

The Financial Crisis and America's Capital Dependence on Japan and China

DANIEL I. OKIMOTO

Synopsis: In the Post-Bretton Woods financial system (1972 – 2009), the United States has been able to borrow heavily from savings-rich countries, like Japan and China. Its access to international capital has allowed the US to cover years of extravagant spending and to enjoy unmatched levels of power and plenty. For lenders, like Japan and China, access to the huge US export market has stimulated aggregate demand, which, in turn, has facilitated economic growth, high rates of employment, infrastructure expansion, and technological development.

Notwithstanding the mutual benefits, the massive scale of Post-Bretton Woods imbalances has placed the financial system under stress. Such macro-economic imbalances usually require a major rebalancing—either immediately through a financial crash or gradually through a “soft” landing.

The financial implosion in 2008 constituted a crash landing. To arrest the steep slide into a possible world depression, most of the leading economies, including especially the United States, have taken bold monetary and fiscal measures. However, these expansionary measures will deepen deficits and generate strong inflationary headwinds while placing pressures on currency exchange rates.

Following the 2008 financial earthquake and its wave of after-shocks, America's access to foreign capital is apt to become more restricted and increasingly expensive. This will erode one of the central structural sources of US power—its extraordinary fiscal flexibility, monetary autonomy, and global economic clout. With a weakened financial superpower, the world may become less prosperous, less stable, less predictable, and considerably more dangerous.

US–Japan relations and the international system

For longer than a half a century, the state of relations between the United States and Japan has been a mirror of major shifts in the international system. From 1945–1952, the bilateral relationship was one of victor and vanquished. The US, victor in the Pacific War, imposed its blueprint of national reform on the vanquished. Out of the US Occupation emerged a transformed Japan—one destined to become a vibrant capitalist democracy and a steadfast

member of the non-communist camp. The US–Japan Security Treaty, ratified in 1952, became the institutional framework for Japan’s integration into the postwar international system.

With expanding ties of trade interdependence, mounting industrial competition, and Japan’s emergence as the world’s second largest economy, the economic dimensions of the bilateral relationship took center stage in the mid-to-late 1980s. Indeed, Japan came to be viewed in some circles as America’s chief rival—the prime threat to US economic interests.

From 1991–2003, however, Japan went through the travails of steep asset deflation and economic stagnation for well over a decade (Japan’s so-called “Lost Decade”). All talk of Japan becoming the next global superpower dissipated. China moved up to supplant Japan as the most imposing economic threat to the United States.

Over the past 30 years, the US has rung up progressively larger trade and current account deficits with China, Japan, and the Persian Gulf states. In 2005, America’s trade deficit hit \$726 billion, or roughly 6% of GDP; of this sum, China accounted for \$201.6 billion, or 28%; Japan, \$82.7 billion, or 11%. Taken together, China and Japan accounted for nearly 40% of America’s total trade deficit. These deficits reflected the unmistakable reality that the US had fallen into the bad habit of spending more—far more—than it saved. To cover its mounting deficits, the US fell into another addictive habit: borrowing heavily from two of its big trade partners, China and Japan.

The evolving state of bilateral relations thus reveals that America’s once overwhelming power has been diminished, as the US has tumbled from its perch as the world’s largest creditor nation—straight to the bottom as the biggest debtor state—the biggest in world history.

Mercantilist finance

During the nineteenth and twentieth centuries, Great Britain developed a system of “mercantilist trade,” whereby the British extracted raw materials from their colonies, converted them into manufactured goods, and sold the finished products back to their colonies at a profit.

Since the end of the Bretton Woods system (1973), the United States has established a less overt but an even more pervasive and more effective system of global exchange, which might be called “mercantilist finance.” Mercantilist finance is a system that has allowed the US to leverage the broad base of its currency—the dollar, the dominant instrument for international transactions—so as to borrow massive sums of money to underwrite its soaring levels of debt. Being able to borrow from the world has given the United States an enviable degree of fiscal flexibility while at the same time providing an extraordinary measure of autonomy in the monetary policies that the US chooses to implement. The dollar’s role as the world’s dominant currency, in short, has placed the US in the unique position of being able to access international capital while enjoying a rare degree of monetary independence at home.

America’s access to global capital has been one of the most indispensable sources of its staying power as the world’s mightiest state. Owing to the willingness of Japan, China, and other states to buy and hold US Treasuries, the US has had the extraordinary luxury of being able to spend without wringing its hands over the costs of borrowing. The US government has been able to develop hugely expensive military weapons systems, prosecute costly wars in Iraq and Afghanistan, and provide essential domestic services to its citizens, including health care and education.

Foreign creditors have been willing to lend to the US because they depend on export access to America’s vast domestic market. It also helps that US Treasuries are considered safe investment havens, particularly in times of uncertainty and market volatility (as has been the case

since September 2008). If, for whatever reasons, foreign investors decide to stop underwriting America's debt, the US would be forced to cut consumption drastically, or America would have to pay steeper interest rates. Clearly, the global system of mercantilist finance has served to sustain US power even in the face of America's lopsided imbalances.

Post-Bretton Woods: international capital recycling

International capital flows: from Asia to the United States

America's dependence on Japanese and Chinese capital is part of a historically unique system of global capital flows, featuring the recycling of capital from non-western countries with high savings, such as Japan and China, to advanced industrial economies in the west, like the United States, with poor savings and excessive spending. In this system, capital has moved from developing to developed regions, not the other way around. In the British empire, capital flowed in the opposite direction: from England, the world's financial center, to the less developed colonial regions.

This "reverse flow" is a historical anomaly. Of course, the creditor countries, such as Japan and China, run the risk that the dollars they hold will depreciate in value over time; by piling up current account deficits, the US is bound to face strong inflationary pressures that are apt to devalue the dollar. Yet, in spite of such concerns, creditor states are still willing to lend huge sums to feed America's insatiable consumer appetite.

Why? One reason is that countries like Japan and China have not generated sufficient domestic demand to reach their own targeted rates of economic growth. This has prompted China and Japan to look to overseas export markets to generate demand. If US consumers wish to purchase Japanese- and Chinese-made products, Japan and China have been more than willing to extend credit.

Faustian bargain

In return for lending, Japan and China have received a basket of benefits. Exports have allowed Japan and China to create jobs at home, build essential infrastructure, lift levels of technology, train manpower, raise productivity rates, and accelerate the pace of economic growth. Such bountiful benefits have outweighed the marginal costs of lending. For countries with large labor forces, like China, it is essential that jobs be constantly created to absorb the mass migration of surplus workers from rural to urban areas.

Higher rates of employment also serve to preserve social order and political stability. Indeed, the legitimacy of the Chinese Communist Party (CCP) leadership has come to hinge, crucially, on its capacity to create jobs and to lift levels of disposable income. Exports have made it possible for the CCP to deliver jobs and elevate the level of disposable income. The CCP has entered into a tacit social contract with its citizens: namely, to keep the engine of economic growth revving at high speeds and in return, the masses will not challenge the authority of the CCP regime. To date, the tacit contract between the Chinese state and the people—has not been breached. Both have kept their sides of the bargain.

American innovation: new products, industries, and sectors

Japan, China, and the world at large also have benefited from the spillover effects of American spending. Since 1992, the US economy has served as the world's prime engine of global growth. US consumers have been voracious buyers of everything from durable goods (e.g., cars) to a

potpourri of services (e.g., financial products). American entrepreneurs have put the borrowed capital to efficient use by developing new products and technologies, establishing innovative start-up companies, and creating whole new industries and high value-added sectors. The United States has functioned as the world's cradle of entrepreneurship, innovation, global productivity, and growth.

Consider the long list of new higher-value added industries born in the womb of the US economy—semiconductors, computers (from mainframes to laptops), software, telecommunications, digital consumer electronics, robotics, the internet, biotechnology, alternative energies, and digital entertainment. US entrepreneurs have expanded the frontiers of technology in creative ways that have generated enormous multiplier benefits for the world at large. Where would the world be without America's incubation of new industries and high technology sectors? Without question, worse off.

US financial engineering: asset-backed securities and derivatives

On the other hand, American financiers also have produced a vast array of new, esoteric, non-transparent, and largely unregulated instruments of financial engineering—namely, derivatives, asset-backed securities (ABS), collateralized debt obligations (CDO), credit default swaps (CDS),—which have infiltrated, fragmented, expanded, and completely transformed the field of lending. The global diffusion of these opaque instruments of securitization has led to an unprecedented expansion of global lending and risk-taking. By segmenting, layering, packaging, and selling securitized debt instruments, US financial engineers have expanded exponentially the level of leveraging in the world.

It took only an obscure catalyst—sub-prime mortgage defaults in 2007—to bring the massively over-levered financial structure tumbling down. One major financial corporation after another—most deemed too big to fail—spiraled downward to the brink of insolvency: Fannie Mae and Freddie Mac (the main US government buyers of housing mortgages), Morgan Stanley, Bear Stearns, and Lehman Brothers (investment banks), AIG (insurance company), and Wachovia, Washington Mutual, and Citibank (commercial banks), to name a few.

When US Secretary of Treasury Henry Paulson decided not to rescue Lehman Brothers in September 2008, the stock markets crashed and credit markets froze. Because sub-prime mortgages had been bundled extensively with securitized debt instruments—especially the aforementioned ABS, CDO, and CDS (originally valued in the trillions)—the Lehman Brothers bankruptcy threatened to bring down many of the marquee names on Wall Street: Merrill Lynch, Bank of America, and Goldman Sachs.

Hence, the US has failed to act as a prudent guardian of the world's leveraged assets and wealth. While American entrepreneurs have created higher value-added technology industries and sectors, American financiers have developed a universe of opaque financial instruments that have served as the building blocs for a highly risky and dangerously overextended “shadow banking” structure. Not surprisingly, the world is now struggling to deal with the severest economic meltdown since the Great Depression in 1929—a largely “Made in America” toxic product.

Complex interdependence: symbiosis

From a global perspective, the US and its biggest trade partners and creditors, Japan and China, have become locked in a symbiotic relationship of complex interdependence. It is, in effect, a Faustian bargain in which the US runs lopsided deficits in exchange for a steady stream of

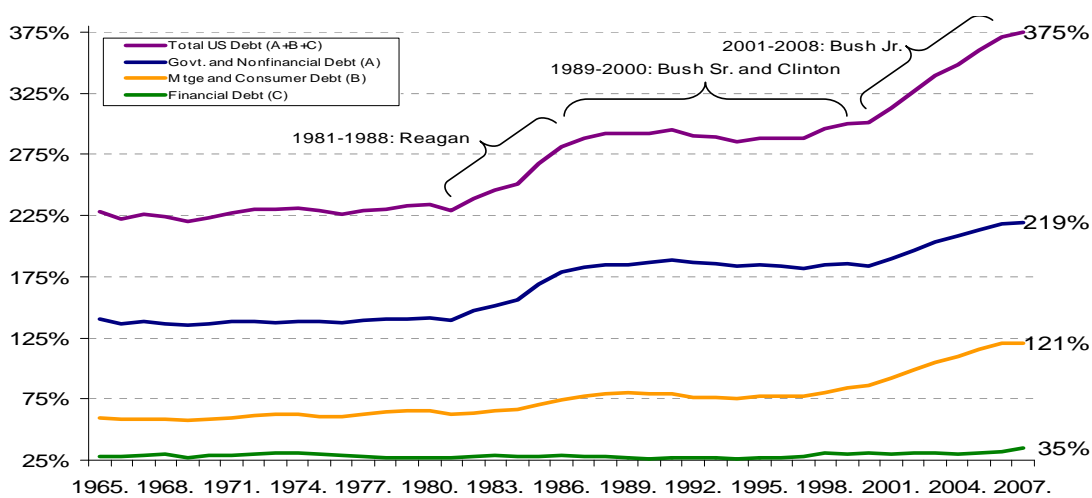
capital inflows while China and Japan hold huge reserves of US Treasuries (susceptible to declining currency value over time) in exchange for job creation, technological development, economic growth, and socio-political stability.

In this Faustian bargain, all parties give and take considerable benefits while assuming high risks. For each nation, it is extremely costly to break the bonds of interdependence. Each nation has an overriding stake in keeping the system working smoothly—even though the system becomes progressively harder to maintain as the level of capital recycling rises. It has taken an epoch-changing crisis—a global implosion, triggered by the Lehman Brothers’ collapse in September 2008, to disrupt the system and to alter the flows of capital.

A sea of US debt

In the system of mercantilist finance, the US has run amuck, ringing up record levels of national debt. Figure 1 shows America’s rate of debt accumulation--government, corporate, financial, and household.

Figure 1: Total US Debt (% of GDP)



Source: Sterling Stamos analysis; Federal Reserve

By the end of 2007, total US debt had risen to \$53 trillion, or nearly four times the size of America’s annual economic output. About 44%—\$23 trillion—had been accumulated since 2001. Between 2001–2007, financial sector debt rose by more than 70% and private household debt by 40%. Of the total, the federal government represented \$9.2 trillion, or 18%; households, \$13.8 trillion, or 26%; and the financial sector, \$15.8 trillion, or 30%.

Not only has the US economy gone on a borrowing and spending spree, but the US has become ever more dependent on foreign sources of capital. From 2003 to 2007, external debt nearly doubled, going from \$6.4 trillion to \$12.5 trillion. The \$12.5 trillion of external debt represents nearly 25% of America’s cumulative total. By 2007, foreign entities (mostly central banks) had purchased 46% of all US Treasury bonds and agency notes—up from only 15% in the late 1980s. As of August 2008, China, Japan, and Saudi Arabia had purchased \$2.740 trillion in US Treasuries debt, roughly 44% of America’s total public debt.

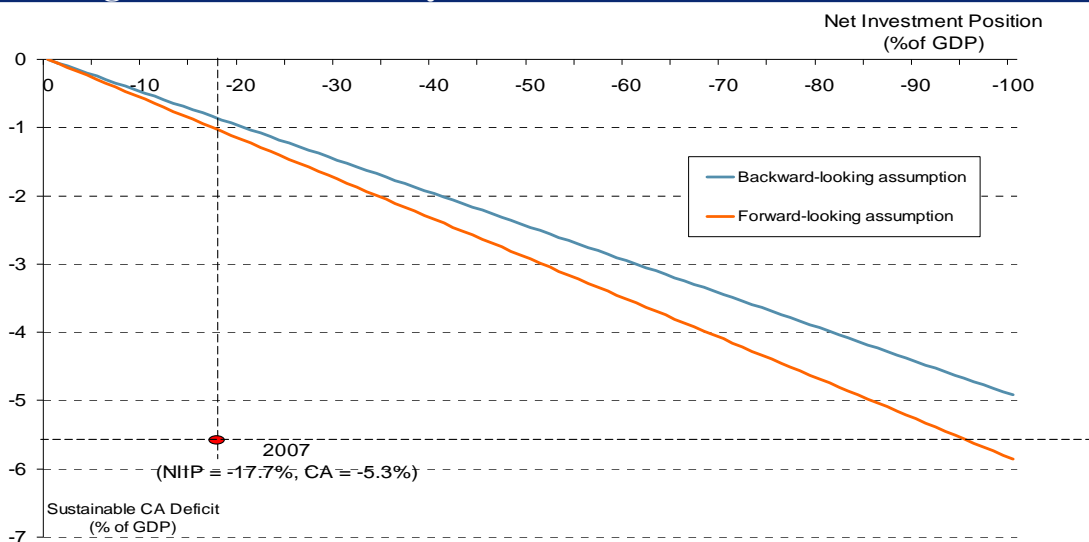
Unsustainability

At current and projected rates, American borrowing cannot be sustained. The costs of capital will climb to such elevated levels that the weight of debt-servicing, alone, will be more than US annual budgets can bear. Using simple metrics, the sustainability of America's current account deficits can be readily understood in relationship to the net international investment position (NIIP).

The NIIP is defined as the net difference between the value of a nation's holdings of foreign assets and the value of US domestic assets held by foreign investors. In 2007, the ratio of America's NIIP to GDP was 17.7%. Assume that the US current account deficits continue at -5% per year over the next ten or so years: a linear projection places the NIIP at 90% of GDP. But a 90% NIIP/GDP ratio probably would be too high for foreign investors, like China and Japan, to stomach. They will lose their appetite for US Treasuries and other agency debt.

To avoid falling into the abyss of a permanent debt-trap, the US would have to contain its annual current account deficits to no more than -3% of GDP per year and no more than a 50% NIIP to GDP cumulative ratio. Containing the NIIP/GDP ratio at 50% would require drastic cuts in expenditures—cuts that would be politically difficult to make. Thus, by 2009, the US was already sliding down relentlessly into the abyss of a dangerous debt-trap.

Figure 2: Sustainability of US Current Account Deficits and NIIP



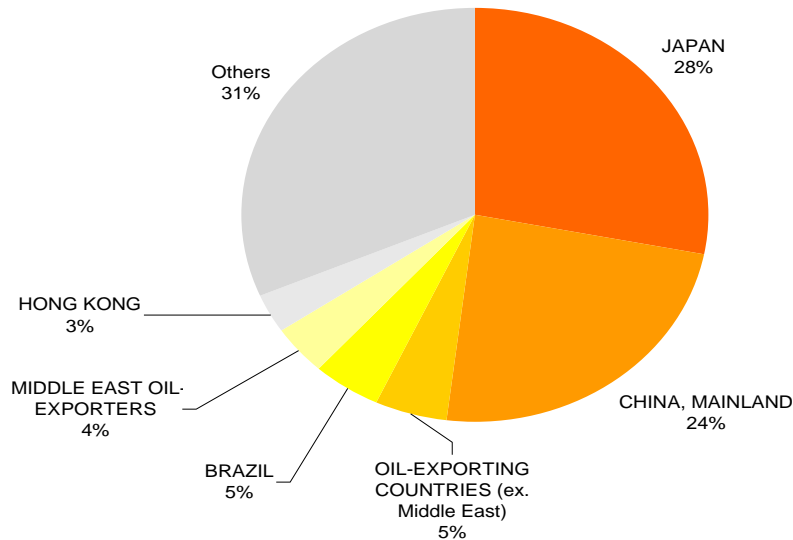
Source: Sterling Stamos analysis; Bloomberg; IMF; Bureau of Economic Analysis

US Treasuries: Chinese and Japanese lending to the US

China and Japan: the two biggest foreign holders of US Treasuries

As seen below (Figure 3), the central banks of two Asian states, Japan and China, have purchased more than half of all US Treasuries held by foreign entities. The actual figure is higher than 52%, because China buys US Treasuries through non-Chinese third-party institutions, and this is not reflected in the national data.

Figure 3: Foreign Holders of US Treasuries (2007)



Source: US Treasury

What is astounding is that China has amassed \$1 trillion of US Treasuries and agency debt in less than a decade. As recently as 2001, China's foreign currency reserve stood at only \$400 billion. By 2008, the \$400 billion had multiplied by five times to roughly \$2 trillion. Never before has a central bank collected such vast sums of foreign reserves at such record-setting speeds.

How do the Chinese and Japanese governments manage their sizeable foreign reserves? What government agencies have the authority to handle the reserves? For what purposes are the reserves used? In holding foreign reserves, do the Chinese and Japanese governments make or lose money?

Carry costs: net losses

Governments do not place foreign reserves in safety deposit boxes for passive, long-term storage in big bank vaults. The foreign central bank authorities usually “sterilize” their dollar reserves by issuing central bank debt or by expanding the reserve requirements of commercial banks. The aim of “sterilization” is to integrate the dollar reserves by reducing the monetary base of the country's local currency. This means that these governments must pay some level of interest on the debt issued or on the foreign currencies placed in reserve. As US Treasuries yield a certain level of interest payment over time, there is normally a difference between the US Treasury yield and foreign interest rates; if the US rate is lower, the foreign country loses money. The sum total of these losses fall into the category of what is called “carry costs,” or the net costs of holding foreign currency reserves.

There are also “reserve asset losses” associated with exchange rate risks. If, for example, the US dollar depreciates relative to the renminbi or the yen—say, by 15%—the value of China's and Japan's dollar reserves falls by 15%. Volatility in exchange-rates—particularly, dollar depreciation over time—exposes foreign reserve holdings to the significant risk of currency

volatility, even if foreign governments buy hedges on possible adverse exchange-rate movements. From December 2007 to February 2009, for example, the dollar fell in value relative to the yen by 14.5%

Moreover, if central banks place a portion of their foreign reserves into sovereign wealth funds (SWF), as China does (but not Japan), the SWF's direct investments run the risk of being diluted by falling share prices, mark-to-market losses, or outright defaults. China has lost substantial sums from direct investments that it has made in the Blackstone Group and Morgan Stanley—an estimated \$5.25 billion (as of March 2009).

Thus, accumulating large foreign currency reserves brings both costs and benefits. It would seem that a large foreign currency reserve ought to generate positive returns by putting the capital to effective use at home. Foreign reserves also provide the advantage of protecting against speculative currency attacks, such as those directed against the Thai baht in 1998, the catalyst for the Asian financial crisis; foreign reserves provide the resources for foreign financial authorities to intervene in currency markets if necessary (to smooth sharp currency movements). At the same time, and on the other hand, the carry costs can outweigh whatever positive returns are gained. By 2009, Japan had reaped positive net returns while China had incurred non-trivial net capital losses.

Japan: positive returns

As of 2009, the Japanese government held about \$1 trillion of foreign reserves, of which about 88% was believed to be in US treasury and agency bonds. Japan's reserve holdings amounted to 18% of total foreign asset holdings at the start of 2008.

Since Japan has been running current account surpluses over nearly four decades, it has been stockpiling international currency reserves steadily over a far longer span of time than China; and from the early 1990s, Japan has been accumulating dollar holdings under unusual macroeconomic conditions at home—specifically, deflationary stagnation.

The longer period of accumulation, slower pace, and favorable interest rate differential between the US and Japan have meant that Japan has managed to avoid the problems of absorption (that is, “digesting” huge sums of foreign currency) with which China has had to cope. Unlike China, Japan also has enjoyed the advantage of having a sound private banking system in place, one that facilitates relatively efficient investment allocations. Owing to these differences, Japan has managed to obtain higher yields from its international currency reserves than China.

Based on published special account financial statements, Japan's foreign reserves have earned \$350 billion through interest differentials while losing \$70 billion through yen appreciation vis-à-vis the dollar over the period 1982–2006. Thus, the net gain came to a substantial figure: \$280 billion (using the US dollar base in 2007).

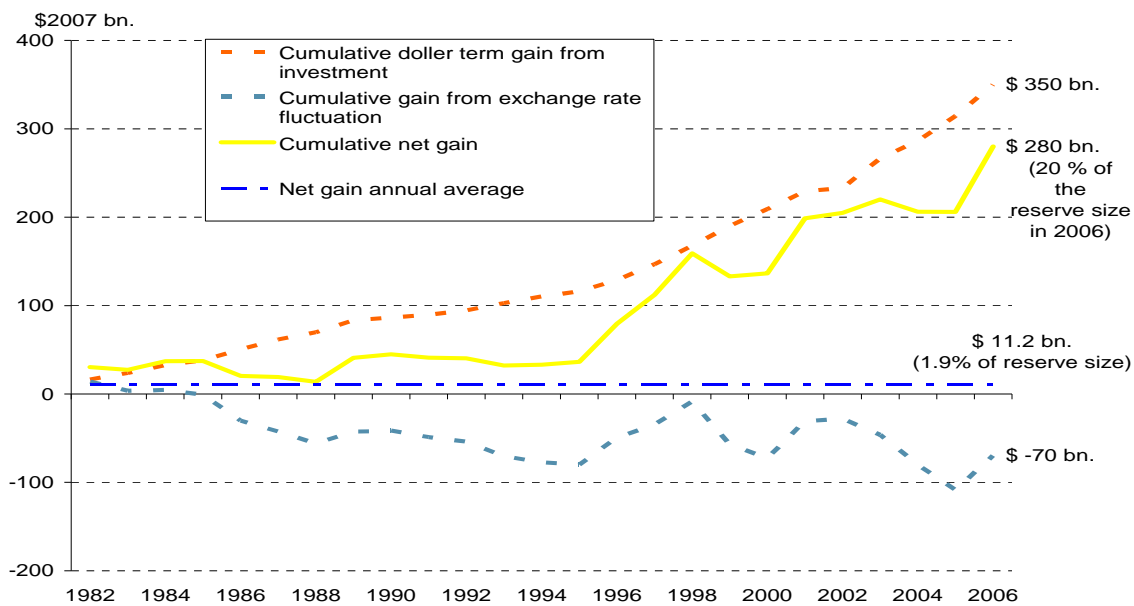
From 1982 to 2006, roughly 40% of the returns from Japan's foreign reserve holdings were transferred into the General Account budget, constituting about 1% of the General Account total. Another 60% of the foreign reserve earnings were kept in the Special Account budget.

Newly obtained capital is placed into the Fiscal Investment and Loan Program (FILP) (*zaiseitoyushi*). As the special account is less transparent than the general account, *zaiseitoyushi* has long been a source of flexible income for the Ministry of Finance (MoF), the bureaucratic agency responsible for compiling Japan's annual budgets. As other sources of funding have shrunk, the income earned from the international reserve now accounts for more than 20% of *zaiseitoyushi*'s funding base.

With the US economy in crisis and currency values fluctuating, Japanese authorities are concerned about the negative impact of sharp yen appreciation. According to the MoF, a one-unit appreciation of yen against dollar will lead to a loss of 0.8–0.9 trillion yen or 3.6% of the cumulative net gain from 1982 to 2006. By this calculation, Japan’s accumulated earnings of \$280 billion would be wiped out by a 27% decline in the dollar from its 2006 level (98 yen per dollar). Japan’s vulnerability to exchange-rate swings is particularly noteworthy because Japan has become an aging creditor country—a nation where 20% of its population is 65 years or older.

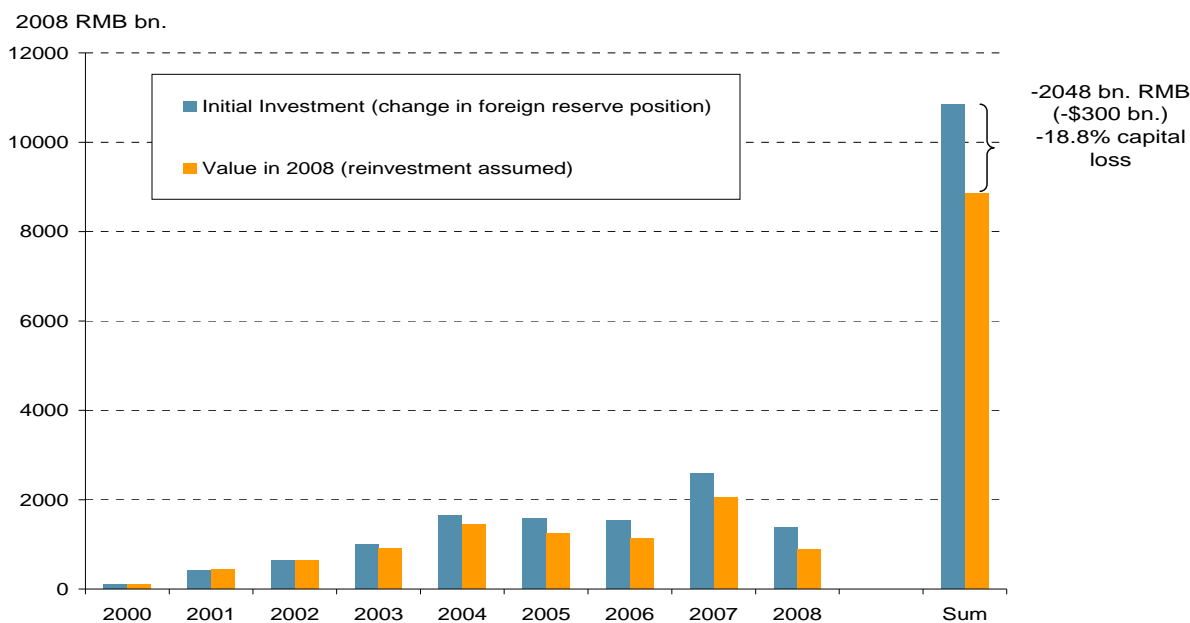
As the US Federal Reserve Bank has cut its interest rates effectively down to zero, the interest rate differential, which used to favor Japan, has evaporated. Moreover, if the dollar depreciates, Japan’s foreign reserves may suffer significant losses. Given the prospect of such losses, the Japanese government—supported by the country’s big export-industries—has supported a “weak yen” policy aimed at containing sudden spikes in the yen’s value.

Figure 4: Japan’s Foreign Reserve’s Real Profit/Loss Calculation (cumulative)



Source: Ministry of Finance

Figure 5: Eroding Value of Chinese Foreign Reserves



Source: Sterling Stamos analysis

China: losses

In contrast to Japan, which has reaped the bonanza of an estimated \$280 billion from its foreign reserve holdings, China, with holdings twice as large, has suffered declines of about 10% per year. The losses have been the result of national differences in interest and inflation rates, the renminbi's appreciation against the dollar, and major losses in the mark-to-market value of direct investments.

China's reserves are managed by a special agency within the People's Bank of China (PBoC), known as the State Administration of Foreign Exchange (SAFE). A portion of SAFE's assets—\$200 billion—have been allocated to the China Investment Corporation (CIC) for investments in higher yielding, riskier assets. Both entities are overseen by the State Council, the chief administrative authority in China. Final investment decisions must be approved by the Standing Committee of the Politburo.

CIC and SAFE operate differently. CIC is run largely as a commercial, relatively transparent operation, mostly investing through foreign managers. It has been called upon to backstop China's banks through off-balance sheet asset management companies, tying up an estimated \$70–90 billion of the funds under management. By contrast, SAFE has operated in more of a stealth mode, using a non-transparent maze of subsidiaries to purchase equities. SAFE is believed to own 0.2% of the total UK equity market, and stakes of greater than 1% in 47 UK companies.

As of July 2008, the Chinese held \$710 billion in US Treasuries and nearly \$446 billion in other agency debt—for a total \$1.14 trillion, making China, by far, the world's largest foreign holder of US government bonds.

Since 1999, China has lost an estimated \$300 billion. This has given rise to strong criticisms directed at CIC, SAFE, and the PBoC. It has also led to differences of opinion within the State Council and CCP about how to manage the foreign currency reserves. The nature of financial interdependence—specifically, the high costs of unilateral exit—has limited the options available to China. Zhou Xiaochuan, Governor of China’s central bank, has proposed that the IMF create a new international currency by expanding the use of its Special Drawing Rights (SDRs). The SDR-based currency would serve as an alternative to—if not an eventual replacement for—the US dollar.

Unloading dollar reserves would be financially and politically very costly; selling a portion of the US Treasuries would damage the value of China’s remaining dollar holdings. Refusing to buy new issuances of Treasuries also would be self-defeating, particularly in the midst of the current financial crisis, because China has a stake in upholding the value of the dollar; and by facilitating America’s recovery, China would benefit from a boost in US demand. For the time being and for the foreseeable future, therefore, the system of capital recycling from Japan and China to the United States will remain in place, even though the severity of the global crisis already has slowed down the flow.

Japanese and American financial crises

The Japan comparison

The current financial meltdown has already wiped out an estimated \$40 trillion in notional wealth, or the equivalent of roughly two-thirds of the world’s GDP in 2008. What is especially worrisome is that there is not yet a bottom in sight. Despite massive injections of capital, credit remains tight, banks are struggling to stay solvent, household consumption is down, capital expenditures have plunged, unemployment is rising, world trade is collapsing, corporate bankruptcies are multiplying, and global growth will contract for the first time since the end of the Second World War.

The magnitude of the meltdown—as well as the uncertainty of when the US economy will recover—have led many analysts to compare the US crisis with the so-called “Lost Decade” in Japan (1991–2002). Is the US headed for a lengthy period of stagnation, asset deflation, followed by a burst of inflation? Will the US be able to continue financing its enormous debt?

Similarities

There are several striking similarities in the Japanese and American crises. Both have emerged out of large real estate bubbles, grotesquely inflated by a sea of liquidity, easy bank credit, low interest rates, and imprudent investments. The central banks in both countries cut interest rates prior to the ballooning of the real estate bubble and held them down longer than was prudent. Both bubbles ballooned to dangerous proportions.

By nature, real estate bubbles tend to be more entangled and slower to unwind than other types of bubbles (such as an equity bubble). In real estate bubbles, bank lending is almost always excessive. In consequence, when the bubble bursts, the banks are left holding sizeable portfolios of non-performing loans (NPL). What ensues is a full-scale banking crisis, coupled with the danger of steep asset deflation. Shaky banks, the heavy burden of NPL, and collapse of equity and credit markets call for costly and bold government action to restore stability and confidence in the financial sector. And the financial sector needs to be restored to health before the economy can recover.

Differences

Overshadowing the similarities are many noteworthy differences. To begin with, the scale of the two financial crises is dramatically different. America's crisis is larger, decidedly more global in nature, more deeply entangled, and much tougher to unwind.

At its peak, Japan's bad banking loans amounted to about 40% of GDP—roughly, \$1.6 trillion. By contrast, because bank lending in the United States had spiraled out of control through the rapid diffusion of securitized debt instruments—ABS (asset-back securities), CDO (collateralized debt obligations), and CDS (credit default swaps)—the scale of the US crisis far surpasses the bank loans at risk in Japan. By 2007, securitized debt had grown to \$63 trillion—greater than the world GDP. What percent of the ABS could be labeled “toxic” is unknown. However, by the end of 2009, the toxic debt write-offs might exceed \$3 trillion dollars—and the financial meltdown is far from over. Should the crisis linger beyond 2009 (a distinct possibility)—the cumulative write-offs would come to dwarf the non-performing loans in Japan.

Furthermore, current crisis is global in scope, not national, as was the case in Japan. The global metastasis of the crisis also means that recovery will require global efforts. The US, by itself, will not be able to stop the free-fall. Cooperative efforts by the EU, Japan, and China will be necessary. The problem is that the world's three main engines of growth—the US, Europe, and Japan—are simultaneously stalled and China is sputtering. Japan's crisis, by contrast, was purely national in nature; and the other three engines of growth—the US, China, and Europe—were relatively robust for most of its “lost decade”.

Government response

If the US financial crisis is graver, more complex, and global in nature, the US government's response has been faster, bigger, and hopefully more effective. Indeed, America's central policymakers—from President Barack Obama to Fed Chairman Ben Bernanke to Treasury Secretary Timothy Geithner—have learned salient lessons from Japan's experience. They realize that the US government must utilize the full range of economic levers at hand. It cannot afford to dither or to resort to piecemeal measures.

To stop the financial and economic slide, the US government has brought unprecedented monetary and fiscal policy instruments to bear—and in record time. On the monetary side, what took the Bank of Japan (BOJ) more than seven years of incremental reductions to reach—namely, de facto zero-interest rates—the Fed has reached in 16 months. Moreover, the Fed has expanded its balance sheet from roughly \$900 billion in 2007 to \$3 trillion by March 2009—providing liquidity to banks, buying up toxic assets, and seeking to thaw frozen credit markets. It took Japan eight years to address the problem of bank insolvency—and longer than that to restore the banks to reasonable health.

The Fed Chairman's decision to pump massive sums into the economy—as an appointed official, with no elected mandate, and largely outside the scope of direct public accountability—is a riveting display of power. Surprisingly, almost no one has challenged, or even questioned, the Fed Chairman's authority. His quick and bold seizing of the initiative is a striking contrast to the BOJ Governor, whose power is circumscribed and whose policy initiatives have been tepid.

On the fiscal side, the US Congress has passed a \$787 billion stimulus package designed to counteract deflationary forces by generating demand and adding more than 3 million new jobs to the flagging economy. Because the 2009 stimulus package is unlikely to be sufficient to pull the US economy out of its tailspin, another large package probably will be needed in 2010. And as

if halting the slide were not a formidable enough challenge, the Obama administration will have to deal with the ticking time-bomb of entitlements—particularly, the spiraling costs of health care and welfare. Thus, the stark contrast in the speed and scope of policy measures taken by the political leadership in the US and Japan is the most striking difference. For a variety of reasons, the US President and Fed Chairman have had a freer hand to exert decisive leadership than the Japanese Prime Minister and the Bank of Japan Governor. In the case of President Barack Obama, his resounding victory in the 2008 election and his post-election popularity have given him a strong public mandate to respond quickly and comprehensively to the financial implosion.

Implications

To finance the paroxysm of spending—perhaps as much as \$4 trillion by the end of 2009—and who knows how much in 2010 and beyond, the Fed will have to hold a long, drawn-out series of auctions of US Treasuries. It must hope that the appetite for Treasuries will not wane. To date, the appetite has not—even with the recent decline of Chinese and Japanese purchases. US government bonds are perceived to be a safe haven during periods of extreme volatility and uncertainty, as is the case today. Once the markets show signs of stabilizing, however, the costs of US borrowing are apt to rise. Treasuries will have to compete with alternative, higher-return investment vehicles to attract capital.

With the US and Europe now saddled with onerous deficits, the dollar and euro appear to be headed down the road to currency depreciation. Inflation is one way of dealing with unsustainable levels of national debt. During the 1960s, 1970s, and 1980s, the strategy of inflating one's way out debt became known as the "Latin American solution." If the US and Europe resort to the "Latin American solution," China and Japan may respond by trying to contain the sharp appreciation of their own currencies by dipping into their vast dollar reserves to intervene in foreign exchange markets. What may ensue is a scramble to the bottom, a race to devalue national currencies.

Because the financial crisis grew out of the crucible of US financial engineering and lax regulatory oversight, many business and political leaders around the world have criticized the US for plunging the world into the abyss of a financial crash and a deep recession. The credibility of the Anglo-American paradigm of market capitalism, which gained traction in the aftermath of the Soviet Union's collapse, has been seriously damaged. Confidence in America's financial institutions and more specifically, in opaque derivatives, such as CDO and CDS, has been severely shaken.

In the midst of this largely "Made in America" financial mess, US financial hegemony appears to be on the wane. While the US will remain the most powerful single nation in the world, its stockpile of financial assets and the image of US finance as the world's most advanced and most efficient have been seriously damaged

Conclusions

Global rebalancing

The current economic implosion has destabilized the post-Bretton Woods system in several ways. The crisis has 1) pushed many of the world's biggest banks and financial corporations to the brink of insolvency; 2) contaminated the spacious, uncharted terrain of securitized debt financing—the so-called "shadow banking" sector populated by hedge funds, investment banks, and other financial institutions; 3) debased the mark-to-market value of the multi-layered, finely

parceled instruments of US financial ingenuity—ABS, CDO, CDS, and other derivatives; 4) collapsed the over-extended structure of leveraging; 5) caused a sudden constriction of credit; 6) triggered a crash in global equity markets; 7) forced states to plunge deeply into the red to stimulate aggregate demand; and 8) placed the flexible exchange rate regime under considerable stress.

Out of this crisis, an altered global system of finance seems to be evolving, one based on a more sustainable global macroeconomic balance, one in which less capital is being recycled from Asia to the post-industrial states. This adjustment is long-overdue. The world has been waiting for the US to curb runaway spending and to raise its nearly non-existent savings rate. The world also has been waiting for the Asian economies to expand domestic consumption so that its growth rates will become less dependent on the US export market.

It would have been less traumatic if the adjustment had come more slowly. In only one year, the US has raised its household savings rate from zero to 4%. With the collapse of overseas markets, China has been forced to spend more of its disposable income at home. It may not be long before private consumption in China will rise from 36%, an unusually low figure for a country of China's size and industrial development, up to the more "normal" range of 45–50% of GDP. Given the size of China's population and the rapid growth in its disposable income, there is no reason why China cannot make the transition from an export-oriented to a more domestic demand-driven economy.

To what extent the financial crash and global recession damage the power, credibility, and leadership of the United States remains to be seen. Can US financial institutions continue to exercise global leadership? Will China, Japan, and other foreign states continue to purchase massive amounts of US Treasuries and other agency debt? How long will it take for the United States to bring its soaring national debt under control? Will China, India, and other emerging powers demand a greater voice in the governance of international financial institutions, like the World Bank and the IMF? Answers to these and other key questions will determine the resilience and effectiveness of the Post-Bretton Woods II system.

In spite of the pain inflicted by the current crisis and the costly adjustments that lie ahead, the rebalancing of the global system could turn out to be a stabilizing development in terms of leading to a more evenly distributed system of demand generation. The world needs to have China, Japan, India, Brazil, Russia, Germany, and other states play more dynamic roles in generating demand for the sustained growth of their own economies.

America's multilateral orientation

Although the US will continue to attract substantial inflows of foreign capital, the sheer scale of its cumulative debt, prospects for dollar depreciation, and shrinking current account deficit will diminish the flood of foreign capital pouring into the US. Given the vast expansion of the Fed's balance sheet, the costs of capital are bound to rise. The US will face the daunting task of paying for years of profligate spending.

Given the higher costs of capital, the US government will have to make hard choices of where to allocate finite resources. It will have less fiscal flexibility to prosecute costly overseas wars. With hard budget constraints, there will be zero-sum trade-offs to make between international and domestic commitments. Since elected leaders will depend on voter support to remain in office, it is likely that domestic priorities—such as health care, social security, education, and renewable energy—will be take priority.

But the US will not withdraw into a shell of isolationism. It will continue to be actively engaged in international affairs—maybe even more actively in certain select areas of soft power diplomacy—but it will try to use its capital in more cost-effective ways. It will look to mobilize support from allies like Japan and Europe.

As Japan and Europe will have their own domestic priorities to meet, however, multilateral cooperation will be selective and not easily achieved. On many issues, the US will have to solicit the cooperation of the rapidly developing states, especially Russia, China, Brazil, India, and the Persian Gulf states. This implies that the US will move away from the exercise of unilateral power—though not entirely—and reorient itself to multilateral efforts.

A reorientation of US–Japan relations

Japanese leaders are perpetually nervous about the possibility that the US will practice “Japan Passing”—that is, pay greater attention to China than to Japan. The fear is not entirely unfounded, since China is growing so much faster than Japan, is flexing its diplomatic muscle, and seems bent on becoming the dominant economic and military power in Asia. Across a range of key issues—from the environment to the North Korean nuclear problem, the United States will be compelled to engage China. China has become too big and too consequential to be relegated to second-tier treatment.

At the same time, China’s rapid emergence as a regional and world power elevates the strategic importance of Japan to the United States. The same holds true for America’s relationship with Australia, India, Pakistan, South Korea, Indonesia, the Philippines, Vietnam, and Singapore. A rise in China’s relative power will give the US stronger incentives to work more closely together with its allies and friends in Asia.

In US–Japan relations, there are several noteworthy policy issues where there are convergent interests and synergistic strengths: 1) renewable and clean energy development; 2) environmental protection (especially the containment of global warming); 3) international and regional finance; and 3) health care. In these areas, Japan is positioned to contribute a great deal. Japan’s cutting-edge research and commercial knowledge in such advanced technologies as batteries, fuel cells, clean coal, solar and wind power, power grids, and waste management make Japan a natural and potentially effective partner for the US. The US and Japan should work closely together to push through a common agenda on the critical challenges of clean technology and climate change. Clean technology and renewable energy offer both the US and Japan a promising pathway for post-industrial growth while at the same time reducing their dependence on oil from the Middle East.

Japan can also play a lead role in helping to stabilize regional finance through the establishment of Asian currency swaps, early warning systems, bond markets, and perhaps down the road, even the creation of a common Asian currency.

Bilateral cooperation in health care research and delivery could also be mutually beneficial. While international security will remain of critical importance, especially because the impact of the current economic crisis will be globally destabilizing, the US and Japan ought to respond to the evolving needs of the global system by extending and deepening bilateral cooperation in these urgent areas. Refocusing on new missions and new goals may be the surest way of bolstering and preserving the US–Japan alliance—and of protecting against the dangers of “Japan Passing.”

The financial implosion in 2008 has rocked the world in ways more damaging than the 9/11 attack on the World Trade Center. In terms of sheer magnitude the financial crisis has had a

more profound, farther-reaching, and longer lasting impact. Not only has the crisis shaken the financial foundations of the global economy, but the coming wave of after-shocks also can be expected to bring down unstable political regimes, expand the already large circle of failed states, increase the number of people living in poverty, exacerbate socio-political conflicts, foster extremist ideology and groups, and set back the forces of globalization. Even assuming that the United States, Europe, Japan, and China exercise vigorous leadership, it may take several more years to restore normalcy, calm, and prosperity. By then, the world may have become a different place. Unfortunately, the world may have become less stable, less prosperous, and considerably more dangerous.

About the author

Daniel I. Okimoto is Professor Emeritus of Political Science, Senior Fellow of the Institute for International Studies, and Director Emeritus and Co-Founder of the Shorenstein Asia/Pacific Research Center at Stanford University. During his 30 years at Stanford, Professor Okimoto played a central role in establishing several interdisciplinary programs and research institutions, including the Stanford Institute for International Studies, Center for Comparative Studies in Race and Ethnicity, the Asia/Pacific Scholars Program, the Stanford Center for Technology and Innovation in Japan, and the Stanford Program on International and Cross-Cultural Education. He is currently Chairman of the Sterling Stamos Global Institute based in Menlo Park, CA. In 2004, he received the Japanese Foreign Minister's Commendation in recognition of his contributions to US-Japan relations during the 150th year celebration of bilateral relations. In 2007, he was awarded the Order of the Rising Sun with Goldray Neck Ribbon by the Japanese government, the highest honor that can be conferred on a non-Japanese. In 2009, he received the "Lifetime Achievement Award" from the Keizai Society of Silicon Valley.