The Financial Crisis and the Tectonic Shifts in the US-Japan Relationship

R Taggart Murphy

The Financial Crisis and the Tectonic Shifts in the US-Japan Relationship

R Taggart Murphy

Daniel Okimoto has written an important article for the *Asia Pacific Review* (vol 16, #1, 2009, pp. 35-55) on the implications of the ongoing financial crisis for US capital dependence on Japan and China. Abridged versions of the article have appeared in both the Japanese and English language editions of the *Asahi Shimbun*. Okimoto's analysis provides a springboard for wider reflections on how the crisis is bringing on tectonic shifts in the US-Japan relationship – and ultimately may alter Japan's place in the world.

Right at the start of his piece, Okimoto reminds the reader of Japan's central role in financing US deficits. This reminder is needed because so much discussion of the issue today focuses exclusively on China's position as a lender to the United States. While it might seem impossible to exaggerate China's importance, many commentators manage to do just that. They present China's emergence as the key foreign purchaser of American government debt in this century as an event *sui generis*, ignoring the preceding decades in which it was Japan that played the central role in permitting Washington to run up deficits with impunity. And they overlook the degree to which significant elements of China's race to industrialization were consciously modeled on Japan's postwar experience – a model that called for the deliberate fostering of globally competitive export manufacturers and the accumulation and hoarding of the international reserves, principally dollars, earned through trade and current account surpluses.

Central Bank holdings of US Treasuries 2007/ 08

Okimoto makes no such mistakes. Taking an American perspective on the evolution of today's global financial architecture and the crisis it faces, he coins the label "mercantilist finance" to describe "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." And he begins his analysis of this system with the US Occupation of Japan and the way it set the parameters for the subsequent unfolding of the postwar US -Japan relationship.

Okimoto calls this system "historically unique" since it features capital moving "from developing to developed regions, not the other way around." Okimoto emphasizes the sharp contrast with earlier global regimes in which the richest, most highly developed countries – e.g., Great Britain of the Victorian era – invested surplus capital in less developed parts of the world. Such a pattern to global capital flows makes intuitive sense, but in the last half-century, the flows have been reversed as the world's richest nation also became the world's leading debtor nation and consumer of capital.

Perhaps one explanation for the system's uniqueness lies in its origins in the singular nature of the the early 1950s. For it was the logic of events in that era that led what was then a desperately poor, war-ravaged Japan into constructing the foundations of its postwar economic policy regime on the twin pillars of exports and the accumulation of dollar claims on the United States. Long before Japan had achieved anything like industrial parity with the United States, it was already shipping surplus capital to that country – and, as the 20th century closed, Japan would be joined by the other Asian rising powers in sending surplus capital across the Pacific to a supposedly richer and more highly developed United States. As I have noted elsewhere, (see "Asia and the Meltdown of American Finance" (http://www.japanfocus.org/-R_Taggart-Murphy/2931)) Japan's postwar economic regime came about through a process more akin to biological evolution than conscious political choice. A number of factors converged to make it seem inevitable in retrospect. They start with the incomplete Occupation purges of Tokyo's wartime elites. The purges eviscerated those elements of the Japanese power structure directly involved in the war itself – the military plus the social control bureaucracies of the *Naimusho* (Interior Ministry) -- while leaving the economic policy apparatus largely intact. Given the overwhelming priority in postwar Japan of rebuilding its ruined economy at a time when the United States was making all the decisions about Japan's security arrangements and the conduct of its foreign relations, the remnants of Japan's governing elites found themselves inhabiting a political space where they could subordinate all other policy concerns to economic reconstruction.

Nearly as important were balance of payments pressures to accumulate and hoard "hard" currency and the sudden, if temporary, relief from those pressures by a surge of American supply orders during the Korean War. Filling these orders brought on a flood of desperately needed dollars into Japan's coffers at a time when dollars were the only form of hard currency on offer. After the war ended, urgent US desires for a visible, non-Communist "success" to hold up as a kind of token in warding off the then-powerful pull of the Stalinist model to developing world elites – not to mention fears that Japan itself could go "red" – induced the US to grant Japan unrestricted access to American markets without insisting on reciprocal access. The first postwar surge of Japanese exports into the US market got under way. By the mid 1950s, American household purchases of Japan's cotton textiles had replaced American military supply orders as the primary provider of the country's hard currency earnings.

Meanwhile, Japan's policy elite was determined to finance the country's re-emergence as a great economic power from internally generated savings. Without money flowing in from foreign direct investment, the only remaining source of hard currency to pay for critical capital imports was exports. 1955 saw the foundation of Japan's Liberal-Democratic Party ("LDP") and the bureaucrat-LDP-large company nexus that would dominate Japanese political and economic life for the next half-century, with the fostering of export-competitive industries as the unwritten national goal.

Japan's Postwar Economic Regime becomes the Asian Model of Development and the Key Prop for the Survival of a Dollar-centered Global System.

Japan's postwar economic regime may thus have arisen without much in the way of political discussion or sense that any alternative was possible, but its continuation long after a complete transformation in the environment that fostered its birth has been very much a matter of political will. It has been nearly 50 years now since Japan needed to worry over its ability to pay for essential imports, and Japanese companies now supply many of the capital goods that the rest of the world uses to equip its factories. Communism no longer offers an alluring alternative roadmap to development. Meanwhile, as Okimoto notes, the United States has gone from being the world's premier creditor – and pretty much the only source of hard currency – to being the largest debtor nation in history. And while the dollar continues for the time being to serve as the closest thing to a universal currency, there are now serious competitors: the Euro, the yen, and – perhaps somewhere not too far over the horizon --the renminbi (yuan).

Yet ever since the breakup in the early 1970s of

Bretton Woods -- the formal institutional postwar global regime that had enthroned the dollar as the world's money and under which Japan had constructed its export-led economy – Japan has consciously acted to recreate its certainties. In every subsequent dollar crisis, Japan intervened to support the American currency and, as Okimoto notes, has continued to denominate the great majority of its export earnings in dollars. On many occasions such as the dollar support operations of summer 1978, the aftermath of the 1987 stock market crash, and the joint US-Japan market interventions of 1995 in the wake of the Mexican peso crisis, these dollar support operations have been initiated by Japan's Ministry of Finance with the support and political cover of the LDP.

In the last two decades, Japan has been joined in its dollar accumulations by China and the other major economies of East and Southeast Asia – a process that accelerated after the Asian Financial Crisis of 1997/98. The lesson most regional governments took from the travails of such countries as Thailand, Indonesia and South Korea during that crisis was to pile up a thick cushion of dollar reserves as means of protecting themselves from future balance of payments crises.

The result has been the emergence of a distinctive Asian Development Model that enshrines exports, trade and current account surpluses, and the accumulation of international reserves – largely denominated in dollars – as the pre-eminent goals of economic policy-making. The model, adopted almost everywhere in the region, quite deliberately seeks to copy both Japan's economic methods and the country's success in becoming a fully industrialized, developed economy. (The significant deviations from the Japanese prototype lie in varying degrees of openness to foreign direct investment.) And indeed the model has been adopted so well that, as Okimoto points out, China has now joined Japan as one of the world's two largest holders of dollars outside the United States itself.

So what we have is conscious political choice on the part of Japan to continue to structure its economy around a model long after the environment that had led to its birth had changed radically. And a conscious political choice by Japan's neighbors to implement much of that model in circumstances very different from those in which Japan found itself in the 1950s. The United States has never, for example, decided for the People's Republic of China how it will defend itself or conduct its international relations. And by the time countries like China and South Korea began running large trade surpluses and emerged as major holders of dollars, the United States was no longer the world's premier creditor country but had become its largest debtor.

Okimoto asks “why” these choices were made and continually re-enforced, since by denominating their export earnings in dollars, Japan and China are automatically lending the United States "huge sums to feed America's insatiable consumer appetite." Okimoto writes that "one reason is that (Japan and China) have not generated sufficient domestic demand to reach their own targeted rates of economic growth" although to some extent this is begging the question since both countries have deliberately eschewed policies that would increase domestic purchasing power. You can't have it both ways; you can either run an economy to generate trade and current account surpluses – suppressing the exchange rate of your currency and following other measures to reduce consumption and encourage savings – or you can run an economy that puts domestic demand in the driver's seat. But gunning domestic demand is essentially a matter of suppressing savings, and as any freshman in an introductory macroeconomics course can explain, when domestic savings outstrip domestic investment, the laws of accounting will automatically produce a current account surplus, and vice versa. A country like the United States that doesn't save "enough" will run a current account deficit; one that like China saves "too much" will run a surplus. (Whether policy makers devote their attention to domestic variables such as savings vs. consumption or target their country's external accounts is typically determined by some mixture of national priorities, political pressures, and intellectual fashions. But the point is, one cannot "generate sufficient domestic demand" without reducing the current account surplus and vice versa. The current account represents the sum total of a country's current economic dealings with the outside world; it captures not only trade but also interest and dividend flows and transfers.)

Okimoto goes on to note that Japan and China have received a "basket of benefits" from their policies that have had, as their end result, the "huge sums" lent to the United States. Among those benefits he emphasizes, significantly, are "higher rates of employment" that serve to "preserve social order and political stability." He is writing primarily here of China; one would also have been interested in his thoughts on why Japan has also consciously acted to support the global financial regime of the past half-century. He does note that this regime has "been one of the most indispensable sources" of US "staying power" permitting the US to act as the "world's cradle of entrepreneurship, innovation, global productivity, and growth." And he adds that all three countries have become "locked in a symbiotic relationship of complex interdependence" the "breaking" of which would be "extremely costly" with the result that "each nation has an overriding stake in keeping the system working smoothly."

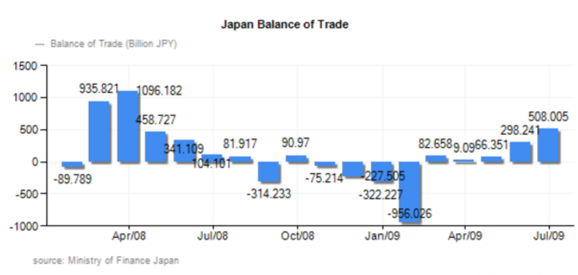
The Break-Up of the Global System?

Alas, the financial crisis may bring on what no one in Beijing, Tokyo, or Washington wants to see – the "breaking" of that system. And while the crisis is indeed proving "extremely costly," it is not clear any more that the system can be restored to what it was.

The reason lies in the collapse of American lending and the readjustment of American household balance sheets. The dry-up of credit in the American financial system brought on by the crisis has forced households to pay down debts – in other words, start saving more. Okimoto notes some of the parallels between what the United States is going through now and what Japan endured during the years that followed the bursting of Japan's late-1980s bubble. But one parallel he may have overlooked is what Richard Koo has labelled a "Balance Sheet Recession" in a book of that title. In a "balance sheet recession" those who borrowed to purchase assets at inflated prices are forced, following the collapse of the asset bubble, to use whatever earnings they can lay their hands on to pay down the debts taken on during the bubble period since the assets are no longer sufficient to cover the debt. In Japan, those debts were largely on the balance sheets of the corporate sector, but in the United States, it was households that took on huge debts, mostly to finance residential purchases.

As American households have found themselves forced into the stark choice of personal bankruptcy or borrowing less and saving more, American household savings have begun to climb. Okimoto notes that US savings rates have risen over the past year from essentially nothing to 4% of income. In an economic environment in which private investment has largely disappeared, the rise in American household savings is inevitably producing a fall in the American current account deficit as US imports decline even more rapidly than its exports.

Since one country's deficit is another's surplus, a fall in the US deficit means a fall in some other country's surplus – and that other country seems to be Japan. (As Michael Pettis notes, "China's trade surplus has contracted very slowly – much more slowly than the contraction in the US trade deficit" -- see http://mpettis.com/ , July 29, 2009 – Pettis goes on to write that "China's share of the US trade deficit has grown significantly. Since the US trade deficit is shrinking quickly, this means that other exporters are getting killed."). Japan is now running the first trade and current account deficits that that country has experienced since the late 1970s during the so-called Second Oil Shock.



Japan's balance of trade

Thus the benefits Japan has been receiving from its participation in the dollar-based system have disappeared. Japan's export numbers are tumbling – bad news for an economy whose export sector has long been its primary engine of growth. Indeed the conventional wisdom now sees Japan's outlook as the worst of the three key players in the global dollar-based financial system – and, indeed, perhaps the darkest of all the major developed economies. It is a real challenge today to find anyone with anything positive to say about Japan's near-term economic future.

There is no mystery as to why. The one globally competitive area of the Japanese economy -- the manufacture of high-value added products for export -- is precisely the area that is hardest hit by the current downturn. America's Great Recession has not only shrunk Japan's leading overseas market for high-value added finished goods (automobiles perhaps the outstanding case in point), it is also playing havoc with its overseas markets for capital goods. Chinese factories, for example, had emerged in recent years as major buyers of Japanese machine tools and other capital equipment, but with their own sales into the American market plummeting, they are not placing many orders today for more equipment.

Meanwhile, other areas of the Japanese economy continue to be plagued by overstaffing and other inefficiencies – a legacy of Japan's understandable reluctance to undermine the institutions and practices that stave off widespread economic distress. The unwillingness to lay regular employees off even when there is nothing for them to do, the pressure on companies to bail out their suppliers and on financial institutions to keep credit flowing to near-bankrupt firms, widespread and seemingly wasteful public works spending – these constitute the actual fabric of Japan's safety net. In the absence of strong, explicit and comprehensive public sector social security arrangements, a government weakens them at its peril. Yet, so the conventional wisdom goes, by propping up so many inefficient firms, by discouraging a genuine market in corporate control from taking root - a market that would force companies to fire people and squeeze supplier costs or face loss of independence - Japan's governing elite prevents the emergence of a leaner, more productive economy.

But despite all these arrangements to re-assure Japanese households that they will not be made destitute, households nonetheless fear declining incomes, inadequate funds for retirement, and outright job loss. They have good reasons. Japan's population is aging rapidly; most middle-aged people are aware that the funds they themselves, their employers, and their government have put aside to finance their retirement are inadequate. Their children are having difficulty finding the desirable "lifetime employment" jobs of the past as companies turn increasingly to part-timers who can be easily laid off. So households don't spend; they don't take up the slack from diminishing export earnings. Japan's ends up with the worst of both worlds: a hugely expensive safety net that doesn't really allay economic insecurity.

Add to the cost of that social safety net the constant pump priming to keep the economy from tipping into depression while the jaws of demography close around Japan's government obligations, and the result is a terrifying fiscal outlook. Again, Japan ends up with the worst of both worlds. Usually, a country facing Japan's fiscal nightmare – Italy, for example, in the pre-Euro days – will see the exchange rate of its currency fall, thus restoring a degree of competitiveness to the country's exports. But as Japan enters the unchartered territory of current account deficits with the collapse of its overseas markets, the paradoxical result is a rising yen. Japan has begun to liquidate the great horde of dollar reserves accumulated over the past half century – a process that is pretty much inevitable once the current account goes into deficit. But as Japan sells dollars, the result is to drive up the exchange rate of the yen, since the dollars Japan holds are being sold for yen. The stronger currency makes Japanese goods more expensive in global markets, further reducing the country's ability to do what it has done to pull itself out of every previous crisis from the end of the Korean War to the oil "shocks" of the 1970s and the bursting of the late-80s bubble: export like mad.

Okimoto notes that between 1982 and 2006, Japan earned some net $280 billion from its foreign reserve holdings, some 88% of which he says are in the form of US treasury and agency bonds. Okimoto reaches that $280 billion number by subtracting the $70 billion that the depreciation of the dollar against the yen has cost Japan from the positive spread or "carry" Japan has enjoyed between dollar and yen interest rates – some $350 billion. But the "carry" has largely vanished since the onset of the current crisis as the Federal Reserve has cut dollar interest rates to practically zero. Meanwhile, as the yen climbs, the exchange loss on the reserves threatens to accelerate.

In other words, as an era of current account deficits arrives for Japan, not only will the country be unable to continue building up its reserves, there is no longer any good economic reason for doing so. Japan will be losing money on its dollar reserves – if it isn't already – while the export markets they long helped keep afloat are shrinking (by holding its reserves in dollars, Japan was effectively financing its biggest export customer, the US). On top of it all, the Japanese government may well be forced to liquidate many of its existing dollar holdings in order to meet some portion of its galloping fiscal obligations.

Recent statistics show this is starting to happen. Japan's holdings of US Treasury securities have begun to fall significantly, dropping 1.3% between April and May, the latest month for which numbers are available. (link (http://www.treas.gov/tic/mfh.txt))These statistics indicate that China's official holdings at $802 billion are now markedly higher than Japan's official $677 billion. Because of widespread private sector holdings of dollar securities in Japan, Japan may still be a larger net lender to the US, but the significance here is in the trend. If this trend continues – and there is every reason to expect that it will – we will be seeing one of two things occur. Either the era of the dollar's run as the closest thing to a universal currency will end. Or the dollar will continue for some time as the world's money, but with China gradually replacing Japan as the primary external supporter of the American currency.

Evidence for the moment tends to favor the latter scenario. Okimoto writes that “with the US and Europe now saddled with onerous deficits, the dollar and euro appear to be headed down the road to currency depreciation.” To which the response would be, “against what?” These two are the world's principal currencies and the exchange rate of one is most commonly measured against the other. Since they cannot simultaneously depreciate against each other, if both are to depreciate, that must mean that they will depreciate against third currencies and/or that their purchasing power will depreciate – a way of describing inflation. So far few signs of inflation exist either in the US or in Euroland, while the two currencies have generally held their own against most third currencies – except for the yen, which has been climbing.

This suggests that both political will and economic realities are acting for the time being to prevent a run on the dollar; i.e., that the dollar-based international system still stands. It is in no one's interests – save perhaps those of radical Islamists – to see the dollar collapse and take with it today's global monetary architecture. And indeed, whatever noises China may be making publicly about the need to move beyond a unipolar global currency regime, the numbers for the time being show that China is increasing its purchases of US government debt – the same statistics that show a fall in Japan's holdings indicate that China's rose in May by 5%. And while political will may be insufficient to stave off bad economic outcomes (after all, no major government wanted to see what has happened to global finance over the past year), so far, despite a good deal of apocalyptic talk, there is no evidence of any worldwide flight from the dollar, no evidence that the US Treasury is having any difficulty selling its debt despite soaring US government deficits, and no evidence of serious inflation in any of the world's major economies – if anything, deflation seems more of a real worry.

But a world in which the primary external support for the US dollar comes from China rather than Japan is going to be very different from that to which policy makers in Washington and Tokyo have become accustomed over the past half century. Okimoto is absolutely right when he says the result will be an inevitable "reorientation of US-Japan relations," but I am not sure I agree with Okimoto that the re-orientation is going to "elevate the strategic importance of Japan to the United States."

Tectonic Shifts in the US-Japan Relationship

In the decades since the Occupation, a quid-pro-quo relationship has evolved between Tokyo and Washington. The quids and quos, if you will, are rarely articulated or even necessarily understood by political leaders in the two capitals. But they have nonetheless served as a kind of hidden electronic fence, setting a perimeter beyond which neither government would go. Japan would always act to support the dollar and do whatever was necessary to see that American external deficits were financed. Tokyo would at a minimum pay lip-service to American foreign policy goals – whether those be the "containment" of Communism or the "war on terror" – and grant the United States unrestricted access to a network of bases throughout the Japanese archipelago. For its side, Washington would never let trade tensions escalate to the point where Japan's access to the US market was ever seriously at risk. It would provide Japan a nuclear umbrella or at least act so as to create sufficient uncertainty in Moscow, Pyongyang, and Beijing to ensure that leaders in those places would never openly consider a direct military attack on Japan.

These arrangements have permitted governments in in the United States and Japan to avoid facing up to fundamental political dilemmas. In Washington's case, they have rendered politically tolerable to the American taxpayer the financial burden of the country's vast, bloated military establishment. "We learned under Reagan that deficits don't matter," said former Vice President Dick Cheney, and in the world he grew up in, where the Japanese were always there to pick up the tab when crackpots convinced Washington you could cut taxes without cutting spending, he was right. You can have all the expensive military toys and wars of choice you want when someone else is there to lend you the money to pay for them – someone who never asks to be repaid.

Meanwhile, in Tokyo, the American nuclear umbrella meant that no government had to think about the need to bridle a bureaucracy with the means of physical coercion at its disposal. The machinations of Yamagata Aritomo at the end of the Meiji era to insulate Tokyo's permanent bureaucracy from political interference had set the stage for a system of colossal irresponsibility. The apple of Yamagata's eye, the Japanese Army, proceeded on its own initiative to drag the country into the morass of an endless land war in Asia and then intimidate its rivals in the Navy into provoking another war with the world's emerging superpower – a war its own analysts knew could not be won. Japan's defeat and the subsequent American Occupation did not change the fundamentals of its governing setup: policy-making by unaccountable bureaucracies; they simply removed the military for the time being from the picture. But there is still no real brake on a bureaucracy that decides for its own reasons that something needs to happen.

No one today can figure out a way to stop a Land Ministry hell-bent on damning every last free-flowing river in the country or paving over every last wetland. No one can rein in an Education Ministry more concerned about a handful of far-right agitators who want to whitewash the history presented to schoolchildren than about critical relations with Japan's neighbors (see the discussion (http://www.japanfocus.org/-Mark-Selden/3173) of the history of the textbook issue) How, then, is a revived military adequate to cope with Japan's security challenges to be made accountable? To be sure, pointed questions and arguments from neo-nationalists about Japan's security arrangements have recently begun to make themselves heard in political discourse in ways that would have been unthinkable a generation ago. But the wider reaction is still to treat such comments as somehow beyond the pale rather than addressing them directly.

The dismissal of Air Force Chief of Staff General Tamogami Toshio last November is a case in point. Tamogami had argued in a published essay that Japan was not the aggressor in the Second World War; that the brutality of the Japanese Army had been overstated. The tenor of the remarks by those who fired him, however, suggested not that they really disagreed with him, but that he had raised matters better left unmentioned in public. But if Japan is unable or unwilling to continue paying for the American military presence in Asia and the American taxpayer does not step into the breech, such matters will have to be raised and thrashed out. Japan will need to understand why it is viewed with such suspicion by neighbors whose own histories are hardly free of bloodshed or brutality. It will need to remove the blanket that smothers debate on the origins of the disasters of the 1930s and 1940s, not so that “rightists” and “leftists” can score points against each other, but in order to understand what happened so that it doesn't happen again – so that a revived military does not, on its own accord, one more time lead Japan down the road to disaster.

Meanwhile, the ever-present remedy of exports has sucked away much of the political oxygen needed for discussion of some fundamental questions of political economy. Questions such as how to restructure Japanese employment practices while providing and paying for social security; how to pump up and sustain domestic demand over time; how to meet the looming financial obligations that Japan's aging population will bring on – these have not been fully addressed. It has been easier just to apply the narcotic of exports.

But as China replaces Japan as America's major supplier of foreign capital, it will no longer be possible for Tokyo and Washington to dodge these matters. I tend to agree with Okimoto when he writes that "the system of capital recycling from Japan and China to the United States will remain in place" if only because the damage China would sustain from pulling the plug on the system is more than any government in Beijing would want to contemplate.

That does not mean, however, that China is going to be the docile, compliant lender Washington has grown accustomed to in Japan. Okimoto notes that, in contrast to Japan, China has already sustained serious losses on its US dollar reserves. Those losses amount to some $300 billion, and Okimoto attributes them to a mixture of interest and inflation differentials, depreciation of the dollar against the reminbi, and the mark-to-market value of direct investments. Okimoto writes that the losses have sparked serious controversy inside China itself over how to manage its portfolio. And they probably help explain the periodic demands from Beijing that the US get its fiscal house in order and act to maintain the purchasing power of the dollar.

It goes without saying that nothing remotely comparable to the quid pro quo underlying the US-Japan relationship exists between Washington and Beijing. China intends to use its growing financial leverage not to pay another country to provide for its security and manage its foreign relations, but to force the reduction and eventual elimination of the US military presence in Asia. China shows every sign of treating exports not as a narcotic but as one of several implements in its quest to become the world's premier economic power. China's support for the dollar will not be automatic; it will be contingent upon the degree to which the dollar's role as the world's leading settlements and reserve currency contributes towards the goals of China's leaders.

The Current Crisis: Disaster or Opportunity for Japan?

It is easy to predict disaster for Japan. Mix in all the horrible numbers – the demographics, the tumbling exports, the metastasizing fiscal obligations – with Japan's weak, fractured governing elite and a sullen, checked-out populace, and what starts to jell is the picture of a country headed into a vortex of inevitable decline. Particularly so if Okimoto turns out to be wrong in his prediction about the "elevation" of Japan's "strategic importance" to the United States. In a world where America's overwhelming "advantage" in the application of brute military force means less and less and in any case cannot be financed, it is hard to grasp how Japan will continue to be as “strategically important” to Washington as it has been. The real threats to US prosperity and order today are increasingly seen as environmental catastrophe, alienated groups of – apologies for the graceless jargon -- “non-state actors,” and America's inability to bridle its own domestic rogue elements on Wall Street and the lunatic right. In such a world, Japan's network of military installations on offer may buy less than it did, particularly when it is no longer paired with the will and ability to act unilaterally to support the dollar.

But one can also make the case that this moment in history offers about the best opportunity Japan is going to get to cut free, finally, from its dependence on the US. The rise of the yen and the coming of a current account deficit are typically regarded as disasters, but they also create opportunity. The terms of trade are turning sharply in Japan's favor – that is to say, Japan can import what it needs for the time being at very favorable exchange rates. (On the rise of the yen and its possible consequences for Japanese recovery see Akio Mikuni's opinion piece (http://www.nytimes.com/2009/08/07/opinion/07mikuni.html?_r=1&ref=opinion).) Japan has the resources to buy itself some breathing space while its companies adjust to a world in which exports can no longer by relied upon to pull them out of holes -- and, in any case, the coming of a current account deficit is going to force this adjustment willy nilly.

Meanwhile, in Washington, Japan is dealing today with an administration which, though disappointing in so many respects, now and again shows signs of a willingness to rethink conventional wisdom. In any case, the Obama White House is probably the best partner Japan can realistically hope for if Japan's governing elite itself comes to the conclusion that the relationship between the two countries must be re-negotiated. Among other things, the example of the Obama administration might induce Tokyo to show some serious leadership on “green technology” issues rather than simply indulge in the PR exercises that have constituted, alas, most of Japan's response to date to the looming environmental disaster. (See Andrew DeWit's discussion (http://www.japanfocus.org/-Andrew-DeWit/3118) of “Japan's Response to Financial-Environmental Crisis”)

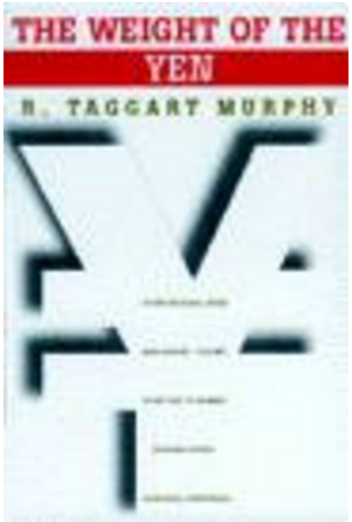
It is surely more than coincidence that Japan now faces on August 30 what could be its most important election ever, one that may bring the country a genuinely new government. The Democratic Party of Japan (“DPJ”), the likely victor in the coming election, is usually described today as the country's major opposition party. It is important, however, to understand just what the DPJ opposes. It is not simply the LDP, but the entire bureaucratic/political nexus that has, to all intents and purposes, governed Japan for the last half century. These power holders show every sign of the same kind of institutional exhaustion that afflicts their counterparts in the US Republican Party or the UK Labor Party – an inability and unwillingness to conceive of new responses to new challenges; a reflexive reliance on tired formulae that no longer command much enthusiasm or support and are implemented because no one in power can conceive of any other way of doing things.

In contrast, DPJ proposals to remove control of the budget from the Budget Bureau of the Ministry of Finance and place it in the Prime Minister's Office; to bring together leaders from many walks of life to chart a new course for the country, show a degree of imagination and daring that have not been seen for a very long time. Similar thinking can be spotted in corporate executive suites as business leaders grapple with a world in which exports can no longer be relied upon to cover inefficiencies and sluggish demand at home. Indeed, Akio Mikuni says in conversation that he now feels optimistic about Japan for the first time in two decades. He believes that the soaring of the yen will bring on a long-postponed day of reckoning for Japanese industry; that the strongest companies will find ways of using Japan's comparative advantages in the creativity and resiliance of its work force and in the financial resources at the country's disposal that will ultimately work to bring about higher standards of living. These in turn could generate institutionalized political pressure for a government responsive to consumer needs.

Such an outcome is by no means assured or even probable. But in crisis lies opportunity; one can hope that as it becomes increasingly obvious that the postwar era is finally over; that there is no going back to the old certainties of a Japan-US dollar axis and the security umbrella that axis financed, new institutions and ways of thought will arise to deal with the new challenges the world presents Japan.

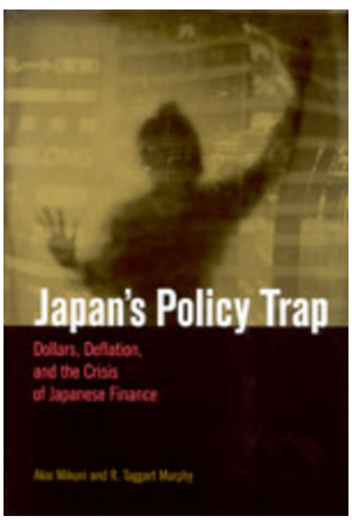
R. Taggart Murphy is Professor and Vice Chair, MBA Program in International Business, Tsukuba University (Tokyo Campus) and a coordinator of The Asia-Pacific Journal. He is the author of The Weight of the Yen (http://www.amazon.com/dp/0393316572/?tag=theasipacjo0b-20) and, with Akio Mikuni, of Japan's Policy Trap. He wrote this article for The Asia-Pacific Journal.

Recommended citation: R. Taggart Murphy, "The Financial Crisis and the Tectonic Shifts in the US-Japan Relationship," The Asia-Pacific Journal, Vol. 32-2-09, August 3, 2009.



(http://www.amazon.com/dp/0393316572/?tag=theasipacjo0b-20)

Click on a cover to order.



(http://www.amazon.com/dp/0815702221/?tag=theasipacjo0b-20)