is clear, from its prolonged recession and from criticisms of the government's incapacity to move quickly to solve its economic problems, that the miraculous Japanese power that threatened to overtake the U.S. hegemonic position in the economic realm in the 1980s has waned. Japan thus remains the nonhegemonic major economic power. Going through a humbling experience of sifting through the country's major economic problems, Japanese policymakers and Japan's financial actors have struggled for answers to Japan's economic recovery problems. Japan's resentment against the United States increased in the 1990s in reaction to the intensification of U.S. criticism of Japan's economic mismanagement, which centers on Japan's economic turmoil and on the lack of effective solutions to such turmoil. This criticism, however, is derived from the fact that in the context of the firmly established economic interdependence between the two countries, Japan's lack of action would negatively affect not only the U.S. and Asian economies but also the stability of the world economy.

Summary

Japan's evolving relationships with the developing countries of the Pacific Rim and with the United States constitute important dimensions of Japan's external economic relations since World War II. We witnessed a dramatic increase of Japan's presence in both these regions in the 1980s. Although they are presented separately in this chapter, it is important to connect the two pictures to see how Japan's relationship with the United States has influenced Japan's involvement in developing countries, particularly at the time of their economic crises. It is also important, to a lesser extent, to note how Japan's relationship with developing countries altered U.S.-Japanese dynamics.

In the 1980s, the shift in U.S. position from the world's creditor to the world's debtor increased the pressure on Japanese creditors; subsequently, the Japanese government became more involved in the Third World debt crises occurring at that time. This led to an interconnection between the North-North debt crisis (although it was never the same type of payment crisis) and the North-South debt crisis.[94]

Considering Japan's involvement in the solution to the Latin American debt crisis, it is clear that the North-North relationship dictated a large part of Japan's participation. Although the decline of Japan's financial position in the world in the mid-1990s slowed, and occasionally reversed, Japan's overseas economic expansion, it has not quite altered the level of U.S.-Japanese economic interdependence or the economic stake of the Japanese financial sector in the stability of the international financial market. In this sense, examining a bilateral framework between Japan and the middle-income countries of the Pacific Rim under financial crises is not enough to understand the determining factors of Japanese foreign economic policy toward these countries and its motivation as a provider of international public goods. The strong interdependence between the United States and Japan in the late 1980s had special implications for the Latin American debt solution, and it continues to wield an influence in the 1990s. Collaboration or collusion among creditors—in this case between Japan and the United States—becomes a key factor in explaining financial crisis management dynamics. This collective action among creditors has given them greater leverage over debtors.[95]

Finally, the analysis in the following chapters emphasizes the active involvement of private economic actors in this triangular dynamic. The economic interdependence that has increased in recent years is not only of concern to governments but obviously of critical importance to private sectors. As the Japanese economy has become internationalized, the economic and political interests of Japan's private sector have become increasingly tied to its activities abroad. In particular, and as I discuss in the following chapters, the intensifying exposure of Japan's private financial sector to economic and political risks abroad has even changed the country's domestic political dynamics.

This evolution of Japan's economic relations with developing countries and with the United States sets the stage for the variation in the Japanese government's response to different financial crises in the past two decades. On one hand, shifting economic power dynamics and interdependence between the United States and Japan under continuing structural power asymmetry favoring the United States has led the Japanese government to respond differently to collective action with the United States. On the other hand, the varied regional context and the respective economic involvement of the Japanese private sector have become critical components affecting the decision-making process of the Japanese government.