1 *The Policy Trap*

As Japan enters its twelfth consecutive year of economic stagnation, it has begun to dawn on the world that something peculiar is going on. The term "recession" is often trotted out, but whatever may be happening in Japan, it does not seem to be a garden-variety recession. "Recession" suggests a sharp, severe economic decline lasting a few quarters; the word carries the connotation of a common disease like the measles or mumps, with a clear-cut cause and an approved course of treatment. But while Japan's authorities appear to have administered the standard recession therapy—interest-rate cuts, easy money, and fiscal pump priming—they have little to show for it other than a staggering level of government debt.

More frightening terms are sometimes heard—depression, liquidity trap—with their deliberate echoes of the 1930s. Those words came into use back then, when economists realized that the world had fallen into something far more intractable than a recession. But except for the intractable part, they manifestly do not fit contemporary Japan. Unemployment rates and bankruptcies may have risen to historical highs, but the country does not look or feel like a country anywhere close to a depression. There are no bread lines, no signs of widespread destitution, no angry, radicalized mobs to provide easy prey for populist demagogues.

"Stagnation" comes closer, since Japan's economy has neither seen much growth in the past ten years nor really shrunk. But while the label works well enough, it does not help us to get a grip on the situation, partly because there is no useful precedent. No one has ever really thought about what it means to muddle along year after year with no improvement and no crash. True, much of the world was in the grip of stagnation twenty-five years ago—"stagflation" they called it, since it combined anemic growth with high inflation. It bothered economists at the time because they had never seen anything quite like it. But again, Japan's problems today do not seem to resemble at all the difficulties faced by the developed world in the mid 1970s. Inflation is nowhere to be seen, the currency is reasonably strong, and the country continues to run high trade and current account surpluses—an economic picture that is the opposite of that in the United States and much of Europe back then.

This is not the first time, of course, that Japan has puzzled the world. Indeed, the country has been something of an enigma ever since the "little land of topsy-turvy" emerged out of a rosy mist of geishas and cherry blossoms to crush the Russian navy in 1905. In more recent times the country posted the most phenomenal record of economic growth in history while violating virtually every single tenet of Western economic orthodoxy. Policy analysts sputtered helplessly about "fairness" and "free rides" while defensive neoclassical economists were reduced to remarking that Japan could have recorded even higher levels of growth if only its government had gotten "out of the way."

The onset of Japan's economic difficulties has led, naturally, to a good deal of "I told you so" crowing from such quarters as well as more reasoned attempts to analyze the "souring" of policy ingredients that are said to have once worked well enough but no longer do. The *schadenfreude* is, however, more muted than one might expect given the threat to conventional economic wisdom that Japan seemed to pose a decade ago. For if the West could not understand how a war-devastated Japan could build the world's premiere industrial machine from scratch in less than twenty years, the onset of Japan's difficulties did not clear up the myriad enigmas enveloping economic and political reality there. There is talk of policy errors by the central bank and grumbling over a succession of weak prime ministers. But those "explanations" do not go very far in helping us grasp how a country can stagger along year after year at close to zero growth with its banking system in a shambles and all the while avoid anything that looks like a real recessionary shakeout.

The Goals of Policymaking

Much of the difficulty in analyzing Japan in both its high-growth and its stagnation phases can be traced to mistaken assumptions about the nature of policymaking in Japan and the objectives of Tokyo's policymakers. Western observers tend, understandably, to assume that these men—they are all men—want prosperity for Japan and that they measure prosperity by the usual yardsticks: employment rates, living standards, per capita gross domestic product (GDP), corporate earnings, productivity growth, and the vibrancy of the markets for money, equities, real estate, and goods. Now, Japan's policymakers have nothing against prosperity as the West defines it, provided that it does not undermine their control of economic and political outcomes. And they understand that the world expects them to discuss their achievements and shortcomings with reference to the commonly employed yardsticks. But they have goals that transcend prosperity.

Japan's decisionmakers have run their country for well over a century now with three objectives: independence, survival, and control—the independence of their country from foreign domination, their own survival as a ruling elite, and their continued control of key economic and political levers. Their historical memory taught them to secure those goals by maximizing production capacity and mastering and controlling important upstream industrial technologies. And they did, but their aim was not to purchase prosperity for Japanese citizens; it was to buy protection in what they saw as a hostile world. They believed that the only sure route to the control of production and technology lay in aggressive, centrally directed capital spending, and they measured their success by the technological and manufacturing prowess of Japanese companies and the size of Japan's trade and current account surpluses.[1]

That remains true to this day. Perhaps nothing more astonishes educated opinion in the West than Japan's obsession with its trade and current account surpluses. There is no doubt that the obsession exists; a decline in the current account surplus that began in the spring of 2001 gave rise to a veritable orgy of doomsday pieces in Japan's media in which commentators went to the extreme of making off-the-wall comparisons of Japan with Indonesia.[2] Agitation of that kind seems to betray basic economic illiteracy, and comments such as that by Ito Takatoshi, a former official of the Ministry of Finance (MOF)—"If nothing is done [about the deterioration of Japan's trade surplus], the yen will eventually drop and Japanese won't be wealthy anymore"—suggests that Japanese educated opinion is still in thrall to the crassest sort of mercantilism.[3] For not only does Japan enjoy the world's largest pile of claims on foreigners—claims that can be used to buy all the imports Japan could possibly need for years to come—it still boasts a panoply of world-beating industries and companies. Real wealth, as economists since the days of Adam Smith and David Hume have understood, comes not from piles of gold or their modern equivalent—a huge and unnecessary buildup of international reserves produced by an unbroken string of current account surpluses—but from the skills and productivity of a country's citizens, with which Japan is exceptionally well endowed.

For the current account is simply that—an accounting entry that captures current cash flows (trade settlements, dividends, interest, transfers) to and from the outside world while plugging the gap between savings and investment in an economy.[4] A poor developing country without a convertible currency might need to monitor its current account to ensure that it has adequate foreign exchange to purchase needed imports. But Japan is one of the world's richest, most highly developed countries. For policymakers in such a place to concern themselves with the ups and downs of the current account can remind economically literate Westerners of grownups still haunted by childhood fears of being picked on in the sandbox.

But this comparison ignores Japan's single-minded concern with the maximization of production capacity and exports. For those charged with carrying out the policies, the current account serves as *the* most critical indicator of economic well-being. To them, a current account deficit flashes dire distress signals: of excessive imports, of poor export performance, and, above all, of savings inadequate to finance investments in production capacity without dangerous reliance on foreigners. Meanwhile, a constant string of surpluses reassures policymakers that they are following the right course: that savings and exports are sufficient to provide Japan with a protective cocoon of claims on other countries. The importance of the current account surplus is so embedded in the thinking of Japan's decisionmakers that to secure it they have been willing to sacrifice much of the prosperity that could otherwise have been theirs. They have seen to it that the surplus was not consumed domestically; instead, they have invested it overseas, where it finances the deficits of trading partners. But unlike King Midas, gloating over gold he would not spend, the Japanese have accepted payment for their export earnings and returns from their investments abroad not in precious metals or their own currency but in dollars—the fiat currency of another country, a currency that has lost two-thirds of its purchasing power over the past three decades.

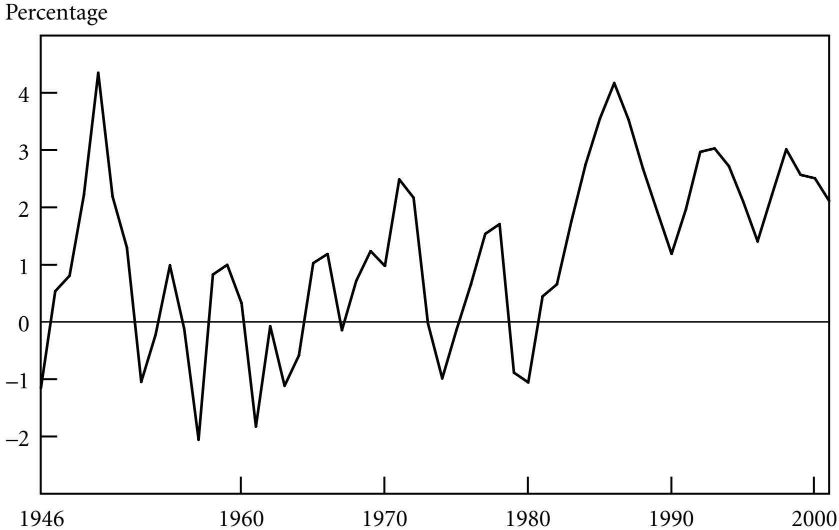
Part of Japan's obsession with its current account and the level of its exports reflects the inordinate sway of the bureaucracy over political and economic life in Japan, a matter we will consider more closely in chapter 2. Free of any requirement for political accountability, the Japanese bureaucracy, like bureaucracies everywhere, operates on a kind of inherited autopilot, fighting, in a manner of speaking, the last war. The bureaucracy assumed untrammeled control of economic policymaking in Japan during the late 1940s, a time when officials had to be concerned about the hoarding and rationing of precious foreign exchange. With nothing to change it, that mentality has persisted to this day. But it also reflects the underlying bureaucratic drive to retain control of economic outcomes rather than ceding control to markets or to foreigners. That, in turn, spells maximization of production capacity financed by domestic savings. Unlike other industrialized nations, Japan has built and maintained an industrial capacity that far exceeds its domestic requirements, a capacity that takes financial form as a current account surplus.

To induce and sustain a current account surplus, Japan's policymakers have allocated purchasing power preferentially, to manufacturers on the one hand and to exporters of financial capital on the other. They chose a centralized banking system as the most effective way of doing this. Manufacturers and exporters of capital were given to understand that their task in the system was to play their respective roles in maximizing production capacity. Profits, the sine qua non of viability in market economies, were incidental. Manufacturers and banks were never expected to pay attention to profits; Japan's governing bureaucracy did that for them. The bureaucrats ensured the viability of important players by controlling key prices in the economy and by socializing risks that in market economies are borne by individual enterprises. Banks lent without credit risk; major companies produced without market and supply risks. Both were thereby made responsive to bureaucratic directive, not to the greed of profit-seeking shareholders. Western analysts often wonder at the lack of corporate governance in Japan, but the absence of outside investors to bring pressure for profit and return has enabled Japan's governing bureaucracy to allocate managerial resources to targeted industries without any distractions.

By their own lights, Japan's policymakers have been successful. They have run current account surpluses now for more than thirty years (figure 1-1 shows these surpluses as a percentage of GDP). The surpluses have accumulated to the point that Japan's claims on other countries have made Japan far and away the world's number-one net creditor nation; in other words, the net claims of Japanese institutions on foreigners—the bonds and equity that they hold, the loans that they have made, and the factories, buildings, and companies that they own abroad, less foreign ownership of Japanese domestic assets—far exceed those of any other country. Meanwhile, Japanese companies dominate a wide range of industrial processes, upstream components, and key technologies, enabling Japan to rack up current account surpluses for as far into the future as the eye can see.

The rest of the world, of course, views things in a different light. Japan's huge surpluses seem less a mark of industrial strength than a system-straining imbalance, a sign that both the Japanese economy and global trade and financial systems are out of kilter. For example, C. Fred Bergsten, the head of a prominent Washington think tank, doubted as far back as 1986 whether "the world will sustain external surpluses on the part of Japan on the order of $50 billion or so for the rest of the decade."[5] Japan's surpluses, which are now more than twice that size, are being sustained into their second decade beyond the one in which Bergsten made his prediction, but his comment was not in the least exceptional. For Japan's imbalances—and their counterparts, the swollen current account deficits of the United States—were not supposed to be possible in today's world. The floating exchange rate system, heralded at its birth in 1973 as an automatic adjustment mechanism that would prevent the accumulation of such payment imbalances, has seen the opposite happen. Payment imbalances reached levels never witnessed

Figure 1-1. ***Japan's Current Account Surplus (Deficit) as a Percentage of Nominal GDP***



Sources: *Balance of Payments,* Ministry of Finance and Bank of Japan; *Annual Report on National Accounts,* Cabinet Office; and *Estimates of Long-Term Economic Statistics of Japan Since 1868,* Toyo Keizai Shinposha. Calculated, arranged, and estimated by Mikuni & Co. © 2002 Mikuni & Co., Ltd.

under a fixed-rate system, a matter that monetarist cheerleaders for floating rates have never satisfactorily explained.

Theoretically, an imbalanced current account should, at some point, correct itself. Current account surpluses ultimately derive from sales made by a country's companies in foreign markets, sales that then are translated into cash within the country and thus into credit in its own currency. That credit should in the normal course of things find its way into consumption and housing investments, stimulating economic activity and bringing on rising prices. Economic activity creates additional demand for credit. Banks, seeing more profits, raise their interest rates. Eventually, rising prices and rising interest rates erode the competitiveness of the country's exports while making imports cheaper. The current account surplus falls, and equilibrium is restored to the country's balance of payments.

But Japan's governing bureaucracy has long had both the desire and the means to suppress consumption by ordinary citizens while maximizing the savings of the wealthy, who—having been traditionally discouraged by both social pressure and the fear of tax audits from too much conspicuous consumption—have a high propensity to save. Exorbitant land prices helped accomplish those objectives by pushing up both housing and general living costs while transferring income from the working population to well-to-do landowners. Responding to bureaucratic rather than market imperatives, the banking system extended credit to exporters by exchanging the dollars they earned for the yen they needed, yen that went to finance capital rather than consumer spending and thereby tended to increase the current account surplus. Meanwhile, the dollars were left inside the U.S. banking system, where they helped finance demand for Japanese goods. That policy regime blocked any tendency toward achieving the equilibrium in international payments advertised by the proponents of floating rates. Production capacity, built without consideration for profitability and without the financial discipline imposed by a market economy, grew far beyond the needs of the domestic economy. But rather than permit market forces to reduce excess capacity, Japan's decisionmakers sought to keep it humming. The waves of exports necessary for this required proactive policies to suppress the exchange rate—policies that we will examine in detail. Those policies ultimately gave rise to the deflationary trap that Japan finds itself in today.

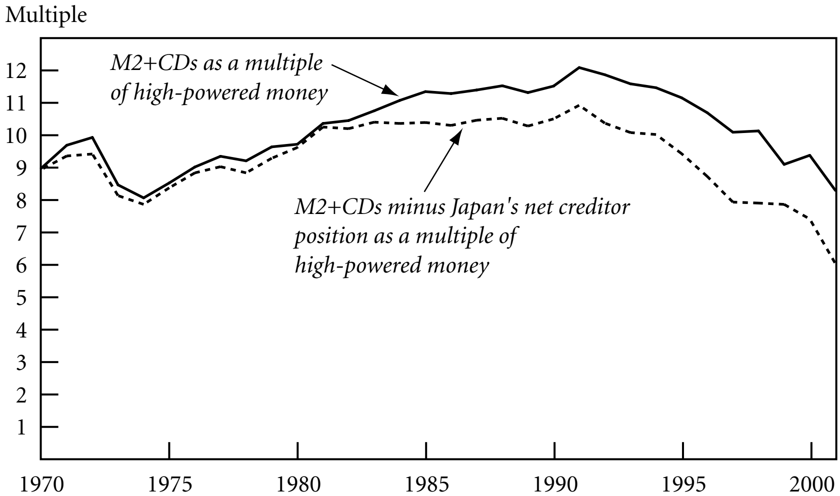
We have written this book in order to describe that trap. We hope to demonstrate that the institutions put in place to perpetuate the current account surplus have distorted monetary policy in a deflationary direction and that the effects can no longer be easily corrected by other policy measures. Not that Japan's governing bureaucracy has not repeatedly tried, by deliberately blowing bubbles in asset markets—principally land and equities—and then, once the bubbles burst, by giving the economy periodic doses of fiscal stimulus. The cash thrown off first by the bubbles and then by the deficit spending went mostly to banks and the post office savings system in the form of deposits, where it helped counteract the deflationary effects of the policies necessary to support the accumulated current account surplus. But the days when such tactics worked are coming to an end, for reasons that we will explain. And they have left Japan with a crushing burden of bad loans that continues to hobble the country's banking system and a public sector debt that is the largest among developed countries.

Partly as a result, the Bank of Japan (BOJ) is running out of policy options. A number of analysts have called on the BOJ to flood the economy with money in order to counteract deflation; they urge the government to issue new bonds and the BOJ to buy them. The BOJ would, in the course of things, pay for or back up the bonds ("fund" them, as bankers say) with new money.

But that new money would have to consist mostly of currency in circulation plus deposits maintained by banks with the BOJ. Together they form what the BOJ defines as its "monetary base." Economists often use the term "high-powered money" for such monies because the central bank can, in normal circumstances, use them both to create other forms of money and to accelerate the movement of money through the economy (increase the so-called velocity of money).[6] In most countries, currency in circulation rises in tandem with economic activity and the expansion of bank credit. But in Japan, that connection has broken down. Currency in circulation has in fact been rising faster than GDP as worries over the soundness of Japan's banks plus the negligible interest rates on offer have triggered large withdrawals of cash from the banking system. Meanwhile, the BOJ has been purchasing Japanese government bonds (JGBs) from the banks and other financial intermediaries that hold them. (In Japan, government securities typically are held not by individuals or any other end-investor but by deposit-taking institutions, a point of great significance to which we will return.) The BOJ has done that for precisely the same reasons that so many analysts are calling for the government to issue a flood of new bonds that the BOJ would buy: to lower interest rates and stimulate economic activity with new money. But there has been no measurable impact except on the growth of the liabilities of the BOJ and the Japanese government. GDP growth remains flat, prices continue to fall, and other forms of monetary aggregates stagnate while high-powered money increases—see figure 1-2, which portrays the growth of the money supply broadly defined (that is, M2 plus CDs) over that of high-powered money. For the banks, facing no demand for loans, are simply placing the money coming into their coffers from the BOJ's purchases of JGBs back into the BOJ, creating an endless loop.

Some have called for the BOJ to range farther afield—to buy equity, land, problem loans. But if the BOJ has not been doing that directly, the government as a whole most certainly has, with funding ultimately provided by the BOJ. The postal savings system and the government's pension funds have been buying equity. Today, the government is the largest net buyer of land. The BOJ has lent money to insolvent financial institutions. Problem loans have been moved into the Deposit Insurance System, which either borrows

Figure 1-2. ***M2 + CDs as a Multiple of High-Powered Money***



Sources: *Financial and Economic Statistics Monthly,* Bank of Japan; *International Investment Position of Japan,* Ministry of Finance. Calculated, arranged, and estimated by Mikuni & Co. © 2002 Mikuni & Co., Ltd.

money from the BOJ or from private lenders under government guarantee. None of those measures have stimulated the economy.

The BOJ thus finds itself today trapped in a deadly impasse—forced against its will, as we shall examine in more detail, to do things that defeat its very attempts to increase the broader money supply and thus boost the economy. Meanwhile, the dead weight of excess capacity has accelerated the deflationary impact of monetary policy on the domestic economy, dampening capital spending and slowing economic activity.

Escaping the Policy Trap

Like a fat man stuffing himself with rich food, Japan has continued to gorge on current account surpluses denominated largely in dollars, and its economy is now being adversely affected. Because exports and foreign currency earnings are essential to a country's economic health, just as protein and carbohydrates are to the physical well-being of a person, that may not be intuitively obvious. But just as someone who eats too much for too many years ends up burdened with layers of extra fat that strain vital organs and promote lethargy and disease, the Japanese economy is sinking under piles of dollars that far exceed the country's needs, and it must work overtime to support them.

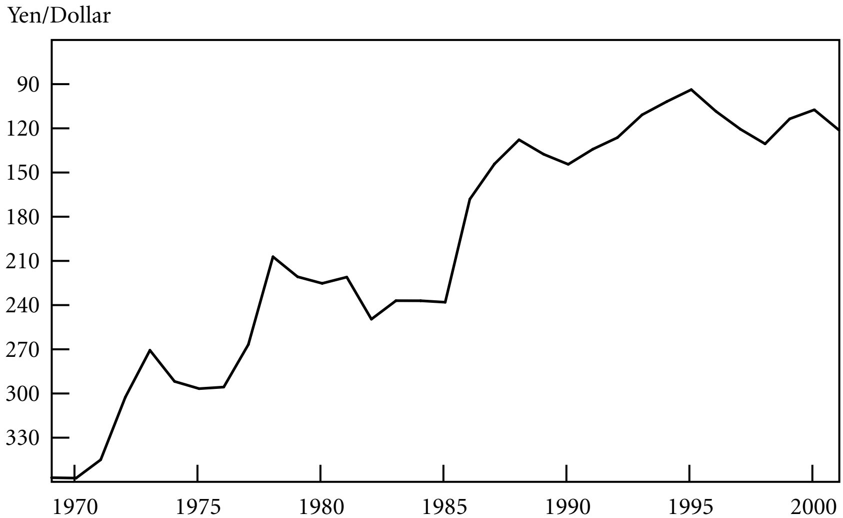
Telling fat people to lose weight is easy. Getting them to make the comprehensive changes in their diet and lifestyle that they must in order to lose weight is hard and often impossible. The same is true for Japan and its rich, fatty, dollar-denominated current account surpluses. Even if the will and ability to overhaul the Japanese economy existed, it could not be done without triggering economic and political upheaval both in Japan and around the world. For a half-century of ruthless pursuit of technological and industrial superiority at the expense of all other goals—including profits and domestic living standards—has given Japan a comprehensive, vertically and horizontally integrated industrial structure that far exceeds its domestic needs.That costly structure must be supported by high levels of demand—that is, by a robust global economy—at a time when developing nations such as China have set their sights on meeting that very demand in order to realize their own economic visions.

Nor can shifting operations out of Japan spring the trap. That, in fact, has been the primary response of Japanese industry to the dilemma in which it finds itself. But while such tactics may, for example, insulate to some extent Toyota's or Matsushita's North American profits from sudden shifts in the yen/dollar rate, they do not begin to solve Japan's overall problem—indeed, they worsen it. The Japanese media have, in recent years, been given to hand wringing over the supposed "hollowing out" of the Japanese economy. Much of that is exaggerated—despite the relocation of many operations abroad, the highest value-added and most technologically advanced manufacturing continues to be done at home. But it does point to the depressing effects on the domestic economy of the tactics adopted by Japanese industry to escape the policy trap.

The Current Account and the Yen/Dollar Rate

The rise of the Japanese currency is illustrated in figure 1-3, which shows movement in the yen/dollar rate since 1971, when the yen first floated against the dollar. Despite a good deal of seesawing, most of the climb in the value of the yen occurred between 1971 and 1987. Periodic surges in the

Figure 1-3. ***Yen/Dollar Rate Since 1955*** [a]



Source: *Financial and Economic Statistics Monthly,* Bank of Japan. Calculated, arranged, and estimated by Mikuni & Co. © 2002 Mikuni & Co., Ltd.

a. For every year after 1969, the rate given is an average for the year.

yen's dollar value have, of course, occurred since then, most dramatically in the spring of 1995. But as of this writing, the yen is not even 20 percent stronger in dollar terms than it was in 1987. That is so remarkable, given that Japan racked up annual current account surpluses of more than 2 percent of GDP during most of the same period, that it cries out for explanation. And the most obvious explanation is that Japan's monetary policymakers have been attempting to peg the yen at a given exchange rate. For if Japan were earning dollars simply to fulfill domestic economic needs, the dollars would at some point have been converted into yen or spent on imports. But Japan is earning dollars not to satisfy wants but to build up a form of political capital.

Some may argue that we are approaching the issue incorrectly. Perhaps it is not so much that the yen has been weaker than Japan's trade numbers would lead one to expect, but that the dollar has been far stronger than U.S. trade numbers would suggest. As of this writing, the dollar is strong not just vis-à-vis the yen but all the currencies (save pounds sterling) of the major

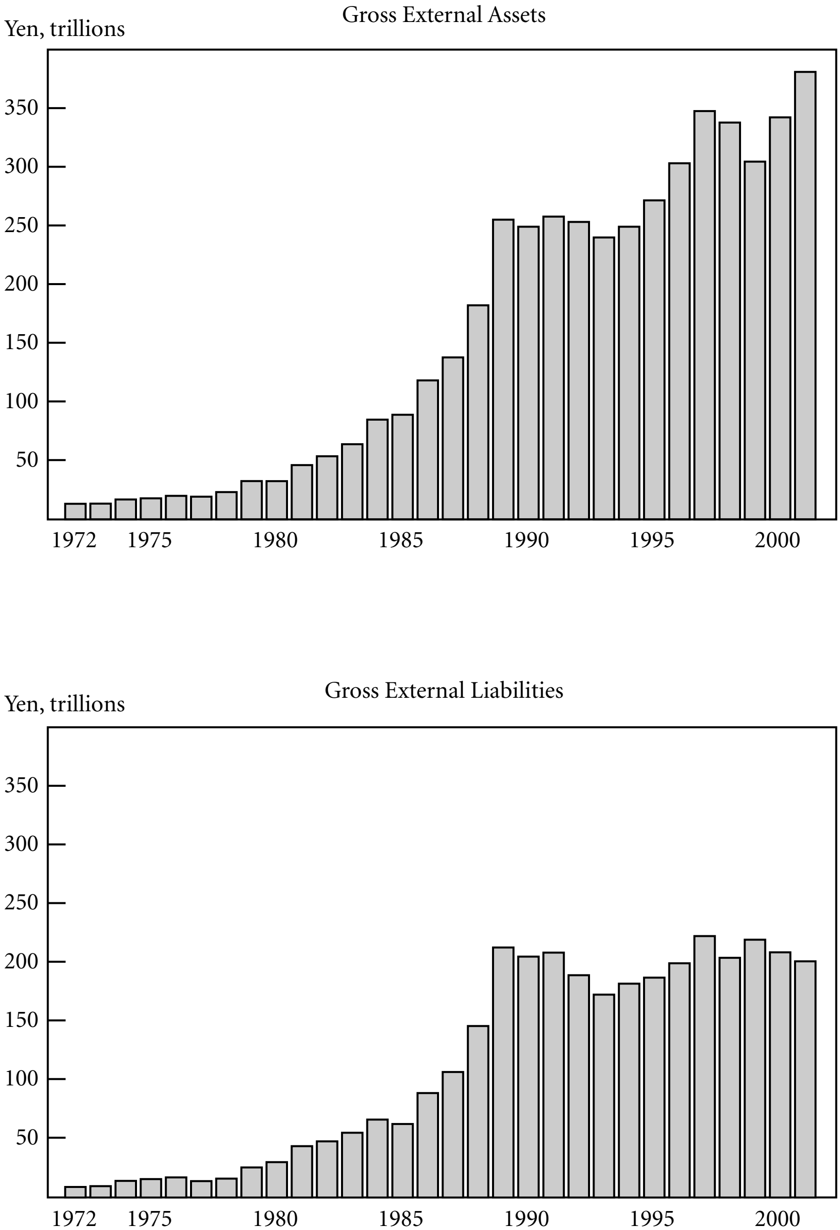
U.S. trading partners. Might not the dollar's worldwide strength suggest that it is the American rather than the Japanese anomaly that ought to be the focus of attention? After all, U.S. current account deficits are even larger in both absolute numbers and as percentages of GDP than Japan's surpluses. Since 2000, China has outstripped Japan as the country running the largest trade surplus with the United States. Surely one has to look beyond Japan for an explanation of the dollar's strength in the face of record American external deficits.

We argue in this book that in fact the Japanese policy regime itself is the key element in understanding the dollar's persistent strength. But before we start to build that case, we need to reiterate that it is not just the present softness of the Japanese yen that is remarkable—the persistence of that softness over fifteen years in the face of relentless current account surpluses demands explanation. In the wake of its debut, the euro may have dropped to levels that no one expected, but that drop may well have been simple birthpangs. And it bears remembering that several of the euro's predecessor currencies—notably the mark—had long been bywords for strong currency. Europe's external accounts have, by and large, provided a reasonable indicator of the relative strength of its currencies.

Not so Japan's. Perhaps the puzzle of endless current account surpluses joined to a softish currency may seem to be resolved by the growth of Japan's claims on other countries, or gross external assets, documented in figure 1-4. Given Japan's current account, there is nothing particularly remarkable about that growth; indeed, it is inevitable. If you earn surpluses in your trade with other countries and do not spend those surpluses on imports—in other words, if you keep running surpluses—you will accumulate claims on other countries. And those claims—the foreign bonds, stocks, and companies you buy, the factories and resorts you build abroad, the loans you make—eventually pose problems. For, like fat that is never transformed by the body into energy through physical activity but is simply stored, claims on foreign countries that are never converted into products or services that the Japanese will use end up creating economic problems.

Therein lies the significance of the information in figure 1-4—for otherwise, this information is little more than a tautology. The great majority of Japan's claims on the rest of the world are denominated in U.S. dollars, mostly because Japan's external trade is conducted largely in dollars. Japan

Figure 1-4. Japan's Gross External Assets and Liabilities



Source: *International Investment Position of Japan,* Ministry of Finance. Calculated, arranged, and estimated by Mikuni & Co. © 2002 Mikuni & Co., Ltd.

runs surpluses not just with the United States but with the entire rest of the world, except for a handful of commodity exporters—mostly, members of the Organization of the Petroleum Exporting Countries (OPEC) and, in recent years, China. Japanese companies bill their overseas customers largely in dollars rather than yen.[7] That helps explain the persistence of an undervalued yen in the face of record current account surpluses. The Japanese economy as a whole retains many of the dollars earned by Japanese exporters; if it converted all of them into goods and services, Japan would not, of course, be running surpluses. It could theoretically convert the dollars into a third currency, such as euros or pounds sterling, but it has not done so, perhaps because the issuers of those currencies are not as hospitable to Japanese exports as is the United States. And then, until the coming of the euro, the dollar was the only currency that circulated in sufficient quantities to accommodate the bulk of Japan's claims. Nor could Japan easily convert those claims into yen without driving the yen up. For large pools of yen to circulate outside Japan not only would Japan have to import more, Japanese importers would have to pay foreign exporters in yen, which they typically do not do.[8]

Many have asked why Japan does not take the intuitively obvious step and print more yen, then exchange its dollars for those yen. But we contend in this book that the authorities have in fact "printed" more yen than real economic activity would warrant, by creating bubbles in asset prices, prodding banks to lend beyond the real credit needs of the economy, and spending large amounts on unnecessary public works. The "printing" of all those yen has, as we hope to demonstrate, been required to support Japan's accumulated dollar position.

But while the relentless growth of Japan's dollar-denominated claims on the rest of the world may seem to answer the question of how Japan can continue to pile up current account surpluses without triggering surges in the yen's value, those claims point to a far more complex puzzle than simply the failure of the yen to strengthen to the point that Japan's surpluses would decline.

Japan's Creditor Position and the Money Supply

Since 1980, when Japan recovered from what is known there as the "second oil shock," brought on by the Iranian revolution, Japan's gross external assets as a percentage of GDP have steadily climbed to the point that they now exceed 70 percent of GDP, as illustrated in figure 1-5. With no end to Japan's current account surpluses in sight, that number promises to rise ever higher.

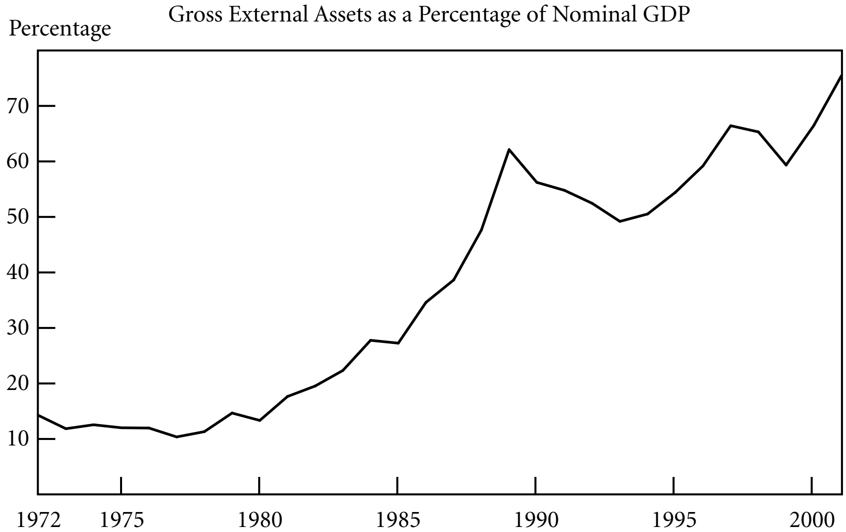
From the immediate postwar years through the early 1980s, Japan's accumulated current account surplus rose roughly in tandem with both foreign exchange reserves and currency in circulation (see figure 1-6). Currency in circulation throughout that period was backed by foreign exchange reserves—overwhelmingly denominated in U.S. dollars—with the ratio of currency in circulation to foreign exchange holdings remaining roughly constant at 3 to 1.

Since enactment of the Bank of Japan Act in 1942, Japan has had a monetary system nominally based on fiat money—theoretically, the yen has been backed only by the government's promise to pay in its own currency. But from 1949 to 1973, Japan in fact pegged its currency to the U.S. dollar. As the economist Ichinose Atsushi pointed out, "From the immediate postwar period through the mid-1960s, it was widely understood that the BOJ determined monetary policy according to the balance of international payments."[9] In other words, as figure 1-6 demonstrates, during that period Japan ran what was essentially a dollar exchange standard—that is, the most important variable determining Japan's domestic money supply was the level of its dollar holdings.

To some extent, of course, that was true of every country in the Bretton Woods system except the United States. That system, which prevailed from 1944 to 1971, institutionalized the U.S. dollar as the foundation of the global financial order. Dollars served as the monetary backing for the national currency of all participants, except that of the United States itself, which was backed by gold. Therefore, each country had to keep a close eye on its dollar reserves.

The Japanese authorities were, however, unusually zealous in exercising control of the country's dollar holdings. In the 1950s and early 1960s, all foreign currency earned by Japanese companies had to be turned over to the government, which carefully rationed the precious commodity in order to maintain a 3 to 1 ratio between domestic currency and the official foreign reserves, a ratio viewed as essential for the credibility of monetary management. Meanwhile, control over foreign exchange constituted perhaps the most important tool in the government's implementation of industrial policy.[10] To preserve precious foreign exchange, the authorities did all they

Figure 1-5. ***Japan's Gross External Assets and Liabilities as Percentages of Nominal GDP***



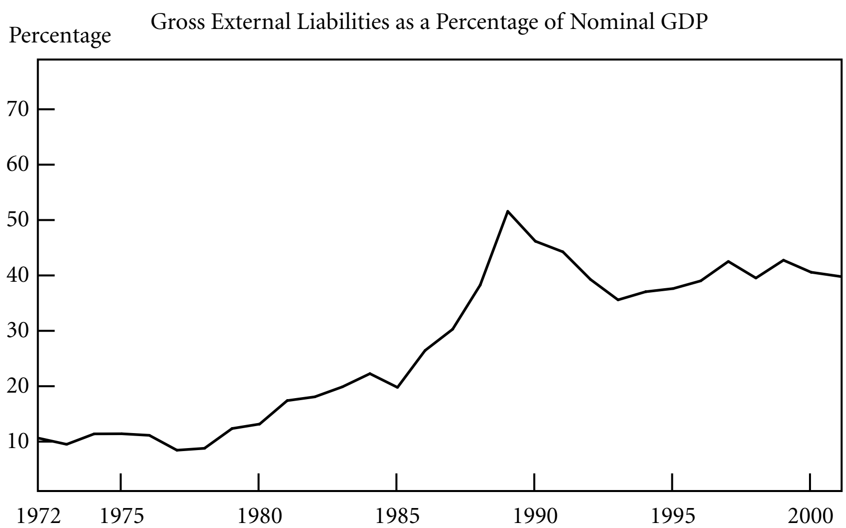


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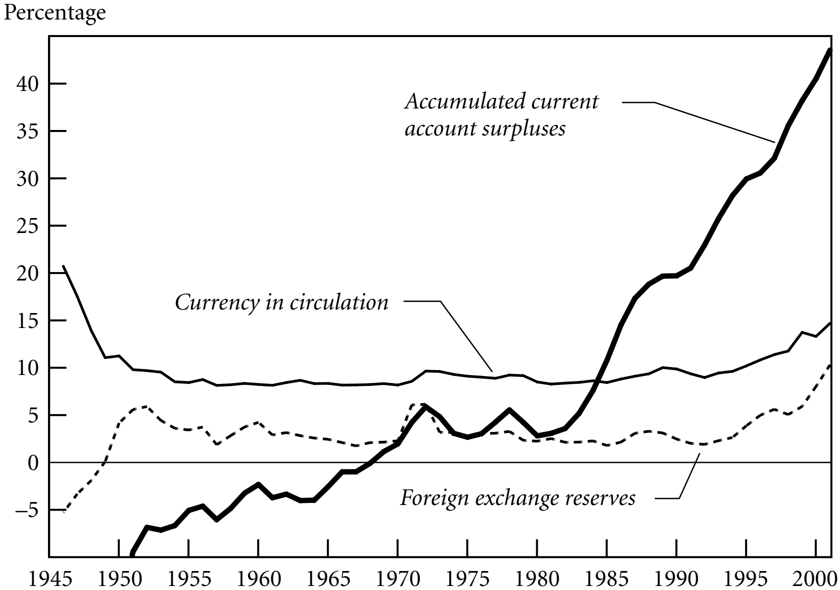
Figure 1-6. ***Japan's Accumulated Current Account Surpluses, Official Foreign Exchange Reserves, and Currency in Circulation as Percentages of Nominal GDP during the Postwar Period***



Sources: *Financial and Economic Statistics Monthly,* Bank of Japan; *Balance of Payments,* Ministry of Finance and Bank of Japan; *Annual Report on National Accounts,* Cabinet Office; and *Estimates of Long-Term Economic Statistics of Japan Since 1868,* Toyo Keizai Shinposha. Calculated, arranged, and estimated by Mikuni & Co. © 2002 Mikuni & Co., Ltd.

could to hold down the current account deficits that automatically drained reserves.

Accordingly, the monetary authorities tightened credit immediately whenever Japan's trade balance went into the red. Thus trade deficits were automatically associated with tight money, while trade surpluses initially triggered easy money—as in the case of the Korean War, which saw Japan earning temporary trade surpluses as it filled the demands of an insatiable American military. The BOJ carried out monetary policy through what was euphemistically termed "guidance" to banks but what in fact amounted to direct control of credit availability and thus control of real economic activity. The BOJ and the MOF worked assiduously to head off any pressure on the fixed yen/dollar rate by ensuring that monetary policy automatically followed the vicissitudes of Japan's balance of payments. To all intents and purposes, then, Japan ran what is known as a currency board system, although that was not what it was called, something we will consider in more detail in chapter 4.

But when Japan began to run chronic trade surpluses in the late 1960s, the relationship between Japan's dollar holdings and its domestic money supply began to diverge drastically from what it had been, as dollars accumulated in the coffers of both banks and the government. The exponential growth of Japanese business made it impractical for businessmen to wait for bureaucrats to scrutinize each application for foreign exchange. Banks were given more latitude to hold dollars, and eventually official foreign exchange reserves no longer served as a useful indicator of either Japan's export earnings or its money supply. In 1970, the country emerged as a net creditor—its claims on other countries for the first time exceeded foreign claims on Japan. Both official and unofficial reserves started to rise rapidly.

At first, Japan reveled in the freedom from balance of payment constraints. In earlier years, whenever growth had accelerated, the trade deficit had increased, because growth fueled demand for capital goods. The BOJ had had to cut back credit availability, and thereby growth, to preserve Japan's dollar holdings. But as Japan became self-sufficient in capital goods production, imports of capital goods, which had formed a substantial portion of the country's imports, largely disappeared and a *structural* current account surplus started to emerge. The BOJ no longer needed to tighten credit; reserves climbed as the current account surplus rose. The BOJ could increase currency in circulation without constraint to accommodate the accelerated activity in the real economy of production and trade.

As long as that state of affairs prevailed, the rapid increase in reserves posed no problem for Japan. But when reserves started to rise even more rapidly than the needs of the real economy for currency in circulation, the authorities faced a new and vexing challenge. The excess reserves threatened inflation, for if the BOJ created yen currency in equivalent amounts—"monetized" the excess dollar holdings, as economists would say—the additional unneeded currency might boost the prices of goods and services, as "too much money" usually does. Had Japan continued the practice of the 1960s and allowed currency in circulation to run at three times the level of Japan's total dollar holdings, today currency in circulation would stand at more than 1 quadrillion yen, rather than the current 70 trillion yen— that is, fourteen times the present level. No country could possibly accommodate that kind of money without horrendous inflation. Of course those numbers are absurd, but they give some inkling of the policy challenge posed by Japan's swollen dollar reserves.

To prevent the onset of inflation, the authorities were forced, in the language of monetary economists, to "sterilize" the reserves—that is, to counteract their impact on the domestic money supply. As we will see in chapter 4, Japan had faced similar dilemmas in the past, as far back as World War I. And in the early 1970s, when confronted by an inflation-threatening surge of dollars pouring into the country, the authorities turned to a special account first set up during the Korean War to cope with the influx of dollars stemming from American special procurements for the war effort. That account, known as the Foreign Exchange Special Account (FESA), gave authorities a place to park excess dollars. The dollars were removed from the BOJ's balance sheet, permitting the BOJ to keep a lid on currency in circulation. But the FESA had to be funded out of taxes. To ensure that the entire burden of sterilization did not fall on the government, the MOF also began to allow private institutions to buy and hold foreign currency. But that really only shifted the burden. For the MOF exercised its extraordinary level of informal controls—"guidance," again—to ensure that the banks and other institutions did not sell their dollar holdings lest the exchange rate soar.

Just as Japan's accumulating reserves were becoming, in the early 1970s, the monetary equivalent of an excessively rich diet, the postwar Bretton Woods system of fixed exchange rates collapsed. The wreck of the system shocked Japan's economic establishment to its core; indeed, the very word *shokku*, derived from the English "shock," entered the Japanese language at that point. No Japanese word seemed to convey quite the stunned horror that fell on Japan's officials as they grappled with the destruction of an external economic framework that had for them been so comfortable. In retrospect, they might have seen it coming. For by the mid 1960s, restiveness at what many viewed as willful exploitation by the Americans of their own central position in the system had already led a number of countries—most notably France—to exercise their right under the system to convert dollar holdings to gold. But Japan never did. Jacques Rueff, a prominent French economist and adviser to French president Charles de Gaulle, cited two reasons why Japan (and West Germany) did not follow France's lead: security and market access.[11] By maintaining their foreign reserves in depreciating dollars, Japan and Germany were effectively transferring purchasing power to the United States and thus indirectly subsidizing American military spending in their respective countries. And as long as the dollars held by Japan and Germany were not converted to gold or another currency, American imports from the two countries did not result in any deflationary impact on the United States, because the dollars used to pay for those imports remained in the U.S. banking system—why Rueff would speak famously of the U.S. "deficit without tears."

But once the Bretton Woods system crumbled, the Japanese found that the increasing piles of dollars began to pose all kinds of problems. They could not sell their dollars for German marks or Swiss francs. There was not enough of those currencies to begin with, and the German and Swiss governments would have reacted with outrage to such a move—but then, of course, Germany and Switzerland were not, unlike the United States, markets that had to be kept open to Japanese products at all costs. Nor could the dollars be sold for yen. That would strengthen the yen to such an extent that Japan's exports would be curtailed, menacing an economic structure deliberately built around export-led growth. And a strong yen could wash away the carefully constructed series of dikes that played such a crucial role in the Japanese system by keeping imports at bay, imports that could drown politically sensitive or "strategic" parts of the economy. Of course, that was the whole point of floating exchange rates—to create an international monetary framework that would automatically, or so its proponents hoped, reduce external imbalances without provoking global system-shaking crises. In Japan's case, that would mean lowering its exports and increasing its imports until its external accounts were back in balance.

But Japan's administrative elite never accepted that logic. With the coming of floating exchange rates, officials believed with overwhelming urgency that come what may, they had to retain some kind of de facto peg, suppressing the yen in order to permit the Japanese export machine to continue humming and to forestall waves of unwanted imports. That meant that the dollars Japan earned could not be exchanged for yen; they had to be retained and recycled as dollars.

Japan's policy of keeping its trade and current account surpluses intact helped the United States to run counterbalancing deficits. For the policy apparatus put in place by the Japanese authorities involved, by necessity, a series of measures to acquire and retain dollars. Had the Japanese not implemented those measures but sold their dollars, the yen would have climbed much faster than it did, reducing both the Japanese surplus and the American deficit. The United States, like any normal country suffering chronic deficits in its external accounts, would have been forced to curb its appetite for imports as its currency weakened to the point that it could no longer finance external deficits. The United States escaped that discipline thanks in large part to Japan, which is why, periodic bluster about the Japanese surplus notwithstanding, Washington has sooner or later always come around to supporting Japan's strong dollar/weak yen policy.

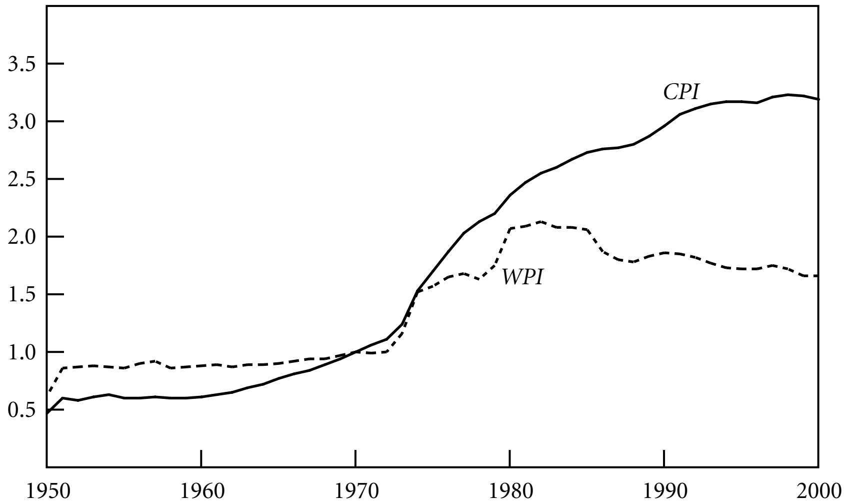
But Japan has paid a price. In the early postwar years, as we have seen, dollars formed the base for Japan's monetary creation and thus the more dollars, the more domestic credit. But once Japan had more dollars than it needed, the dollars paradoxically began to decrease domestic credit availability since money, as we will see, had to be drained off in taxes to support them. A credit squeeze imposes a deflationary drag on an economy. To counteract that drag, the Japanese authorities employed various means, eventually resorting to the creation of the greatest bubble in history.

Deflation and Claims on the Outside World

The notion that holding large piles of dollars is deflationary may seem counterintuitive. How can more money be deflationary? Certainly, there can be little doubt that Japan has, in the past decade, experienced the first significant deflation to be seen anywhere since the 1930s; figure 1-7, which depicts the movements of the wholesale price index, demonstrates that. We argue that deflation is rooted in Japan's snowballing external assets, which represent claims on foreigners that Japan cannot really use. Japan cannot exchange enough of them for either imports or yen. They far exceed Japan's import needs and, as we have seen, if they were exchanged for yen, the yen would become so strong that many if not most export-dependent Japanese companies would be ruined.

The dilemma that those claims pose for Japan and why they are ultimately deflationary can be understood by moving from the rarefied world of statistics and charts to the reality of production, sales, and cash flows that those statistics reflect. When a Japanese manufacturer like Sony sells a product abroad, it receives dollars. Sony can do one of four things with those dollars:

Figure 1-7. ***Movement of the Wholesale Price Index and the Consumer Price Index in the Postwar Period (Base Year 1970)***



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—immediately exchange the dollars for yen held overseas by foreigners.

—use the dollars to import capital goods or other products manufactured outside Japan whose manufacture was financed in dollars (that is, the necessary labor and supplies were paid for in dollars).

—retain the dollars to finance its own investments abroad.

—sell the dollars for yen to a Japanese bank and use the yen it receives to pay wages and suppliers in Japan.

The first two alternatives create no financing problem. But Japanese manufacturers have not much followed them. If they had followed them, Japan would not have accumulated the surpluses it has; either imports would have risen sharply or the yen would have gone through the roof, braking Japan's export drive. The third alternative—retaining dollars—requires borrowing yen from banks to pay wages in Japan. In the 1980s, many Japanese companies did begin to do that. For the most part, however, companies have sold their dollars to Japanese banks for yen.

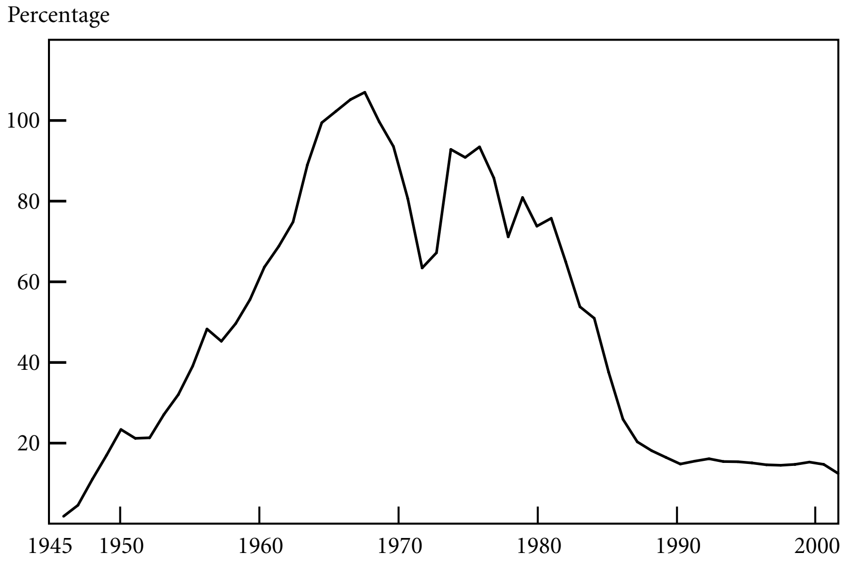
But the Japanese bank where Sony exchanges its dollars for yen can no more use those dollars in Japan than Sony can. The bank must usually lend to its Japanese clients in yen, not in dollars. (The bank can, of course, exchange or lend the dollars to Japanese companies importing foreign goods. But since Japan runs trade surpluses, the country has obviously been earning more dollars than it needs for imports, and each year, it earns more and more.) So the bank in turns sells most of its dollars to the BOJ, which then turns them over to the FESA.

Before Japan's dollar earnings outstripped the country's need for international reserves to finance imports, the Bank of Japan could match the banks' dollar holdings with yen credit creation. That yen credit creation went, in a manner of speaking, to pay the Japanese manufacturers who made the exports in the first place. But once the holdings of dollars grew too large for Japan's needs for additional credit, something had to be done with them.

One alternative would have been to sell the dollars for yen. But, as we have seen, there are simply too few yen circulating outside Japan. If Japanese banks had begun to sell dollars in large quantities, the yen would have strengthened, damaging exporters' competitiveness as Japanese goods became more expensive in foreign markets. Instead, public and private sector Japanese financial institutions deployed the dollars overseas. Many of them ended up in the form of U.S. government and agency securities owned by Japanese government entities including the BOJ, forming a major part of the $700 billion plus held at the Federal Reserve Bank of New York on behalf of foreign central banks. The rest took the form of loans, bonds, or equity investments that financed economic activity abroad. Some of that economic activity resulted in increased demand for Japanese exports. But by the early 1970s Japan's dollar holdings already were rising faster than its exports. After the OPEC oil price hikes of 1973, Japan again could profitably use all the dollars it earned since it needed so many of them to pay its oil bills. But beginning in the mid 1970s and particularly after 1980, Japan's accumulated dollars rose far in excess of its exports. That is illustrated in figure 1-8, which shows Japan's exports as a percentage of the country's external assets (all the loans, bonds, equities, companies, factories, and so forth it owns abroad). As the figure demonstrates, those assets now outstrip annual exports by the order of five to one.

The dollars earned by Japan's excess of exports over imports stem from production outstripping domestic consumption, which in turn derives from production capacity greater than that required by Japan's domestic needs. In fact, Japan's production capacity not only exceeds the country's

Figure 1-8. ***Exports as a Percentage of Japan's Gross External Assets***



Sources: *International Investment Position of Japan,* Ministry of Finance; *Balance of Payments,* Ministry of Finance and Bank of Japan; and *Estimates of Long-Term Economic Statistics of Japan Since 1868,* Toyo Keizai Shinposha. Calculated, arranged, and estimated by Mikuni & Co. © 2002 Mikuni & Co., Ltd.

domestic requirements, but since the early 1980s it has exceeded what Japan can export as well. Excess capacity of such magnitude is inherently deflationary. To counteract that deflation, Japanese authorities have resorted to creating yen liabilities unrelated to production, in two ways: by creating asset bubbles and by spending on useless public works.[12]

Yet they were necessary to maintain a current account surplus, which requires production to exceed consumption and savings to exceed investment. In order to ensure that the surplus continued, Japan had to be willing to accept payment in dollars. But because the extra production, the wages and supplies, that went into making that surplus had to be paid for in yen—because the excess of domestic savings over investment that resulted in that surplus had to be denominated in yen—the authorities were forced to fund Japan's accumulating dollars with yen liabilities.

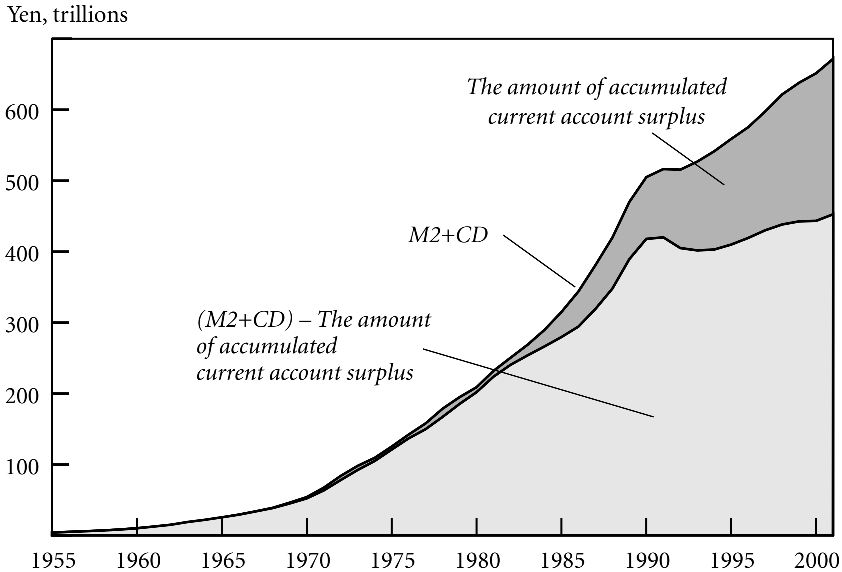
That portion of Japan's total production that represents the excess of exports over imports is not available for consumption in Japan. Yet wages were paid out to produce it. As long as Japan's surpluses continue to accumulate, as long as Japan continues to hold its surpluses in dollars, all of Japan's economic activities have to be paid for by the total sales proceeds *minus what is exported*. Therefore those who are paid to produce cannot be allowed to spend everything that they earn; ways must be found of reducing their income, and the difference must go to support the excess of production over consumption.

Japan's governing bureaucracy first encountered that dilemma at the time of World War I; in chapter 4, we will examine what happened. Since that time, they have learned to cope with it by deliberately reducing the income of those who actually produce goods and services. First, high land prices helped transfer income away from Japan's working producers through high rents and land sales at stratospheric prices. The land bubble of the 1980s worked exceptionally well in transferring income away from producers and in creating deposits independent of real economic activity. But with the collapse of the bubble, a combination of hikes in regressive consumption taxes and reductions in progressive income and capital gains taxes had to do much of the work of transferring income away from working people and to well-to-do Japanese with a low propensity to consume. Second, wasteful spending on useless public works—what Alex Kerr describes as "the Business of Monuments"—has also reduced the income available to actual wealth producers while putting it in the hands, as we will see, of those who place it on deposit and do not spend it. And as land prices have declined, despite the best efforts of bureaucrats, fiscal spending has had to increase in order to keep pace with the current account surplus.

The problems stemming from Japan's accumulated dollar hoard can also be understood through the prism of accounting. A fundamental rule of financial accounting requires that assets be matched with liabilities. The dollars that Japan holds are, in accounting terms, assets. Those assets require liabilities to match them—to "fund them," as bankers would say. And it is in the way that Japan's monetary authorities have had to find and create those liabilities that the story of Japan's deflationary dilemma unfolds.

Overwhelmingly, in Japan those liabilities take the form of yen deposits. When the deposits are not put to work inside the Japanese economy through loans or equity investments but instead go to support a pool of idle dollars (idle at least as far as Japan is concerned), they remove money from

Figure 1-9. ***Money Supply Less Accumulated Current Account Surplus***



Sources: *Financial and Economic Statistics Monthly,* Bank of Japan; *Balance of Payments,* Ministry of Finance and Bank of Japan. Calculated, arranged, and estimated by Mikuni & Co. © 2002 Mikuni & Co., Ltd.

the financial system. The money in those deposits is not being spent on imports, it is not being spent on Japanese goods and services, and it is not being spent on real investments in factories and equipment. It simply supports idle dollars. The drain created by Japan's idle dollars is illustrated in figure 1-9, which shows the money supply (defined as M2 plus CDs) minus those dollars. Domestic credit needs must be met from what remains. When enough money is drained from a financial system, deflation—falling prices—follows and with it economic slowdown.

To put Japan's dilemma in other terms, the workers and suppliers who are paid in yen to earn excess dollars do not produce anything that is ultimately exchanged with other Japanese. They produce things for foreigners. If the foreigners in turn produced things that were bought by Japanese, that would not be a problem. But they do not—that is what it means to have endlessly accumulating trade surpluses. And the deposits that go to pay the

Japanese who have produced things for foreigners without return represent a drain on the Japanese economy.

U.S. Deficits and Japan's Dollar Surpluses

The dollars held by Japanese entities are claims on the U.S. Federal Reserve System, exercisable directly or indirectly through U.S. banks. It does not matter whether deposit holders at the Federal Reserve are U.S. nationals or foreigners. When American entities pay for imports by wiring dollars to an exporter's account—which they typically do—those dollars never leave the U.S. banking system. A Japanese bank or the FESA may nominally own the dollars, but they continue to function as money in the United States, serving as funding for American economic activity.

By holding its reserves in dollars, Japan has more or less encouraged the United States to spend and import more. The United States does not need to pay for imports—that is, earn foreign exchange through exports or asset sales—as long as exporting countries such as Japan are satisfied to receive claims on the Federal Reserve as payment. If the U.S. currency were still backed by gold, the chronic deficits with Japan would have seen the transfer of American gold holdings into Japanese accounts. But instead, because of the willingness of Japan to receive claims on the Federal Reserve without ever exercising those claims, American deficits with Japan are automatically financed. Japan's exports of goods to the United States come with the exports of capital (that is, the dollar holdings) necessary to pay for them. Indeed, the buildup of "foreign" dollars in the U.S. banking system during the past two decades seems to have had macroeconomic effects comparable with a deliberate easing of monetary policy by the Federal Reserve, and it almost certainly contributed to the run-up in American asset prices (for example, the NASDAQ bubble) of the late 1990s.

These arrangements can be considered a kind of duplication of reserves in the United States and Japan. By continuing to pile up claims inside the U.S. banking system, the BOJ is in essence lending to the Federal Reserve, creating monetary reserves that are theoretically twice as large as the underlying transactions that gave rise to the reserves because the money can be used in both the United States and Japan. But, as noted, Japan cannot monetize its dollar holdings for domestic use without inviting problems once those holdings exceed the need for currency in circulation. That is the financial problem posed, to put it crudely but accurately, when Japanese workers make goods for Americans but are then never paid with American goods or services.

Japan is not the only country in history to have accumulated large net claims on foreigners. But in most cases those claims have been denominated *in the creditor's currency*. Switzerland and Germany, for example, also have run large current account surpluses during much of the last three decades; Switzerland's external assets, like Japan's, far exceed its annual exports. But these countries allowed their currencies to appreciate and did not block imports, with the result that their international balance of payments never became as lopsided as Japan's. Furthermore, German exports typically were paid for in marks; Swiss claims on foreigners typically were denominated in Swiss francs. From a financial point of view, it makes no difference whether claims are accumulated on foreigners or on residents as long as they are denominated in the country's own currency; the money never leaves the domestic banking system. Central bankers can ignore the claims.

But if those claims are denominated in a foreign currency, then they become problematic, because beyond a certain point they cannot be used domestically. In Japan, that point was reached by the late 1960s, when the country's dollar holdings exceeded its need for currency in circulation. Since that time, Japan has been deliberately transferring purchasing power to the United States—a transfer that has taken the financial form of buoyant U.S. money, bond, and equity markets and, increasingly, deflation in Japan.

In the 1970s, when the dollar was finally delinked from gold and the Japanese began to accumulate surpluses denominated in nothing but claims on the central bank of another country, foreign exchange markets reacted with waves of instability, driving down the price of the dollar on the assumption that the situation could not be sustained. And periodically since then—most notably in 1987 and 1995—tremors have shaken global markets at the prospect of an unwinding of Japan's accumulated dollar position. But most of the time—particularly since 1989—markets generally have been reassured that Japan's capital exports to the United States will never be repatriated, that its position will never be unwound.

Japanese officials have worked tirelessly to maintain that reassurance, acting to keep Japan's surplus invested in the United States and to thwart speculation against the dollar. The original rationale for Japan's accumulation of dollars lay in the notion that demographic trends would ultimately lead to a decline in Japanese savings, that Japan would need finally to draw down those dollar holdings. But any sign that that is in fact starting to happen, that Japan is finally beginning to spend its accumulated dollar holdings—that is, that its current surplus is beginning to shrink—has been met with an outpouring of anxiety. And whatever rationale might be on offer, officials have invariably acted to perpetuate existing arrangements.

Japan's dollar surpluses form a nearly unique problem in modern economic history. (We say "nearly unique" because Taiwan, which has comparable levels of dollar-denominated international reserves, suggests some parallels with Japan.) Saudi Arabia and the Gulf emirates have enjoyed surpluses since the 1970s that are comparable in scale to the Japanese surpluses. But while those countries do have their own currencies, in economic terms their currencies are nothing more than accounting entries. They have no serious economic activity other than pumping oil out of the ground and selling it on world markets for ten to twenty times what it costs them to extract it. They are little more than dollar-based *rentier* economies, and their economic significance would disappear overnight if oil were replaced by another energy source.

But Japan is the world's second-largest economy, not because Japan can extract extortionate rents but because over the past half-century the Japanese have built the most wholly integrated industrial structure on earth. Japan still outclasses the rest of the world in cost control, product quality, and technological sophistication in a number of centrally important finished goods—most notably automobiles—as well as a wide range of upstream product segments. Japanese companies have to rely on foreigners only for commodities, aircraft, and cutting-edge computer, information technology (IT), and Internet-related products for which they, in turn, provide components that no one else makes.

This situation has been the implied goal of Japanese economic policy since the late nineteenth century—the building of an industrial structure that would reduce reliance on foreigners to the bare minimum. And while Japan has faltered in the last decade in the IT arena, that should not disguise its overall success in reaching its goal. But that success has landed Japan in a trap. As all the hand wringing over a recent shrinking of the current account surplus demonstrates, the trap itself is not understood, not to mention any realistic means of escape.

The Public/Private "Divide" and the Policy Trap

We have described Japan's policy trap with the language of accounting—the increasing difficulty faced by the authorities in creating domestic liabilities that can offset Japan's largely useless dollar assets. But those accounting conventions illustrate a larger reality. In Japan, no clear dividing line exists between the public and the private sector. As we will demonstrate, Japan's banks are essentially creatures of its governing bureaucracy. Banks support corporations with credit allocations determined by bureaucratic objectives rather than concerns for profitability. Neither banks nor corporations are expected to provide for their own institutional survival, which is why both can ignore profits. They play their respective roles in the Japanese economy, ensconced in an all-enveloping system of mutual protection, with their viability the ultimate responsibility of the bureaucracy.

Since first invented by Venetian merchants in the late Middle Ages, financial accounting has served as an indispensable tool for those charged with responsibility for the survival and growth of economic entities. Accounts prepared under the rules of double-entry bookkeeping provide a comprehensive picture of financial health and flash immediate warning when things are going wrong. Independent financial institutions in Japan applying proper accounting rules could not have accumulated the dollar positions they have. The mismatch between the dollar assets they hold and the yen liabilities they use to support them would have drawn the attention of any prudent manager, not to mention an outside regulator or investor.

But in Japan, banks and other institutions are allowed and even required to sustain risks that would be regarded as unacceptable elsewhere in order to preserve their place in the Japanese system. For the supposedly independent entities of Japanese finance—banks, securities firms, insurance companies—are not genuinely independent; they function as part of one large integrated system that has served to socialize risk. Mismatches that would have been caught and corrected at the level of the individual bank or company in a Western economy surface only at the national level in Japan—in the current account, the balance sheet of the Bank of Japan, the assets and liabilities of the entire financial system—where they can no longer be disguised or avoided.

For in the last twenty years, Japan's accumulated current account surplus has outstripped both official reserves and currency in circulation, accelerating at a rate higher than the GDP growth rate and bringing on a deflationary build-up of dollars. It is here that the essence of the policy trap in which Japan finds itself is to be found, and we believe that it lies at the heart of the difficulties that Japan has experienced over the past decade.

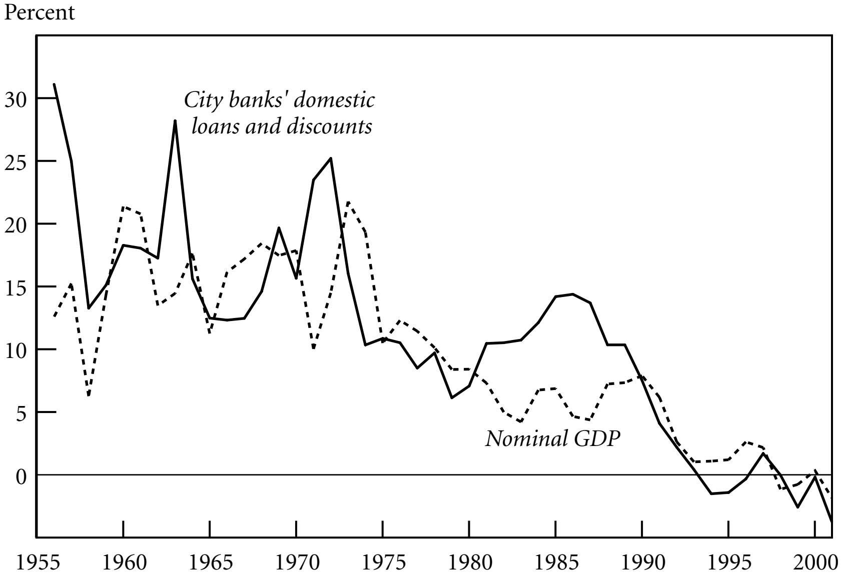
The Japanese economy has long been described as a bicycle that must be kept moving lest it tip over—when neither borrowers nor their financiers demonstrate significant profits, growth is essential for both to remain solvent. In the 1990s, the bicycle pretty much stopped moving, and while it has not yet tipped over, the stagnation of the last ten years has presented Japan's elite officials with a historically unprecedented challenge that their institutional memory gives them little guidance in coping with.

Considering the dimensions of Japan's policy trap, a growing chorus of economists worldwide has, as noted, urged Japan to print yen in response in order to create inflation. We will argue that the structure of the Japanese financial system, the nation's tax policies, its real estate markets, and a host of other factors have combined to make it far more difficult to create inflation today than most economists realize. That makes the dilemma faced by the Japanese authorities all the more acute because to work properly, the Japanese financial system requires at least nominal GDP to grow. And at the heart of the inability today to boost either real growth or inflation—the components of nominal GDP—lies Japan's mountain of dollar claims, which acts like a huge hole in Japan's monetary bucket.

Hence the policy trap that we intend to describe in this book. We see no way out of the trap short of a reversal in Japan's current account or, in other words, a shift in the fundamental parameters of savings and investment that ultimately determine the current account. But we are not talking exclusively or even primarily about economic measures here; a reversal would both require and cause far-reaching political and institutional changes. And those changes would not stop at Japan's borders. Reducing Japan's surplus cannot occur in isolation; it must be accompanied by a reduction in deficits somewhere else—most obviously through far-reaching shifts in the U.S. economy, which since 1945 has exhibited a bias toward consumption and against saving that has given rise to a current account deficit that is now structurally embedded in the U.S. economy.

Japanese policy officials thus find themselves boxed in, with no choice other than to continue piling up dollar claims. But as the deflationary

Figure 1-10. ***Year-on-Year Growth Rates of City Bank Loans and Nominal GDP***



Sources: *Financial and Economic Statistics Monthly,* Bank of Japan; statistics compiled by the Japanese Bankers Association; *Annual Report on National Accounts,* Cabinet Office. Calculated, arranged, and estimated by Mikuni & Co. © 2002 Mikuni & Co., Ltd.

impact of the dollar claims grows ever larger, policymakers in Tokyo are running out of methods to create the matching liabilities needed to fund them. In Japan, those liabilities take the form primarily of deposits. The bubble economy of the late 1980s represented an attempt to break out of the policy trap by rapidly expanding those deposits. As shown in figure 1-10, which documents the excess of bank credit creation over GDP growth, the authorities were successful during the 1980s in fostering an expansion in bank credit that far outstripped the expansion of the real economy. That flood of credit helped foster two of the greatest asset bubbles in history, with the market value of companies listed on the Tokyo stock exchange briefly surpassing that of its equivalent in New York while Japan's real estate prices soared to such heights that, in one widely quoted statistic, the implicit market value of the grounds of the Imperial Palace outstripped that of all the real estate in Canada. The trading in those assets at levels that bore no relation to economic fundamentals brought on a surge in yen deposits—the liabilities needed to fund Japan's dollar assets.

But creating deposits through bank loans became far more problematic following the twin crashes of the Japanese real estate and equity markets in the early 1990s, which brought down with them an avalanche of bad loans that buried much of the nation's banking system. With the collapse of the bubble, the Japanese government has had to turn to massive public works spending in order to create liabilities. Japan's public works "monster" acts to create deposits, to put money in the hands of people who will take it to the bank or the post office rather than spend it, thereby creating the necessary liabilities to support Japan's dollars. But the cost has been an explosion in public sector debt that has begun to threaten the government's continued ability to create those liabilities.

A Natural Limit?

The day of reckoning for Japanese mercantilism thus has repeatedly been postponed. Commentators talk of the 1990s as a "wasted decade" for Japan, but the country has not collapsed. Japanese industries may no longer bestride the world as visibly as they did in the 1980s. They may take a back seat to the Americans in IT-related industries. But Japanese companies continue to dominate an impressive array of key upstream product segments. And while Japan's administrators may no longer be able to provide the steadily rising household incomes that characterized the period from 1955 through 1990, Japan's industrial preeminence guarantees that for the foreseeable future the country can make or buy what it needs to feed, clothe, and house its population in reasonable comfort. The situation is far from ideal, but it seems tolerable both to the elite and to the wider populace. The elite certainly has no intention of risking its hold on power by instituting any kind of fundamental structural change, while the wider public displays little appetite for the economic and political upheavals that would be the inevitable price of a real shift in existing power alignments.

That seeming stability is reinforced by the global economic environment in which Japan is embedded. Japan's dollar-support policies helped the United States run eye-popping current account deficits that permitted the country to extend the economic expansion of the 1990s for years beyond the point that domestic capacity and labor market constraints would otherwise have halted it. There are no important parties anywhere in the world—not in Washington, not in Brussels, not in Beijing—that would welcome the long, steep recession necessary to end U.S. current account deficits. Tokyo can thus count on automatic reinforcement from abroad for continuing its present policy regime. Whatever lip service may be given to making "reforms" that ostensibly aim to increase Japanese and decrease American imports, no one seriously wants to risk disturbing the status quo.

While the political forces aligned in favor of continuing the present policy may seem overwhelming, we believe that ultimately it will reach a natural limit—and that the limit will be reached sooner rather than later. Over and over again during the past ten years, the Japanese government has announced that the corner has been turned, that the economy is in an upswing. And over and over again those hopes have proven false. Japan's stagnation has persisted far longer than even the most pessimistic analysts anticipated when the grip of the present stagnation first became clear in the early 1990s. And while those who predicted that the stagnation would end in a "hard landing" rather than a robust recovery have also, to date, been proven wrong, the fact that it has continued far longer than anyone thought possible is no guarantee that it will continue indefinitely. Among other things, we believe that Japan is rapidly running out of ways to support its endlessly growing pile of dollar claims and that when the day comes when those claims can no longer be supported, the world could see a horrific deflationary spiral in Japan, a crash in the global value of the dollar, or both.

Further, in an ironic twist, Japan's continuing economic stagnation has begun to threaten the supremacy of Japanese manufacturing, with visible erosion in the country's competitiveness. Japanese companies have been unable to repeat in the personal computer and mobile phone segments their earlier successes with electronic calculators and VCRs. Since miniaturization has long been a notable strength of Japanese industry, Japan's stumbling in the transition from mainframes to PCs seems particularly ominous. The twin crunch of higher domestic costs and inroads from Korean and Taiwanese competitors copying Japanese manufacturing methods has forced Japanese companies to retreat. Even Japan's greatest success story in the past decade—mobile phones—turns out, on closer examination, to be less than total. Japan's biggest competitors are firms such as Nokia and Ericsson, operating in a Europe that has demonstrated a far greater willingness to fund and support national industrial champions than a United States with its often blind ideological hostility to anything that smacks of industrial policy. Japan's mobile phone makers, long coddled by Nippon Telephone and Telegraph—and the Ministry of Posts and Telecommunications (now part of the Ministry of Public Management, Home Affairs, Posts, and Telecommunications), which stands behind it—are fragmented; while they dominate the domestic market, they have not yet taken their place on the honor roll of Japanese industries that have conquered the world. A formidable line of predecessors in industries ranging from textiles through automobiles, machine tools, televisions, VCRs, and many others followed the characteristic Japanese path of first dominating domestic markets and then proceeding to extend their dominance to the entire world. But mobile phone makers have not yet joined their ranks. Indeed, it has been more than a decade since the Japanese have made a global conquest of an important industry.

Japan's large manufacturers have in the past decade chosen instead to concentrate on upstream components whose sales are assured rather than risk venturing into new product segments, leaving the battle for supremacy in new markets and new arenas to their Western competitors. And while Japanese companies continue to enjoy great strength, as noted, across a wide range of product segments, the success of the Koreans in such areas as D-RAM chips has shown that even a component-focused strategy is not without its pitfalls. Korean companies such as Samsung have taken a leaf from Japan's book, pouring vast amounts of investment into production facilities in order to capture market share. Caught between innovative Western firms that, as much as any firms can, control the direction of the most important new markets and new industries, and Korean, Chinese, and other Asian competitors with far lower costs, even Japan's dearly purchased and heretofore seemingly impregnable industrial supremacy is now threatened. Since that supremacy and the construction of a vast production apparatus to support it has long been the ultimate goal of Japanese economic policy, the end of that supremacy could finally force Japan's policy elite into the political and structural overhaul necessary to cope with a rapidly changing world.

A Political Dilemma Masked as an Economic Problem

At the beginning of this chapter, we noted that mistaken assumptions were clouding proper analysis of Japan's dilemma. The biggest of those mistakes lies in the way the dilemma is understood. It is described as an economic problem, and to be sure it manifests itself in a variety of economic phenomena. Monetary and fiscal policies, corporate strategy and governance, structural drags on efficiency—all have accordingly drawn the attention of analysts. But Japan's dilemma is ultimately political. Japan's economic system is the product of political arrangements. Calls can be heard everywhere for reform—for more competition, for allowing markets to determine corporate control, for ending bureaucratic "interference." But as long as those exhortations ignore the underlying political reality, they are no more useful than utopian demands for world peace and universal prosperity that do not confront the roles of war and poverty in perpetuating existing power alignments.

Tokyo's policy regime today may seem to outsiders to be hopelessly malfunctioning and outdated. But it is not the outcome of a few recent cabinets trying to cling to power or of the jockeying among political parties to cultivate votes. Its roots lie far back in Japanese history, well before Japan's construction of the political facade of a constitutional democracy—one governed, with one brief hiatus since 1955, by the stable, conservative Liberal Democratic Party (LDP). That facade has been useful in providing Japan with an acceptable face to the outside world and in neutralizing any potential for disorder from leftist or other dissatisfied groups with the capacity to make trouble. But the facade is little more than a distraction in trying to get a handle on the reality of the policymaking that has now landed Japan in a trap whose grip seems even stronger, if—for the moment—less painful, than the notorious liquidity trap diagnosed in the 1930s as the cause of the Great Depression. To understand how Japan fell into this trap and how its jaws might conceivably be sprung, we must first turn to the deep-rooted political arrangements that determine policy.