

Japan: Game Over

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In April 2001 Junichiro Koizumi became Prime Minister of Japan. Since then analysts and pundits have argued over whether he would succeed in restructuring the nation's economy or prove another in its seemingly endless series of incompetent leaders. Yet this debate is beside the point, for its premise—that corporate and banking reform would return Japan to the path of economic growth and avert a financial disaster—is no longer valid. It is simply too late for the country to avoid a crisis, probably in the latter half of this decade, that will destabilize its domestic politics, endanger its global network of financial and trading relations, and collaterally damage many other countries. Rather than focusing on the successive acts of the Koizumi drama, therefore, it would make more sense to identify the threat Japan poses to the rest of the world and to prepare for its consequences.

The Burdens of History

To understand how Japan's economy became so dysfunctional, one must look beyond the country's deflation, inefficient corporations, and debt-riddled banks to the underlying malady that produced these symptoms: excessive savings. This problem has afflicted Japan for decades, and its continued existence augers ill for the 2000s.

A country's gross savings rate is determined primarily by the behavior of households and corporations. Households save money to purchase homes, pay for education, and provide for retirement. Japanese, however, have long tended to put aside more of their income than do their peers in other G7 economies. One reason for this frugality is the relatively high price of housing, which means that aspiring homeowners must accumulate more money for down payments. Another is the country's demographic profile: a very large number of workers are in their forties, fifties, and sixties, the ages at which people everywhere save the most. Corporations, meanwhile, retain earnings largely to finance their present and future investment needs. If market forces function properly, they disgorge the rest of their income to their owners, who are ultimately households. But when market forces are attenuated and do not motivate companies to distribute their profits, they sometimes hold that capital internally and use it for uneconomical purposes. This raises the corporate savings rate and, by diminishing the flow of resources to

workers and investors, additionally compels households to save more in order to achieve their target levels of wealth. In this sense the Japanese government's historical practice of shielding feckless companies from the rigors of market competition has prevented the gross national savings rate from falling even as the country approached, and then attained, economic maturity. As late as the period 1993-2000 Japan's rate averaged 31% of GDP, as opposed to 20% for the European Union and 16% for the admittedly improvident United States.

This persistent capital surplus puts Japan in a real quandary. When too many companies and individuals refrain from spending, there is not enough aggregate demand to absorb the goods and services that the economy produces. Inventories then accumulate, workers are laid off, and commercial activity decelerates: a serious recession might ensue. If this downturn frightens people and they react by hoarding still more of their income, the imbalance between supply and demand worsens and recession transmogrifies into depression. Since its savings rate is more than 10% higher than the EU's, and almost twice that of United States, it is not surprising that Japan has long had trouble achieving significant GDP growth.

To avoid prolonged economic contraction, a country in such circumstances must find someone who wants to borrow and spend its excess savings. Only three groups can perform this function: corporations seeking to acquire new plant and equipment, a government wanting to finance a budget deficit, or foreigners who intend to purchase more Japanese products. Over the last few decades Japan has employed all three of these expedients. In the 1970s the government ran a budget deficit that absorbed much of the country's extra savings; and when that deficit was eliminated in the early 1980s, the country exported more of its superfluous capital through a growing current account surplus. Diplomatic pressure and a stronger yen then combined to discourage this expedient, and in the latter half of the decade the external surplus shrank to the 2.5%-3.0% of annual GDP that has obtained ever since. This was still large by international standards—more than enough, obviously, to irritate other countries—but it accounted for

only a fraction of the country's capital surfeit and hence left Japan's macroeconomic dilemma largely unresolved.

Since the middle 1980s corporate investment has been a much more important source of demand. Judging from the experiences of the United States and Germany, which are the other global leaders in industry and technology, the equilibrium rate of private non-residential investment in a mature economy is about 10% of GDP per annum. Spending at this pace enables companies to replace obsolete plant and equipment while also amassing an appropriate volume of new capacity. Depending on such other factors as the growth of the country's labor force, this volume of capital expenditures suffices to generate a healthy expansion in GDP: perhaps 2% per year in Germany and 2.5-3.0% in the United States. If investment rises above that equilibrium level, short-term economic output will also increase because capital accumulation is itself productive activity. But such extraordinary spending worsens a country's long-term prospects by creating more industrial capacity than can profitably be employed. The result—as should be familiar to Americans now that the euphoric over-investment of the late 1990s has given way to recession—is often a protracted economic slowdown.

Japan's bout of over-investment was much longer and more profound than anything the United States would later experience. As the country approached developed-nation status in the late 1970s and early 1980s, its ratio of capital expenditures to GDP declined toward the US and German level: between 1980 and 1984 it averaged a fairly reasonable 13.4%. But then the downward trend reversed. Unduly loose monetary policy, poor regulation, and reckless lending by Japanese banks encouraged enterprises to expand their collective capital budget to 17.6% of GDP in 1988 and then to over 20% of that standard in 1990 and 1991. This was almost twice what a sophisticated economy like Japan should have been spending, and it explains much of the over-capacity and poor productivity have characterized the country ever since.

Over the course of the 1990s the ratio of capital expenditures to national output has declined somewhat, reaching 15.5% in 2001. This decrease was welcome insofar as it

meant that some industries were becoming more efficient, but it also resurrected the specter of inadequate aggregate demand and left Japan, once again, seeking an outlet for its capital, goods and services. Enlarging the trade surplus was not a realistic option, for doing so would have infuriated Tokyo's diplomatic and commercial partners as well as hurting influential domestic lobbies. By default, the path of least resistance was fiscal stimulus. Yet this could not take the form of mere "pump-priming", for once the surge in government spending subsided the country would again confront a structural savings surplus. What Japan required was constant state demand that would soak up its unneeded capital year after year. It was thus natural that the government budget would move from a surplus at the beginning of the 1990s to a deficit of 2.4% of GDP in 1993 and thence, gradually, to 8% of GDP in 2001. This expansionary fiscal policy compensated for shrinkage in the corporate sector and enabled Japan to achieve real growth of approximately 1% per annum in the 1990s rather than stagnating completely or falling into a depression.

Having relied on aggressive corporate and governmental spending for so long, Japan now finds itself in dire straits. Unwise investment has rendered many enterprises insolvent, undermined the banking system, exacerbated the country's deflationary tendencies, and lowered the returns households earn on their investments while copious deficits have inflated the gross national debt from 61% of GDP in 1990 to some 140% of GDP in early 2002. The realization that the government must eventually raise taxes to meet its financial obligations, meanwhile, has underscored the public's penchant for saving. Thus Japan today faces the same problem of deficient aggregate demand as it did a decade ago but possesses considerably fewer resources with which to address that challenge. How it will avoid a sharp economic contraction in the early 2000s thus becomes a salient question.

The Paths Forward

Given that companies can no longer afford to increase their capital spending, there are only three ways in which Japan can maintain macroeconomic stability. The first two options—a massive increase in the current account, and further fiscal deficits—assume that the country continues to save apace and seek to redress the consequent imbalance by

bolstering aggregate demand. The third possibility, corporate and financial reform, would work through a different mechanism. It would make firms more efficient in their use of capital, thereby lowering the corporate savings rate and channeling more wealth to households. Workers and individual investors could now achieve their financial goals more easily and, therefore, would start spending more of their income. With both the corporate and the household savings rates declining, there would be less excess output for the government and the foreign sector to absorb. Unfortunately, a detailed examination of these three strategies demonstrates that, if implemented at this late date, they would all lead to the same unpleasant outcome: a financial collapse sometime after 2005.

Perhaps the most radical of the three approaches would be intentionally to depress the value of the yen such that the current account surplus expands dramatically. Several prominent macroeconomists have espoused this approach. Their contention is that if a country saves more than it invests, it should ship its excess capital overseas so that foreigners may buy more of its exports. Extra savings would thus translate, logically and automatically, into stronger aggregate demand.

The magnitude of the necessary adjustment, however, is daunting. If one assumes, as a very rough approximation, that the ratio of corporate investment to GDP should decline from 15.5% to 10% and that the government's budget should move from a deficit of 8% of GDP toward neutrality, then the gap in aggregate demand could easily exceed a tenth of national product. To fill that gap, the current account surplus must triple or quadruple in size. This would require an enormous change in the exchange rate. The present rule of thumb is that sustained yen depreciation of 10-15% produces a 1% increase in GDP. If anything like this relationship obtained at such extremes, the currency must fall from today's rate of some ¥120 per dollar to beyond ¥250 per dollar to yield the additional demand Japan so clearly needs. Moreover, the currency must stay at this level for five, ten, or more years—as long, that is, as economic actors insist on saving so much of their income.

Skeptics contend that no country possesses the tools necessary to engineer so great a change in the value of a floating currency. As evidence for this proposition they cite several episodes in Japan's recent monetary history. Throughout the first half of 2002 the Bank of Japan (BOJ) was expanding the money supply by over 25% relative to the same period last year, but this effort had no noticeable effect on the value of the yen. Then, from April to June the BOJ intervened in currency markets six times, spending a total of ¥4 trillion in an attempt to weaken the yen—only to see the currency rise inexorably against the dollar. Throughout these months private investors were curtailing their purchases of US stocks and bonds, and this decrease in demand was much more important than the BOJ's relatively modest initiatives.

Still, the argument that governments cannot meaningfully affect exchange rates is not universally correct. *In extremis*, a central bank could print an infinite quantity of money and use it to purchase huge volumes of foreign currencies. The laws of supply and demand would dictate that this eventually make the exchange rate weaken. Thereafter the central bank would need to continue intervening, printing money as necessary to keep the current account surplus at its target size. This process might be difficult to manage precisely, but the only way other countries could prevent it from having the desired general effect would be to turn on their own printing presses. If the United States and some of Japan's other major trading partners refrained from such competitive devaluations, the BOJ should be able to expand the current account surplus quite significantly.

The second option would be to “muddle through” with fiscal policy, using deficit spending to absorb extra capital and strengthen aggregate demand. This, Tokyo's de facto current strategy, is attractive because it permits a modicum of GDP growth while not requiring painful structural changes within Japan. Vested interests are thus protected and the political system remains quiescent. Underlying this strategy, however, is an erroneous belief that the national debt can grow apace without ultimately engendering serious trouble.

Japan can definitely bear greater financial burdens than other countries. Its savings rate is vertiginous, its people own ¥729 trillion in deposits at banks and in the postal savings system, its central bank holds foreign reserves worth ¥55 trillion, and the current account surplus brings in between ¥10 and ¥15 trillion in income from abroad every year. Even better, this abundant liquidity tends to stay pooled in the country's own capital markets because, having lost vast sums abroad in the late 1980s and early 1990s, Japanese investors now prefer to keep their money in yen-denominated assets. Tokyo likewise benefits from deflation, which has held the real interest rate on the benchmark 10-year JGB well above 2%, and that on corporate paper still higher. Such returns are respectable by global standards, and they imply that there is not much penalty for holding yen assets. As a result, the authorities have been able to float just over 95% of their Japanese Government Bonds (JGBs) to relatively tractable Japanese capitalists who are much less likely than foreign speculators to launch an attack on the yen. As long as such favorable conditions prevail, Tokyo should not have too much difficulty financing its debt.

Yet it is easy to make too much of Japan's strengths. Whereas regulatory pressure and fear of overseas markets may predispose investors to keep their money at home, even the most conservative institutions will move offshore if they perceive the domestic risks as rising too high. The preference for yen-denominated assets is thus relative, and could erode if the national debt mounted inordinately. Similarly, the notion that the government need not worry about its finances because it can tax away the private sector's wealth is fallacious because the effect of doing so would be to impoverish households, force people to save yet more of their income, and perpetuate the insufficiency of aggregate demand that is Japan's fundamental structural flaw. Viewed in this light, the country's unusual financial attributes give it more room to borrow than most countries enjoy but confer no permanent immunity to market forces.

There is reason to believe, furthermore, that the country has already exhausted much of its advantage. Since the commonly cited figure for the gross national debt—140% of GDP as of early 2002—ignores the government's off-balance sheet assets and a wide range of hidden liabilities, it should only be regarded as a ballpark estimate.

Nevertheless, the size of the debt is so large, and its rate of increase so fast, that these measurement errors are ultimately inconsequential. The gross US debt, by comparison, presently stands at approximately 53% of national output; and the corresponding ratio for profligate Italy peaked at 125% in 1994 before subsequently beginning to shrink. Judged by these standards, markets have already given Japan the benefit of the doubt.

Indeed, to stabilize the debt at today's levels Tokyo must adopt spending cuts and tax hikes that would, in combination, improve its budgetary position by 8% of GDP. It is hard to see how the government of any democracy could impose such draconian burdens on its citizenry. A policy of "muddling through", however, would ineluctably cause the scale of the necessary adjustment to increase. The Economist Intelligence Unit calculates that the gross national debt will surpass 190% of GDP in 1996 and 230% of that standard by 2010. Standard & Poors is slightly more sanguine, putting the figure for the latter year at "only" 200% of GDP. But in either case balancing the budget would require transferring well over a tenth of annual economic output from the household sector to the state—a feat that would assuredly be impossible within the present political system.

The day of reckoning need not come soon. Fund managers do not care if a disaster is inevitable, only if it is likely to occur within the relatively short timeframe over which they are investing. Institutional investors will accordingly maintain their holdings of Japanese assets as long as they perceive the benefits of international diversification and high real yields as outweighing the danger of a market crash. This will enable Tokyo to issue more and more JGBs, and the national debt will continue to expand even as the financial system gradually grows more vulnerable. The situation will become especially parlous toward 2008-2010, when the government must simultaneously increase its social security payments and roll over a very large volume of outstanding JGBs. Eventually, an otherwise manageable crisis—perhaps the disintegration of the LDP, the failure of a major banking group, a terrorist strike in Tokyo, or a military conflict in the Middle East—will frighten even the most conservative Japanese investors, who will redeploy their capital to safer foreign markets. The interest rate that the government must pay to borrow will then rise sharply, and Tokyo will have no alternative but to compel the BOJ

to print money and purchase prodigious quantities of JGBs. Now the laws of supply and demand will take effect; and the value of stocks, bonds, and the yen will plunge in a manner that could, given the right policies, enable the current account surplus to expand. Belatedly and inadvertently, Japan will have entered the depreciation scenario.

The third way in which Japan might try to maintain macroeconomic balance—and the one with which both Prime Minister Koizumi and the Bush administration appear enamored—is structural reform. Enthusiasts variously emphasize deregulation, the privatization of semi-public corporations, the reorganization of banks, and attracting more foreign investment, but these programs share some common features. They all, for example, envisage a period of 2-3 years in which feckless corporations are pushed into bankruptcy, the unemployment rate rises, and social and political stresses mount. To ameliorate this pain, they presume supportive macroeconomic policy, including tax cuts and additional fiscal spending. Finally, they all expect the companies that emerge from this process to be more profitable and more willing to release their earnings to the household sector. Once the economy has started expanding again, a combination of higher returns on market investments and better employment prospects will encourage households to increase their consumption. With both the corporate and the household savings rates falling, Japan's capital surplus will contract and the corresponding strains on the government budget and the current account will abate.

The logic informing this scenario, however, is flawed in several respects. For example, the reformists' argument does not fully register the effect of restructuring on enterprise behavior. It is true that greater competition, stronger corporate governance, and a better understanding of the cost of capital would motivate enterprises to distribute more of their earnings to shareholders—and hence would lower the corporate savings rate—but market forces would also compel enterprises to curtail their wasteful investment spending. If capital expenditures fall as quickly as corporate savings, the sector's net financial position might not change at all.

Nor is the household sector's capital surplus likely to contract much. Rehabilitating banks and corporations is but the first step in repairing the economy: building household wealth so that the elderly may retire comfortably is also crucial. This, however, will be a real challenge. People did not feel sufficiently rich in 1989 and 1990, at the height of the real estate and stock market bubbles; and since then, they have lost over ¥500 trillion in wealth and seen their future tax burdens grow more onerous. If workers want to recoup some of these losses before leaving their jobs, they will insist on hoarding their income long after the restructuring process has reached fruition. In other words, if Japan embarked on a program of comprehensive reform in early 2003 and completed that effort by early 2006, consumption would stay anemic through the end of the decade. In the interim, the country would still suffer from an elevated savings rate and inadequate aggregate demand, the government would be forced to maintain its aggressive fiscal policy, and the national debt would grow at more or less the same pace as in the “muddling through” scenario. Put simply, any invigoration of domestic demand would come too late to render the government's finances sustainable.

In summary, then, all three strategies lead to the same destination: yen depreciation and a massive expansion in the current account surplus. The differences lie in the timing of this adjustment and the extent of the ensuing economic trauma. In the case of intentional devaluation the currency falls quickly, whereas in the fiscal and reform cases depreciation comes much later—possibly toward 2010—and is triggered by capital flight. This delay is important because it translates directly into a bigger national debt. If the adjustment occurred today, when the debt is “only” 140% of GDP, the inflationary transfer of wealth from creditor households to indebted corporations and the government would be relatively modest. But if the adjustment is postponed until the country's obligations have grown larger, it will require commensurately more inflation and a greater fall in living standards to redress its finances. The question, therefore, is how much Japan is willing to pay for a few more years of relative tranquility.

The Road Chosen

The safest bet is that the country will dither as long as possible and then pay a very high price. The ruling Liberal Democratic Party (LDP) has maintained power for the last 47 years, almost without interruption, by cultivating close relations with a range of established economic interests. Some of these depend heavily on imports and would be severely harmed if the yen weakened. Households, too, would suffer as depreciation eroded their ability to purchase foreign goods and services. Political exigency would thus inhibit the main factions of the LDP from embracing a policy of aggressive depreciation. Equally compelling in this regard is the effect that a plummeting yen would have on Japan's diplomatic stature. When the currency fell to ¥147 per dollar in August 1998, China denounced Japan's behavior as irresponsibly hurting its neighbors and temporarily persuaded the Clinton administration that Beijing was a more reliable diplomatic partner than Tokyo. Memories of this discomfiture are vivid in Japan, as are fears that another episode of marked depreciation would permanently vitiate the country's international powers. So while LDP governments may favor moderate depreciation to stimulate GDP growth within the existing economic system, they will not seek to balance aggregate supply and demand through the current account. Instead, they will pursue a spendthrift fiscal policy, probably interspersed with some half-hearted attempts at reform, until investors panic and Japan's markets crash.

By itself, however, a sharp fall in the value of the yen will not close the gap between aggregate supply and aggregate demand. Once the yen has dropped to ¥160 or ¥180 per dollar the Japanese government will presumably panic, announcing far-reaching structural reforms and pledging to raise taxes and cut the budget deficit. Capitalists may then reallocate their money back into Japan either to participate in the promised corporate restructuring or, more cynically, to benefit from short-term market rallies. This inflow would push the exchange rate back up. The benefits of a weaker yen would also decrease due to "real appreciation", as the higher price of imports gradually pushed up export prices and thereby eroded Japan's gains in competitiveness. For both of these reasons Japan could reach a new economic equilibrium with the real value of the yen somewhat lower than today, and the current account somewhat bigger, but with aggregate demand

still deficient. Since GDP growth would remain elusive, the government must persist in its deficit spending to prevent recessions, and the national debt would continue to rise—albeit more slowly than in the late 1990s and early 2000s. After some time a new shock would precipitate capital flight, provoking the second in what could prove a long series of cyclical disturbances.

Yet if at any point Tokyo chose to interpret the yen's depreciation as a sort of *force majeure*, relieving it of its domestic and international constraints and enabling it uninhibitedly to cultivate external demand, the outcome might be more positive. In this case the government would prevail upon the BOJ to purchase as much foreign currency as necessary to counteract capital inflows and real appreciation, thereby keeping the current account surplus near its target size. Foreigners would denounce this intentional depression of the exchange rate, to be sure, but Tokyo could reasonably respond that it was in everyone's interests that the world's second-largest economy return to health. In effect, Japan would force the rest of the world to adjust to its preferred level of savings.

The Implications for the Rest of the World

The threat posed by Japan's financial problems should not be underestimated. Smaller countries have occasionally run very large current account imbalances, but it would be virtually unprecedented for a global economic power to produce a surplus that consistently measured 10% of GDP. At today's exchange rate that would mean an additional \$400 billion in net Japanese exports and an equal volume of new capital outflows. The world could not easily absorb such a shock. Among the particular challenges would be the destabilization of Japan's domestic politics, greater volatility in the country's foreign and military policies, and a strong deflationary influence over East Asian and global markets.

Within Japan, depreciation of the magnitude contemplated in this paper would wreak havoc in import-dependent industries, causing bankruptcies to proliferate, banks to fail, and the unemployment rate to surge. In this sense the country would experience many of the social and political stresses that it avoided so sedulously in the 1990s. During this

interlude there will inevitably be recriminations against those politicians, regulators, and business people whom the electorate blames for its discomfiture. If the LDP has survived until this late date, it may now fragment and its factions coalesce with other political groups to form new parties with distinct ideologies and objectives. No one should be surprised if several governments rose and fell in rapid succession, and if Japan's internal and external policies became rather mercurial.

The possibility of diplomatic instability is one that deserves particular attention. Among the likely targets of popular indignation will be foreign interests that are perceived as having contributed to, or profited from, Japan's misfortune. This would be particularly hazardous for China, which has long tried to supplant Japan as the dominant political and economic power in East Asia and whose assertiveness is already a source of some consternation in Tokyo. As Japan slides into economic turmoil and voters lose confidence in their leaders, the public may grow more fearful of Chinese influence and the bilateral relationship become more contentious. But US interests could also be jeopardized, for while the Bush administration has wisely refrained from the "Japan Bashing" of the late 1980s and early 1990s, it has vociferously urged Tokyo to implement structural reforms that would entail considerable pain but can no longer avert a financial crisis. If the Japanese people believe that this advice was wrong, or tendentious, they may blame the United States for their travails.

It is at this point that Japan's economic tragedy could threaten East Asia's security. Whatever its shortcomings, the LDP has long supported the defensive alliance with the United States. This bulwark has obviated the need for Tokyo to develop an independent military policy, and hence has fostered the pacifistic culture that now flourishes there as well as partially assuaging the geopolitical concerns of other regional states. It would be a pity if this advantageous situation were undermined by a combination of popular fury at the LDP and misunderstanding of Washington's role in the economic debacle. For in these circumstances many Japanese might decide that they cannot rely on outside assistance and that their country must adopt a more assertive security policy. The likelihood of strategic miscalculation in East Asia would then rise.

The economic repercussions of a Japanese crisis would be equally profound, as illustrated by the cases of Southeast Asia, China and Hong Kong, and the United States. Since 1998 most of the Southeast Asian countries—with the exception of Malaysia and a few others—have abandoned their pegs to the dollar and opted either for floating exchange rates or for pegs to trade-weighted baskets of foreign exchange. As a result, many of the regional currencies have tended to move in closer alignment with the yen than they did in the past. With more or less government intervention, those currencies should be able to follow the yen downward against the dollar and the euro. But this transition would not be smooth; for the yen's value may fluctuate widely while Japan works to achieve a new equilibrium, and the other currencies could not replicate those movements exactly. Even if this volatility proved transitory, it would increase the markets' perception of risk; raise the cost of hedging; and, on the margin, discourage international investment. Although these setbacks should not prove insuperable for comparatively resilient states such as Thailand and Singapore, they might upset the already fragile government of Indonesia and they could divert its neighbors' attention from the struggle against terrorism and other multi-national endeavors. It seems likely that all diplomatic campaigns involving the region would become somewhat harder to organize and prosecute.

The People's Republic of China (PRC) and the Hong Kong Special Administrative Region (SAR) are situated differently because their currencies are pegged and fixed, respectively, to the dollar. Here depreciation would require overt changes in policy. As in 1998, however, the PRC's first inclination would be to defend the existing *Renminbi* exchange rate and to contrast its restraint with Tokyo's failure to support the yen. At a time when many of the other East Asian currencies were rapidly losing value, this resoluteness would earn Beijing considerable gratitude in Washington and many other capitals. Any longer-term decision must wait until the impact of the yen's depreciation on China's external balance became clear. Then the choice would be made on mercantilist grounds: if adhering to the peg caused the current account to deteriorate into a structural deficit, the government would opt for devaluation in order to protect its foreign reserves. Yet this would presumably be a modest change, one that left the

Renminbi significantly stronger, on average, than it is today and hence allowed the PRC to argue that it was helping promote regional stability and global economic growth.

This effective appreciation would present various domestic difficulties. Trade comprises almost half of China's GDP, so depending on how strong the *Renminbi* remained, the country could lose anywhere from one to three percentage points from its annual growth rate. If the losses were minimal, their primary impact would be to retard the pace of political and economic reform. Beijing believes that its present growth rate is only slightly above the level necessary to maintain social stability, and when economic activity decelerates the government routinely tempers or postpones controversial policy initiatives. Thus one might expect the PRC to step back from the reorganization of the State-Owned Enterprises, the restructuring of the state banks, and further efforts to increase tax revenues. But if the losses were larger, the Chinese government would see its public support diminish and could experience more frequent instances of popular unrest. Frightened by these trends, Beijing may feel compelled to repress dissent even more ruthlessly than it presently does, or to play the nationalist card by adopting a bellicose attitude toward Taiwan and inveighing against the United States and Japan for their contributions to that island's *de facto* autonomy. If this happened at a time when the Japanese people were already feeling insecure, the probability of strategic misunderstandings would perforce increase.

Hong Kong would likewise be caught between a desire to hold fast to its present exchange rate on the one hand, and the challenge of a regional devaluation on the other. The SAR got a foretaste of this dilemma in the East Asian Financial Crisis of 1997 and 1998, when most of its neighbors' currencies plummeted in value. Because its exchange rate with the US dollar was fixed by means of a currency board, Hong Kong's terms of trade deteriorated sharply; and the only way the economy could regain its competitiveness was through a debilitating bout of deflation. Thus producer and consumer prices declined by 4.7% and 9.4%, respectively, from 1997 to 2001. The effect of deflation on asset prices was even more pronounced—as evidenced by a 46% slide in the Hang Seng stockmarket index in the year after August 1997. Not surprisingly, given

this enormous loss of wealth, Hong Kong's real growth rate slowed from an average of 4.6% between 1994 and 1996, to 2.5% in 1997, and then to an alarming -5.7% in 1998. At least some of this pain might have been avoided if the SAR had chosen the path of devaluation.

Hong Kong is still vulnerable to this dynamic. If the yen and other East Asian currencies suddenly depreciated and then stabilized at much lower levels, prices within the SAR must again adjust downward. But since the scale of the regional devaluation would be much larger than in 1997, the ensuing recession would also be deeper, longer, and more painful. Hong Kong's standard of living would fall in this process, and criticism of the government would intensify until at some point the authorities felt compelled to reconsider their commitment to the currency board.

Widespread depreciation would likewise harm the US economy. In the emerging markets crises of 1997 and 1998 the United States played a very important remedial role: the Federal Reserve held interest rates lower than it would otherwise have done in order to provide liquidity to the global economy and to stimulate spending by American corporations and households. In essence, the people of the United States functioned as "consumer of last resort", providing the incremental aggregate demand needed to prevent a global recession. But this was a costly policy insofar as subnormal interest rates contributed to distortions in asset prices and excessive corporate investment. These excesses were revealed when the bubble burst, leading to a recession in 2001 and depressing GDP growth for months, and perhaps years, thereafter. Saving the world would prove even more costly if the yen attained a long-term equilibrium somewhere beyond ¥250 per dollar. Japan provides 11% of all US imports, and most of these are concentrated in a few sectors, such as automobiles and electronic goods. If the dollar price of these imports declined by half, the unemployment rate in some American industries and geographical areas would spike upward. The devaluation of other Asian currencies would exacerbate this effect, especially if China, which accounts for another 9% of US imports, followed suit. Thus a wave of deflation would emanate across the

Pacific and engulf the United States, sweeping away many corporations and banks and causing protectionist sentiment to rise.

Washington would presumably resist this pressure because, as in the late 1990s, it would see the stabilization of the global economy as essential to American interests. So rather than engaging in competitive devaluation or raising new barriers to trade, the US government would attempt to invigorate domestic commerce. Monetary policy, however, would quickly prove ineffectual. The United States has already absorbed several deflationary blows—including the stagnation of the Japanese economy, the financial crises of the middle and late 1990s, and the implosion of the American stockmarket bubble—and these have persuaded the Federal Reserve to lower short-term interest rates to a scant 1.75%. If interest rates are still this low when the Japanese debacle occurs, the Fed will have very little room for further monetary stimulus and the government will be forced to rely disproportionately on fiscal spending as a means of bolstering aggregate demand.

This would be inconvenient in at least two respects. First, since the Japanese yen and several other East Asian currencies would remain weak for five or ten years, the United States must persist in its loose fiscal policy for a long time. It would now be the American government and not US households or corporations that served as “consumer of last resort”. The budget deficit and the national debt would accordingly rise more quickly than economists presently reckon. Second, and more problematically, the United States would now have fewer tools with which to address additional contingencies. In the event of a major terrorist strike against the United States, or a war in the Middle East or on the Korean Peninsula, the Federal Reserve could not react by slashing interest rates and the executive might have trouble expanding the budget deficit still further. The same logic would apply to the other economies—certainly the European Union and perhaps China—that were resisting the temptation to debase their currencies. Put simply, none of the big economies could easily provide additional aggregate demand, and the risk of a global recession would be greater than at any point in the last several decades.

Conclusion

Given the magnitude of these risks, it is essential that the international community take another look at Japan's economic situation and prospects. Instead of observing that Japan is not Botswana or Argentina—which is both true and irrelevant—the optimists should explain how Tokyo can close a budgetary gap that totals 8% of GDP and will only grow larger with the passage of time. If they cannot offer a plausible answer to this question, then they must acknowledge that the national debt is already beyond control. Meanwhile, rather than throwing up their hands in frustration at Japan's official intransigence, the pessimists should focus on the implications of a debt crisis. These include internal and diplomatic instability, short-term volatility in foreign exchange markets, and pronounced deflationary tendencies in global financial markets.

The major powers must prepare for these eventualities. Geopolitically, they must work to ensure that Japan's financial collapse does not jeopardize East Asia's diplomatic and security relationships. For Beijing, this means assuming a less critical stance toward Tokyo and letting events naturally and unobtrusively enhance Chinese influence. For Washington, it requires shifting to a conservative rhetorical position that de-emphasizes economic policy and focuses instead on the importance of continued defensive cooperation. In addition, the United States should seek greater operational integration of its armed forces and Japan's so as to engender more mutual trust and respect. Such goodwill is invaluable, for it improves the chances that the Japanese people will remain committed to the bilateral alliance even in adverse circumstances. Economically, meanwhile, the G7 countries should tolerate a higher degree of inflation and nominal interest rates than they have in recent years so that central banks have more tools with which to address future emergencies. Perhaps the European Union should revisit its Stability Pact, which, by limiting governments' fiscal and monetary powers, is already retarding GDP growth. What these and other governments must realize is that the greatest threat to global prosperity is no longer inflation but deflation, and its embodiment is Japan.

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