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East Asia's Dollars

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By R. Taggart Murphy

Americans have long been warned that running large, continuous deficits courts disaster. 'We are living on borrowed money and borrowed time', was the way Walter Mondale put it to the 1984 Democratic Convention, when the US government's cumulative deficit was some $7 trillion less than it is today. Three years later, a spate of cartoons and op-eds would depict the 1987 stock-market crash as a vicious hangover; the just deserts of a wastrel nation. The ever-accumulating deficits so frightened the first President Bush that he famously reneged on his 'read my lips' promise not to raise taxes. In 1992, Ross Perot launched the most successful third-party presidential candidacy since Eugene Debs by making the rivers of red ink his central campaign issue. Clinton's great boast was that he managed temporarily to close the government deficit, although the trade deficit continued to grow during his administration.

It was not supposed to work that way; the government deficit had long been understood as a prime cause of the trade deficit. But before the puzzle resolved itself, George W. Bush arrived in Washington and, with his tax cuts, wars and lavish spending directed at his electoral base, ripped open the sutures that the Clinton administration had stitched between us government spending and tax revenues. Both the government and trade deficits soon reached levels that would have been regarded as inconceivable by most economists a few years before. Doomsayers extended far beyond the ranks of Democrats and old-school fiscal conservatives; at the beginning of 2005 Warren Buffett announced that he was so scared by the deficit trends that he was largely going to quit buying stocks or bonds denominated in dollars. [1] At the Davos Forum that year, C. Fred Bergsten of the Institute for International Economics warned of a dollar crisis 'within weeks'. [2] In a widely reported speech at Stanford a month later, Paul Volcker, former chairman of the Federal Reserve, spoke of an economy 'skating on thin ice'. [3] With beleaguered Republicans dependent on low taxes and government largesse to remain in power, and Democrats unelectable on an explicit programme of higher taxes and spending cuts, these men saw no plausible scenario other than a dollar crash for any reversal in the ever-growing-deficit trends. At some point, the foreigners who help finance the two deficits would surely refuse to throw more good money after bad. They would dump their dollar holdings, leading to a crash in the dollar that would finally force Americans to live within their means.

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Warren Buffett

But none of this has happened. The markets reacted to the doom-saying with the insouciance of a dog shaking itself dry. By the end of 2005 the dollar stood 15 per cent higher against the euro, 13 per cent higher against the yen, than it had in January; and this during a year when both government and trade deficits continued to set new records practically every month. Hence the conundrum: the savviest observers pronounce the trend lines of the deficits to be unsustainable; no realistic scenario can be imagined under which those trends will be reversed through political action, leaving only a dollar crash to do the job; yet the dollar crash stubbornly refuses to occur. Keynes once compared the stock market to a beauty contest in which the winnings went to whoever could pick the contestant thought by the other judges to be the most beautiful. If this is true of stocks, it is emphatically the case for currency markets. The day is long gone when the ebb and flow of international trade determined the value of currencies. Daily volume on the world's foreign-exchange markets runs in the trillions of dollars, with the us dollar bought or sold in roughly 85 per cent of all currency trades—most of them speculative. If enough people believe that enough others will hang on to the dollar come what may, then the dollar will not fall, whatever happens to the us deficits.

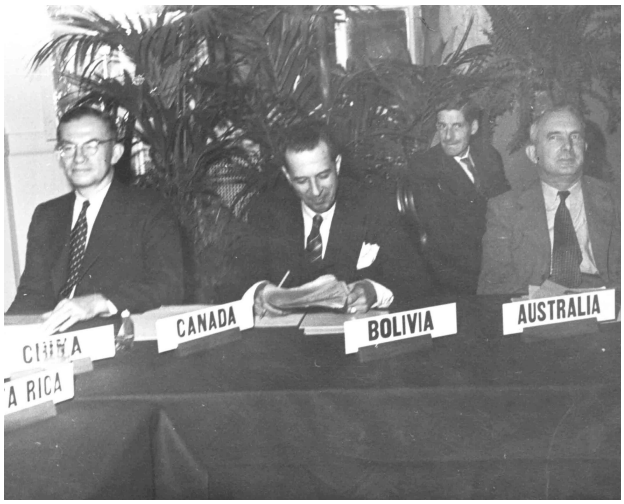
There is no secret about the identity of the biggest dollar holders. They are the central banks and other financial institutions of Japan, China, South Korea, Taiwan, Hong Kong, Saudi Arabia and the Gulf Emirates. If the dollar is going to crash, one or more of these places is going to have to change its stance towards the American currency. They display such a seemingly reflexive commitment to accumulating and retaining dollars that some commentators have described the current global financial order as 'Bretton Woods ii'—a continuation by other means of the dollar-centred international order that prevailed in the postwar decades. The label does not itself explain why these states behave as they do. But it suggests that, for whatever reason, they have motives other than maximizing returns on their foreign-currency holdings; that they have a vested interest in the continuation of a us-led financial system.

A voluntary order

The Bretton Woods system conceived by Keynes and Harry Dexter White in 1944 was more than a simple recognition of the reality that the United States would emerge from the Second World War in a position of overwhelming economic strength and that any workable global financial regime had to start from that premise. It mandated specific institutional action and imf approval to reset the exchange value of any currency in the system vis-à-vis the dollar. Most importantly, it required that the us maintain both the will and

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the ability to sell gold at $35 an ounce to foreign central banks on request, which meant that Washington had to take action whenever trade deficits threatened a precipitous loss of gold. When in 1971 the Nixon administration suspended the gold sales, did not use economic tightening to reverse the structural trade deficits, and could neither persuade nor browbeat its trading partners—notably Japan—to undertake compensating adjustments, the system collapsed. But despite a decade that saw the exchange value of the dollar plummet, the financial world continued to revolve around the dollar and does so to this day.



Bretton Woods

There is every reason for the us to be happy with Bretton Woods ii since Americans reap vast benefits from the arrangement, most importantly in the ability to finance trade deficits with impunity—what French economist Jacques Rueff famously labelled 'deficits without tears'. Among other things, that allows Washington to project military power around the world at little real financial cost, since the necessary money is first created by the Federal Reserve, then exchanged for goods and services from foreigners, and borrowed back by the us Treasury. [4] (Technically, it does not matter in what form foreigners hold dollars, whether us government debt, corporate debt, equities or anything else with a $ sign. As long as the securities are denominated in dollars they remain within the American banking system, where they serve to create credit in the us.)

But if the benefits to the us in Bretton Woods ii may be obvious, the benefits to those who prop it up are much less so. Indeed, the system is curious in at least two ways: unlike Bretton Woods i, there is no formal institutional requirement on anyone to support it; and adjustment burdens have generally been shouldered not by the system's primary beneficiary—the us—but by its creditors. To be sure, Volcker put the American economy through a recessionary wringer in 1979, bringing inflation down and thereby slowing the precipitous decline in the purchasing power of the dollar that had set in after the collapse of Bretton Woods i. The first Bush administration raised taxes, while the Clinton administration succeeded in producing a balanced Federal budget. But the US would have needed to take these sorts of measures anyway. Washington was not acting disinterestedly to save a global system, but rather to head off runaway inflation and economy-crushing interest rates. On the other hand, Japan's support for the dollar was a major cause of the 15 years of deflation and low growth it endured after 1990, while lower-income China used savings extracted from its impoverished citizens to finance American consumption.

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Initially it was the OPEC nations, led by Saudi Arabia, that did most to prop up a dollar-centred international order after the collapse of Bretton Woods i. Their swollen revenues were put on deposit in London; where they were recycled by leading commercial banks in the form of loans to non-petroleum developing countries, financing the latter's import bills. True, several OPEC nations briefly flirted with the idea of charging their customers in a currency other than dollars, but for a mixture of practical and geopolitical reasons (at the time, no other currency circulated in sufficient quantities and the Saudi regime depended on us military protection), they stuck with dollars.

But since 1977, when Japan became the first developed nation to recover from the worldwide mid-70s recession, it has played the starring role in dollar support operations. It was Japan that unleashed the floodgates of its burgeoning financial wealth in the early 1980s to finance the so-called Reagan Revolution—America's first experiment in steep tax cuts without concomitant spending reductions. It was Japan that pumped credit into the international system in the weeks after Black Monday—19 October 1987—when the us stock market lost one quarter of its value in a few hours. It was Japan that largely financed the first Gulf War, sold billions of yen for dollars in the wake of the Mexican peso crisis of 1995, and kept buying dollar securities right through the Asian financial crisis, 9-11 and the invasions of Afghanistan and Iraq. In the last ten years China has joined Japan as a primary supporter of Bretton Woods ii; its official dollar reserves may even exceed the $880 billion Japan reported in May 2005. But when the vast dollar holdings of Japan's private sector banks and companies are added to that official figure, it becomes clear that Japan continues to play the central role it has for 25 years now in supporting the global value of the dollar—and by extension, us hegemony.

Weight of the past

Why? What for? In strictly economic terms, Japan would seem to have only one compelling reason for its dollar support operations: as the world's largest holder of dollars, Japan stands to lose the most in any general dollar crash (other than perhaps the us itself). Japan finds itself in the position of a market player who has cornered so much of what is being traded that he cannot liquidate his position without destroying its value—and in the meantime, has to pony up more and more to support it. But economic calculations can illuminate only part of a picture that includes fifteen years during which the Japanese financial system seemed to outsiders on the verge of a collapse that stubbornly refused to happen. It includes a political elite, groping with realities they had never anticipated and for which neither their own history nor examples from abroad offered much guidance. It includes a political system that suffers from an institutional flaw rooted deep in its past, and a series of elaborate disguises used by the elite to conceal the sources of its power. And finally, the picture includes a long history of active support for the dominant foreign country of the day, one aim of which is to forestall any threat to domestic power alignments.

The 1868 seizure of power by the modern Japanese elite came dressed up as a restoration, rather than a revolution, and took place in accordance with existing indigenous legal procedures, such as they were. In contrast to the Chinese revolution 81 years later, the last Shogun did not flee to a remote island and establish a rival regime to that of Tokyo; he formally 'returned' power to the Emperor. Yet despite the formal trappings of legitimacy, the Meiji Restoration was a coup d'état launched by disgruntled elements on the fringes of the existing elite. They seized on the ancient institution of the Throne, theretofore a virtually powerless token of legitimacy, and

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used it as a cloak under whose cover they smashed a feudal system of fiefdoms and quasi-independent power-centres, and centralized political and economic institutions of control in their own hands with a ruthlessness that would have drawn Napoleon's admiration.

The samurai from the hinterlands of Japan's southwest who converged on Edo in the 1860s, renamed it Tokyo (literally, eastern capital), forced the abdication of the Shogun and brought the Emperor and his Court in from Kyoto, were not inclined to share power with Osaka's merchants or await the organic development of capitalist institutions. They sought to forestall the fate of the rest of the non-Western world—colonization at the hands of the imperialist powers—while suppressing at home an increasingly restive and impoverished peasantry. The merchants were generally ruined or expropriated and the countryside squeezed even more mercilessly than it had been under the shoguns to extract every spare yen to finance Japan's race for industrialization. Controlling stakes in the fledgling banks and industries were concentrated in the hands of former samurai, backed by a new bureaucratic mandarinate organized along Prussian lines. Meanwhile, imported institutions of social control were grafted onto an existing feudal order to deter domestic unrest. These institutions included universal male conscription, a militarized public-education system, a deliberate reworking of folk-religious practices into a politicized, centrally administered State Shinto, and the inculcation of a hyper-nationalist ideology of Emperor-worship.

Throughout their half a century of rule—roughly 1868 to the early 1920s—the leaders of Meiji Japan also played a deft and high-stakes game in positioning themselves in a global financial-cum-military order revolving around the City of London. That order saw the machinery of a supposedly neutral universal gold standard working in tandem with the law of comparative advantage to bring about what was touted as a best-of-all-possible-worlds outcome. In fact, the order was managed by the Bank of England and policed by the British Navy. Countries such as Turkey and Egypt that ran out of gold or silver and defaulted on their debts found themselves facing loss of territory and even independence at the hands of the Western powers.

Japan's leaders were acutely sensitive to the power dynamics that underlay the global financial regime of the time. [5] The rapid draining of gold from the country in the wake of Commodore Perry's 1854 'opening' had been a proximate cause of the collapse of the shogunate; the domestic gold:silver exchange ratio was 1:5, so out of line with the prevailing international ratio of 1:15 that savvy traders quickly bought up much of the country's circulating gold coin using its overvalued silver. The entire financial thrust of the subsequent industrialization had as its primary motive the accumulation of gold—or more precisely, the accumulation of claims on gold. For when Japan actually succeeded in acquiring ownership of sufficient gold—extracted as reparations from a prostrate Qing dynasty after the 1895 Sino-Japanese War—to render its credit acceptable abroad, the country's leaders chose to buy the goodwill of Britain by leaving the gold in the vaults of the Bank of England, rather than bring it back to Japan. The policy was known as zaigai seika—literally, 'specie kept outside'. It relied on the ability of 'high-powered money' (that is, money used to create other money: gold, bank reserves, international reserves) to play two simultaneous roles: in this case, as backing for Japan's own credit creation and also as part of Britain's money supply.

Keynes would describe the mechanism in his first major published work, Indian Currency and Finance, when he noted how earnings from India's surplus trade with Britain that were left

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in London became part of the domestic money supply there and did not lead to a loss in British purchasing power. Keynes was cited by a later Bank of Japan governor in justifying zaigai seika. The policy would form the financial backdrop for the signing of the Anglo-Japanese Alliance in 1902, which sealed Japan's admission into the club of nations supporting the existing global order. In 34 years, the country had moved from a poor backwater, whose very future as an independent nation was in doubt, to an important pillar of British hegemony in East Asia and an imperialist power in its own right. The resultant freedom of action, among other things, gave Japan the wherewithal to raise on global markets the funds necessary to wage and win the 1904–05 Russo-Japanese War, which in turn helped lay the groundwork for the Russian Revolution.

Changing hegemons

But for all their success, the Meiji architects of Japan's rise to global respectability had not solved core political problems, including the construction of institutions with the full legitimacy to determine succession and bestow the right to rule. [6] For power was theoretically exercised in the name of an Emperor who did not in fact rule. Behind the façade of the imported institutions of parliamentary government and the elaborate fiction of Imperial blessing, the men who had seized power in 1868 continued to run the country themselves as a kind of collective oligarchy, controlling the great bureaucracies they had built. They failed, however, to leave their successors any sort of mechanism that could adjudicate among competing claims to power. The passing from the scene of the Meiji oligarchs coincided with the collapse of the British-centred world order in the fields of Flanders. A power vacuum in East Asia was among the many consequences of the inability of Great Britain and the unwillingness of the United States to assume system-sustaining functions in the wake of the First World War. Mid-ranking officers in the Japanese Army grabbed the levers of control at home and filled that vacuum, raining destruction down on their neighbours and ultimately their compatriots.

Yet Japan's devastating military defeat at the end of the Second World War did not lead to the replacement of one government with another. Washington's endless self-congratulation notwithstanding, the American Occupation did not engineer any fundamental break in the nature of Japanese rule. The constitution written by the occupiers no more settled the question of who had the ultimate right to determine the country's agenda than had the leaders of the Meiji era. True, it aspired to reposition sovereignty with the Japanese citizenry, supposedly acting through its legislature, rather than the Emperor. But the great bureaucracies that determined what actually went on in Japan were still unaccountable to any outside source, be it Emperor or Diet. The judiciary was still independent in name only. There was no oversight—from elected legislature, court of law, or monarch—over what any of the great bureaucracies were doing, and no accountability.

But two things had changed. First, the prewar and wartime bureaucracies with the means of physical coercion at their disposal—the military; the Naimusho, or Interior Ministry—were either fragmented into less powerful shards or emasculated altogether and brought under the thumb of the Budget Bureau of the Ministry of Finance. Meanwhile, the great economic ministries—Finance; Munitions, now renamed International Trade and Industry—were left largely untouched. Second, the United States assumed for Japan those functions by which a state is most commonly identified: providing for national security and conducting foreign relations. In most nations, questions of security, foreign policy and the

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allocation of public funds to competing domestic interests form the stuff of politics. But with foreign and security policy taken out of Japan's hands, and reconstruction the obvious priority in the immediate postwar decade, political discussion largely vanished; with its disappearance, a necessary infrastructure—most importantly, a vigorous, independent quality press and a cadre of public intellectuals—atrophied.

With the 1955 merger of the two major conservative parties to form the Liberal Democratic Party, the postwar configuration of Japanese political life was complete. The merger was taken to forestall any possibility of leftists coming to power, something that the us had effectively insisted on as a condition for ending the Occupation. But the 1955 system also included the sublimation of all other national goals into single-minded devotion to economic growth and acquiescence in the US–Japan 'alliance'. [7] The aim was to build an industrial superpower under American military protection and within a stable dollar-centred global financial framework; the Japanese elite did not concern themselves with the long-term sustainability of either.

As Japan emerged from postwar devastation and launched a renewed drive for industrial growth so dazzling that it acquired the label 'miracle', it seemed as if the tale of the Meiji years was being retold. Again, Japan moved in the space of a couple of decades from a poor backwater to a major player, snuggling up to the superpower of the day. Again, it would serve as a crucial military asset for that superpower vis-à-vis the great Eurasian continental—and now Communist—empires. Again, it would leave the proceeds of its export earnings within the superpower's banking system, providing indirect financial support for the superpower's ability to project military force. And again its subordination to a financial-cum-political global order managed and policed by the superpower would permit it to sidestep fundamental political questions.

The contemporary Japanese political setup thus resembles a flourishing vine that has grown to great heights, but would likely tumble should the pole around which it twists—the United States—ever itself fail. But the image requires qualification, for not only does the pole support the vine, but the vine has, for the past 35 years, become an increasingly important prop for the pole. The us needs Japan today to a far greater degree than Britain ever did. Japan's companies manufacture a range of both high value-added components and finished products on which American technological and military supremacy totally depend. Japan's continued central role in financing the us trade and government deficits and propping up a dollar-centred international order is, as we have seen, the key explanation for Washington's ability to project and sustain a vast global military establishment without crushing domestic tax burdens. Since the mid-70s, at every crisis point when it has looked as if upheavals in the foreign-exchange market might force the us to live within its means, it has been the Japanese elite that has acted to support the dollar, the Bretton Woods ii regime and, by extension, the continuation of American hegemony. As Mikuni Akio and I have argued, this has not been due to any particular affection for Washington on the part of that elite, but 'because it identifies its own survival with the continuous build-up of (Japan-owned) dollars in the American banking system'. [8] Any alternative would demand a fundamental reconsideration of the assumptions of the 1955 system, and thus risk fostering another dangerous and debilitating intra-elite struggle.

Fleeting fantasies

For a brief period—from the late 80s until the early 90s—the Japanese elite did appear to give

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serious thought to a fundamental restructuring of the relationship with Washington along more independent lines. From the 1979 publication of Ezra Vogel's Japan as Number One, they had been told by both their own home-grown cheerleaders and a diverse group of seemingly clued-in foreigners (I was part of the chorus, although like most non-Japanese I expressed some reservations) that they were on the verge of global economic pre-eminence, if they hadn't already achieved it. Japan appeared to have surpassed the United States by every significant measure of economic strength save sheer size; and that was only a matter of a few more years. Particularly after the 1987 stock-market crash, interpreted in Tokyo as a damning verdict on American profligacy and economic weakness, the Japanese elite seemed convinced they were living in the last days of American economic hegemony.

To be sure, the US still provided useful military protection against what was seen as Japan's major external security threat and close neighbour, the Soviet Union. And the residual buying power of the American market was thought to form a necessary bridge to Japan's historic assumption of the role of the world 'headquarters economy', to quote a National Interest article forecasting precisely that. [9] But Japan had already taken the lead in containing the damage from the 1987 stock-market crash. Its companies dominated every important new technology and its banks dwarfed their foreign rivals. The seemingly bottomless money pump of the domestic real-estate market made it possible for the Japanese to buy any asset, anywhere, for what seemed, from their perspective, chump change. The Ministry of Finance withdrew its historic opposition to the globalization of the yen and launched study programmes on the conversion of East Asia into a yen bloc. All that seemed to be required was formal acknowledgement of the underlying reality: the passage of hegemony over the global economy from the US to Japan.

But the Japanese money pump of the late 80s had been built on the quicksand of ever-rising land prices. When the authorities intervened to slow the rate of increase, they discovered that they had thrown the entire mechanism into reverse—and then could not stop it. Before land prices finally bottomed out, a Japanese financial system that had appeared on the verge of global dominance would have to retreat from international markets into a forced overhaul at home, which saw some of its proudest names disappear in a series of shotgun mergers. A Japanese electronics industry that had trumpeted its supposed supremacy in semiconductors in the pages of Scientific American watched in stunned disbelief as American companies it had never heard of—Apple Computer, Microsoft, Intel, Sun Microsystems, and—walked away with leadership in all the important emerging information technologies of the 1990s (mobile phones the one exception). Against all expectations, the us managed to reduce and finally eliminate the fiscal deficit between 1990 and 1995 and was rewarded with robust growth and a strong currency. Meanwhile, Japan seemed to lurch from one incoherent policy response to another, while its government debt accumulated at a pace even the US had been unable to match.

During the 1990s a sense of realism gradually settled in again after the puffery of the 'bubble economy'. Japan's elite came to see that they were facing the first fundamental challenge to their control since 1945. The rest of the world interpreted the problem as primarily an economic one, and indeed it manifested itself in such phenomena as stagnant gnp, rising unemployment, bankruptcies, tottering financial institutions and deflation. But it was at heart a political challenge: how and whether the Japanese system should reconfigure itself to cope with unanticipated new realities in a

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world where the old methods no longer seemed to work. To mainstream economists in much of the world, the solution to Japan's troubles seemed obvious: the full-fledged adoption of the institutions of liberal capitalism—corporate governance by outsiders, free trade, a purge of large, unprofitable banks and manufacturers and a sell-off of their assets to those who could manage them for higher returns, transparent markets for labour and corporate control, the busting up of cartels, price setting—for interest rates, the yen, labour, land, food, housing—by markets rather than bureaucrats.

The loudest exhortations along these lines emanated from Washington—ironically, since had Japan actually implemented these policies, the result would probably have been an economy-wide shakeout that would have forced large-scale liquidation of Japan's dollar holdings and sharply curtailed its ability to prop up a us-centred global financial order. After all, companies and banks left to fend for themselves without the accustomed protection of an all-enveloping bureaucratic system would have come under strong pressure to do everything they could—including selling dollar assets—in order to survive the free-for-all of a market economy. Japan might have emerged on the other side of that shakeout with a stronger economy, as conventionally defined; but in the process its practical support for Bretton Woods ii would have come to an end.

There was, in fact, never any real possibility that Japan's power holders would commit political suicide by abandoning control over the economy to markets that they did not trust. But the circumstances of the 1990s nonetheless posed formidable problems: how to guide a financial system back from the precipice without provoking a crash; how to manage an economy where increases in nominal gnp (real gnp plus the rate of inflation) could no longer be taken for granted; how to lower the expectations of a sullen and disenchanted citizenry without provoking real civil unrest. On top of their unprecedented domestic challenges, they had to cope with a new global economic order in which the direction and pace of economic growth seemed to have passed from straightforward manufacturers to those who had mastered the art of delivering complex bundles of services—uncomfortable for a country whose greatest economic strength lay in making things.

A neoliberal turn?

In responding to these challenges Tokyo followed what, 1931–45 excepted, had been the guiding principle of its foreign policy since the late 19th century: subordination to the global interests of the superpower of the day, in return for a degree of protection and indulgence. Much mainstream Western opinion, however, would misinterpret this reaffirmation of Japan's place in the American-centred order as a decisive turn to neoliberalism. The misunderstanding is due in part to a mixture of amnesia and wishful thinking. For a decade or more, the financial press, neo-classical economists and Wall Street analysts alike had been predicting the direst of consequences unless Tokyo got religion and adopted all the correct neoliberal reforms. Since the disaster had not happened—Japan's financial system had not collapsed; its manufacturers continued to dominate several key sectors—perhaps the reforms had been instituted on the sly. In addition, Japan's elite deliberately fostered the notion that the country had made a turn towards neoliberalism. The language and some actual practices imported from what the Japanese like to call 'Anglo-Saxon capitalism' proved useful both in lowering middle-class expectations and in promoting efficiency. The widespread talk of resutora, coined from that Wall Street favourite, 'restructuring', plus a few visible foreign takeovers of ailing companies—Nissan Motors; Long-Term Credit Bank—served to concentrate the minds of

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Japan's salaried workers and managers, faced with the undreamt-of horror of reporting to foreigners younger than themselves or even losing their jobs. And the neoliberal talk was, of course, music to the ears of a superpower whose attention had been forcibly distracted by events elsewhere.

Indeed, until January 2006 one could get the impression that Japan had become another devotee of Wall Street sermons. Management-fad jargon flowed glibly from the mouths of Japan's young bankers and business people, ceos talked the talk of shareholder value, mba programmes sprouted in Japan's universities (I teach in one of them), and m&a was no longer a dirty term. In the wake of a dizzying succession of faceless, in-and-out prime ministers, Koizumi Junichiro emerged in 2001 and put on a convincing act as a reformer determined to drag his country into the 21st century. The White House lapped it up while the left muttered darkly of Koizumi's subservience to America's globalist, neoliberal hegemony.

Subservient to Washington Japan may be, but the notion of a wholesale conversion to neoliberalism should be taken with a heap of salt. If some in Japan's business and financial circles had convinced themselves that a new era of dealmakers and 'value' had thrown the old bureaucrat-run economy into permanent eclipse, behind the scenes Japan's Ministry of Finance—and its offshoot, the Financial Supervisory Agency—was still calling the most important shots. This was evident in the bill to 'privatize' the postal savings system, upon which Koizumi hung his spectacularly successful September 2005 call for elections to choose a new Diet. On the surface, this seemed the perfect contest between the dinosaurs of old, bureaucratic Japan and the new order. Postal savings have been the central financial pillar of the 1955 system. Collected through a dense network of post offices that blankets the country, they form the world's largest pool of discretionary cash. This has traditionally been turned over to the Ministry of Finance, which has used the money to sop up Japanese government bonds, finance projects in the districts of LDP politicians and support the dollar. Post offices offer slightly higher interest rates, more branches and friendlier service than the traditionally haughty banks. Postmasters, particularly in rural areas, are important local figures, often with LDP connections; it is not unusual for the position to be passed from father to son.

Koizumi ostentatiously burnished his 'reform' credentials by picking a fight with LDP backbenchers who opposed the Japan Post 'privatization' bill. They understood that it represented a first step in draining the source of their power—the networks of rural LDP supporters whose jobs are financed, directly or indirectly, by postal savings. But the notion that the bill heralded the emergence of a shareholder-driven economy overlooked the fact that the bill had been written by the Ministry of Finance (Koizumi admitted that he had not even read it); it implied that MOF bureaucrats were prepared to cede control of restructuring the Japanese economy to investment bankers and capital markets. To be sure, Koizumi pulled off an impressive political sleight-of-hand. His opponents in the LDP, closely linked to the rural-based construction industry and the post office bureaucracy, fell for his ploy of announcing he would call an election if the bill were defeated. They voted it down, allowing him to define the election as a choice between 'reform'—himself and his handpicked candidates—and those 'against change': anyone who opposed him. The manoeuvre sucked out of the system the oxygen that might otherwise have permitted genuine champions of reform to start a small fire.

In reality, Koizumi's 'landslide' re-election in September 2005 entrenched the power of the

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Ministry of Finance over the Japanese economy. The Japan Post bill was promptly reintroduced and passed. There was never any possibility that the postal savings were going to be suddenly withdrawn from the markets for us and Japanese government debt securities, in order to chase higher returns elsewhere; for at least ten years the money remains largely at the disposal of the MOF, which has no desire to spark soaring interest rates or a currency crisis. What the new law did do was create a situation in which less of the postal savings need be diverted to rural white elephants and more can be devoted to dealing with Japan's sagging public finances and restructuring the financial system.

Horiemon

Conventional wisdom abroad nonetheless held that Koizumi's re-election represented the dawn of a turbo-charged free-market system. Many Japanese themselves were also seduced by this talk. The leading symbol of the supposed new economy was a young entrepreneur by the name of Horie Takafumi. Horie had been slated for a position in the elite when he secured passage through its most important gate—matriculation at the University of Tokyo. But instead of doing what was expected of him—graduate and join the ranks of the governing bureaucracy or a major company—he left the University without a diploma. Modelling himself on the likes of Bill Gates and Steve Jobs, who had also dropped out of elite schools, he set up a company to pursue opportunities offered by the coming of the internet. His firm, Livedoor, grew rapidly and soon, in classic Wall Street style, Horie began to launch takeover bids, using his mastery of the new media to appeal over the heads of entrenched managers to the shareholders who theoretically owned the firms. In the process, he became an icon for younger Japanese, defensive about their country's supposed eclipse by the likes of Apple Computer and Goldman Sachs. Schoolchildren nicknamed him 'Horiemon'; the suffix, derived from the English 'monster', having morphed into the designation for a boyish action hero (Pokemon, Doraemon).



Horie Takafumi

Clad in T-shirts and jeans, Horie became a familiar figure on Japanese television, upbraiding stuffy, besuited executives for their stick-in-the-mud ways. Horie was very much of a piece with Koizumi's talk of 'reform', and ran on the Koizumi list against an LDP heavyweight, Kamei Shizuka, in the September elections. Kamei is a proudly unreconstructed champion of the traditional buy-rural-votes-with-big-infrastructure-projects system and won easy re-election in a district that has done very well with the old ways. But Horie's run boosted Koizumi's 'reform' image while enhancing his own celebrity.

That celebrity was probably his downfall. On 16 January 2006, every TV station, radio broadcast and newspaper featured wall-to-wall coverage of hordes of prosecutors descending on Livedoor's offices; a week later, Horie was

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arrested. Several of his associates were thrown in jail, and another was said to have committed suicide; the more scurrilous journals hinted at murder. What ensued was a classic all-enveloping scandal of the type that has punctuated Japan's political life since 1945. As if on signal, the entire media establishment went into overdrive, pouring vituperation on a figure who just a few weeks earlier had been celebrated as an avatar of the new prosperity. Karel van Wolferen has argued that scandals represent a central structural feature of a Japanese political order that is not ultimately grounded in law; that scandals correct excess and resolve power struggles which, in other countries, would be settled by courts or elections. [10] The prosecutors who threw Horie in jail were in no hurry to bring any indictment. After a month of rifling through his company's papers—giving time for the quality press and the networks to whip up the equivalent of a national lynch mob—they finally settled on violations of the securities and exchange code, and later with accountancy fraud.

In Japan, prosecutors do not initiate proceedings on their own initiative against figures suspected of financial crimes. Nor do they act on behalf of disgruntled investors. They move only at a sign from inside the Ministry of Finance and other bureaucracies charged with overseeing the country's economy. The media coverage of Horie's downfall invited comparison with the Enron affair, and it appeared that he was engaged in dubious financial gamesmanship (his favourite tactic involved repeated stock splits, which provided a window of opportunity—while the new shares were being issued and the old shares could not be sold—in which to ramp up the price). Horie may indeed have been a Japanese version of the finance conman long familiar in the West, and the prosecutors will undoubtedly be successful in nailing him for something. [11] But vilifying him for manipulating his company's accounts recalls Casablanca's Captain Renault finding himself 'shocked, shocked!' at the gambling in Rick's Café, while pocketing his winnings. Many Japanese companies are world champions at accounting tricks.

Horie's real 'crime' lay in his failure to see that the neoliberal trappings with which Japan's spokesmen have bedecked their economy in recent years were just another imported suit of clothes, to be discarded as last year's fashion the moment they had outlived their usefulness to the real power holders. This kind of borrowing and discarding has been going on since the 1860s—take in something from the West, keep what is useful and throw out the rest, particularly when it challenges the fundamental distribution of power. Prosecutors gave the game away when one of them announced that Horie's arrest would remind people that 'wealth comes from hard work'. Horie's celebrity made him the perfect target for a message that only the dimmest could fail to get: neoliberal talk is fine for Washington; it can usefully serve as a cloak for welshing on unwritten employment norms, such as job security and steady increases in income. But anyone who tries to use it as a means of disrupting existing power alignments will find himself an example of that favourite Japanese proverb: the nail that sticks out will be hammered down.

Van Wolferen's suggestion that scandals of the Horie type are an essential element of a political order that lacks an institutional means to halt excess has an important corollary: the scandals can slip out of control and take on a life of their own, to the point of threatening the inner core of the governing elite. The Horie scandal is running true to form; on 5 June 2006, bureaucrat-turned-fund-manager Murakami Yoshiaki was arrested on charges of insider trading, stemming from his involvement in Horie's deals. Murakami was much more of

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an establishment figure than Horie. He had been an official of the Ministry of International Trade and Industry before he left on a self-appointed mission to shake up staid Japanese management with American-style shareholder pressure. Murakami seemed genuinely to believe that he was doing good in addition to doing well, and he was arguably the best-known investment-fund manager in the country. Yet Murakami's network of elite connections—one reason for his success—did not stop the scandal from enveloping him and others with whom he did business; including even Fukui Toshihiko, governor of the Bank of Japan, whose erstwhile stainless reputation is now besmirched by his investments in Murakami's fund.

While the scandal may touch yet more establishment figures before it plays itself out, it has for the time being cast a palpable chill on talk of restructuring the economy along neoliberal lines. A Koizumi chastened by the Horie scandal has proved himself useful in laying the groundwork for some necessary changes—a more efficient economy and a more urban-centred political system—without affecting fundamental power structures. The flirtation with more radical, destabilizing neoliberal notions has been terminated and an opposition party that might have imposed some form of political accountability on the bureaucracy has been decisively routed.

A new third player

In addition, a convincing economic recovery finally seems to be taking root, after several false starts. But will it last? Any disruption to Japan's export markets could easily derail a recovery since, for all the talk of revived domestic demand, these remain central to Japanese corporate profits and the ability to service debt. Since the early 1950s, exports have been the lodestone of Japan's growth—most particularly, exports to the United States. While that is still happening, as any glance at Detroit's woes can attest, equally important in recent years has been Japan's exports to China—both the physical and the financial kind. China's hunger for Japanese capital goods, to allow it to produce the exports to feed an American market, permitted Japan's capital-goods manufacturers to boost capacity-utilization rates to the point where they were making money again. The positive cash flow meant that balance sheets could be strengthened and debt paid down, allowing the banking system to put the worst of the so-called 'bad loan crisis' behind it.

China has thus helped alleviate what had come to seem an insoluble problem: the overwhelming pressure on the cost structure of Japanese industry once it joined the ranks of the developed nations. Japan had long sought to preserve what is essentially a 'late developer' model: export-led growth; systemic protectionism; severe restrictions on foreign equity; and cartels that funnelled cash into industrial coffers in order to offset the price-cutting necessary to win export markets. But during the 1990s the yawning gap between domestic Japanese prices and those overseas finally sucked in and chewed up cartel after cartel ('price destruction' was the term coined by distraught Japanese businessmen), while the collapse of real-estate prices crippled the financial mechanism that had seen cheap financing channelled from household savings to industry. And no matter what was done to shackle market forces, there was no escaping the economic reality of well-trained Chinese willing to work twice as hard as their Japanese counterparts for one-tenth of the wage.

But Japanese industrial leaders found the means of coping with this threat to their way of doing business by undertaking what amounted to a division of labour with China. Both countries engaged in tacit cooperation to

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support the dollar, permitting Americans to purchase Japan's high-value added products—automobiles, machine tools, aerospace components—and China's lower-end products, manufactured largely on imported Japanese equipment. For many Japanese working-class households, the end of job security has been partly alleviated by waves of cheap Chinese imports of food and clothing. The country's informal economic mechanisms—'lifetime' employment, a reluctance of banks to foreclose, mutual assistance between companies in the major business groupings (keiretsu or guruppu gaisha)—have come under strain but continue to function well enough to forestall the final shakeout that so many foreign observers had predicted. The Japanese economic system has survived essentially intact. But this survival has necessitated the acceptance of a third player, whose arrival has introduced a whole new set of problems and uncertainties. Since the mid-1950s, there had been only one really important external task for Japan's administrators: managing the United States. The security framework provided by the Americans and unrestricted access to the US market had to be protected at all costs; that essentially constituted Japan's foreign policy. Now, however, an unpredictable China has become part of the picture.

Glaring across the Sea of Japan

Reaction to events in China has played a central part in modern Japanese thinking, from the collapse of the Tokugawa shogunate down to the present day. Japan's forced industrialization in the late 19th century was a direct response to the sight of a weak and prostrate China carved up by the Western powers. For fifty years after the 1895 Sino-Japanese War, much of what Japan did abroad was premised on attempts to forestall the rise of an independent Chinese power, while buttressing its own. Japan's long postwar acquiescence to the status of an American protectorate is in part, as we have seen, a matter of following the path of least resistance. But it is also due to the belief, held by much of Tokyo's political elite, that the alternative to American protection is incorporation into a new Chinese Empire as a tributary state. As Japan's economic dependence on China deepens, the rationale for an American counterweight becomes all the more obvious; to Beijing of course, as well as to Tokyo.

This may explain some of the theatrics of Sino-Japanese relations over the past few years. To outsiders, the spectacle of anti-Japanese demonstrations in China, of visits by prime ministers to shrines celebrating Japan's war efforts, of brouhahas over the wording of a few passages in school history texts, can seem bizarre. But in a region where politics has long been practised as theatre, the striking of these poses suggests underlying messages: 'Do not confuse our investments with tribute; we will not fall into your orbit'. 'We are prepared to make things difficult for you—very difficult—if you continue to acquiesce in the hegemonic ambitions of an external power in blocking our return to our historical pre-eminence in Asia'. Increasing world-political tensions under the Bush administration have only accentuated these stances. The Chinese know that the radical foreign-policy intellectuals who assumed positions of influence in the Bush White House had identified China as the new American enemy and were spoiling for a fight, until their attention was diverted by Osama bin Laden. While Japan hastened to prove itself the perfect 'ally' in the Bush war on terror, to its neighbours the country increasingly looked like an American patsy that could never be trusted.

It is safe to say that, barring a realignment of Japanese politics—made all the less likely by the September 2005 elections—Tokyo will continue to play the key role it has for the past thirty years in sustaining the global reach of

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American power: supporting the us dollar. But it can no longer act alone; it now depends on a China that is 'in the deal'. What factors determine the corresponding policy in Beijing?

The Chinese government can give the impression of proud self-confidence; this is after all a regime that has presided over the most rapid improvement in living standards in human history, a government that took a shambles of a country and turned it into a major power that commands respect and even apprehension around the world. But it is nonetheless haunted by fear of disorder and of challenges to its fundamental legitimacy. Consider the hysteria with which the Beijing government reacted to the appearance of a cult-like 'new religion' in the form of the Falun Gong, or the chance that the memoirs of Zhao Zhiyang might surface. A secure, self-confident government would not make the suppression of a cult or the memoirs of a deceased leader its paramount policy objectives, nor would it devote immense efforts to policing the internet for unfavourable posts about itself. But for the members of a political elite who saw lives and careers among their parents destroyed by the chaos of the Cultural Revolution, there is no such thing as a threat to social peace and stability that can be safely ignored. In terms of its legitimacy, the Chinese Communist Party positions itself today as the proper successor to the mandarinate that ruled China for thousands of years. Whatever credibility it has derives less from Marxist postulates than from age-old notions of Chinese political philosophy; among them the automatic right to rule by an educated class and the Mandate of Heaven, which stipulates that prosperity and order demonstrate in and of themselves the legitimacy of rulers, while poverty and disorder are proof of the reverse.

China's dollars

How does China's dogged persistence in holding so much of its national wealth in dollars fit this picture? China needs to create some ten million new jobs a year to forestall politically dangerous unemployment; Chinese leaders are acutely aware that large numbers of idle young men form a most reliable recipe for political disorder. The strategy for creating those jobs involves the steady transfer of production capacity from other countries—principally, the US—to China. The products of China's factories are mostly sold abroad, again with the US taking by far the biggest share. Virtually everybody—not just the Americans—pays for Chinese exports with dollars; many of which China retains as foreign exchange reserves, largely in the form of us government debt securities; that is, in direct financing of the us government deficit.

For anyone with an eye for numbers, the evidence of this strategy blazes out of China's balance of payments statistics like flashing lights on a police car. Most countries that run surpluses on current account (trade plus transfers and dividend and interest payments), like Japan, see the money recycled through lending abroad, foreign acquisitions and the like. As its spate of high-profile acquisitions around the world demonstrates, China is certainly recycling some of what it earns from trade to buy mines, companies and oil wells abroad. But more investment flows are coming into China than are leaving it; this is what finances the factories that dot the Chinese landscape and the skyscrapers sprouting everywhere in its cities. Meanwhile, China's current-account surplus translates into a vast build-up of dollar holdings. Whatever else China's leaders may think about the United States, they can have no illusions that the dollars they have accumulated can ever be redeemed for anything close to their current nominal values. Suggestions have been made that China redeploy its holdings from us government securities to other instruments that offer higher return—equities, for example,

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or even non-dollar instruments—and use the resulting income streams to restructure unprofitable, state-run companies. Politically, these companies cannot be closed since they continue to support the livelihood of much of China's population. At the same time, they form a kind of black hole for Chinese finance, threatening to suck the domestic financial system into a debt-driven implosion unless they can somehow be made at least minimally profitable. [12]

The problem with the suggestion that China finance a restructuring of its state enterprises by selling its dollar hoard is that China has become too big a player. Any attempt to shift large parts of its reserves out of the market for us government debt risks precipitating a us bond-market crash that would carry other markets with it and thereby defeat the purpose. What happened when South Korea's central bank floated the notion of diversifying its portfolio out of us government securities in February 2005 is a case in point: both the dollar and the us bond market nose-dived, prompting flurries of denials from the Koreans. Korea's $69 billion holdings of us government securities are less than a tenth of China's. That leaves China with its present strategy: keep the engines of growth humming with exports on the one hand and a constant flow of foreign investment on the other. If rapid growth goes on long enough, China presumably hopes that the percentage of the country's total assets tied up in the state-run enterprises will be small enough to be manageable in any slowdown.

China also hopes that, if and when the dollar-centred global financial regime unravels, it will have an economy sufficiently developed to permit the yuan to takes its place among the world's major currencies without the need for external backing that the country's dollar reserves currently provide. That will allow it to deal with the collapse in American purchasing power when the us is finally forced to live within its means.

A final reckoning?

Forecasting that collapse is, however, devilishly hard; and there can be no assurance that markets will wait politely until the Chinese financial system is sufficiently robust to cope with the fallout. For markets are jittery everywhere; their fears almost endless. Renewed inflation in the United States, an unseasoned Federal Reserve chairman who has yet to confront his first real crisis, a politically crippled Bush administration, the implosion of the us housing bubble; all on top of spiking commodity prices, the ever-present threat of calamitous disruption to the flow of petroleum by events in the Middle East, the galloping us trade and government deficits, and indeed worries over the Chinese financial system—any one of these, or yet something else, could trigger a panicked flight from the dollar that would overwhelm the ability and willingness of the East Asian central banks to contain the flood.

There is talk in financial circles in Tokyo that the Ministry of Finance has concluded that global imbalances have become too great; that the limits of Japan's dollar support capability have finally been reached. A real chance exists that Japan will stop throwing good money after bad in the next dollar crisis and sit on its hands. Of course the price would be heavy—once the dollar goes into freefall and the yen breaks past its historical high water mark of ¥79/$1, Japan will be facing the write-off of much of its accumulated dollar hoard and the potential loss of hundreds of thousands of manufacturing jobs. But Japan has learned a great deal during the past fifteen years about coping with and spreading out the pain of job loss; Mikuni Akio has suggested that, finally freed of the deflationary burden of supporting vast pools of idle dollars (idle as far as Japan is

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concerned), the Japanese economy could find new strength in an era of a super yen. [13] Among other things, the new purchasing power of Japanese households could not only help compensate those facing job loss but could finally provide the elusive shift to an economy driven by vibrant domestic demand rather than exports—the stated goal of Japan's policy makers for a generation. A case can be made that Japan is in better shape now to deal with the economic fallout of a dollar crisis than it has been at any time in the past twenty years.

The political fallout is another question entirely. The collapse of the dollar will take with it American hegemony; the United States will be hard-pressed to sustain its global military reach in a world where it must earn euros or yen to pay its foreign creditors rather than fob them off with more us government paper. No matter what form it takes, the end of American hegemony will bring the return of the central Japanese political question—the right to rule—with a vengeance; particularly so because it may well be accompanied by serious upheaval in Japan's most important neighbour. There is no obvious present substitute for the American market in providing the engine of demand to sustain the kind of growth China needs in order to manoeuvre its way past the ever-looming threat of a domestic financial crisis, unless it were to be Japan itself.

Japan's sole experiment over the past 150 years of going it alone was a disaster. Of course much has changed since then. Scattered flares today shooting up from the right of Japan's political landscape—the new emphasis on 'patriotism' in schools; the growing acceptability of revisionist talk about the war years; the palpable thirst in conservative circles for an assertive foreign policy backed by a strong military—do not begin to add up to the hysteria and intimidation of the 1930s. But, alas, no real sign exists that Tokyo has built the kind of institutional infrastructure capable of charting a wise new course for the country should Japan slip out of the American embrace. That indeed may be the ultimate reason why, in a dollar crisis, Japan will revert to form and step in one more time to salvage a dollar-based international financial order: fear of an inability to cope with what lies beyond. But if Japan chooses to sit on the sidelines, or if its intervention is insufficient to prevent the end of what we have labelled Bretton Woods ii—a real possibility given that today's imbalances are far greater in both absolute and relative terms than those of the late 70s or late 80s, when Japanese intervention was decisive—Tokyo is likely to find itself having to deal with any manner of unanticipated new realities. These could range from a withdrawal of the US from East Asia, to peremptory demands from Washington that it assume most of the financial burden of a continued American military presence in the region, to political and economic upheavals in China, Taiwan and the Korean peninsula.

[1] 'A Word from a Dollar Bear', Forbes, 10 January 2005, describes Buffett's shorting of the us dollar.

[2] See David Smith, 'Sinking Dollar Could Put the Whole World in a Skid', Sunday Times, 30 January 2005.

[3] Volcker summarized the speech in 'An Economy on Thin Ice', Washington Post, 10 April 2005.

[4] Thus the additional costs incurred by the Pentagon during the first year of the occupation of Iraq were roughly equal to the incremental purchases of us Treasury securities by the central banks of Japan, China, South Korea, Hong Kong and Taiwan. As long as those central banks do not sell these

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securities (or fail to roll them over when they mature), Washington bears no additional financial burden in mounting a vast military operation, beyond the (relatively) modest interest payments. Taxes need not increase; Americans need not work harder to produce more goods for export or reduce their consumption in order to pay foreigners back the money they have borrowed from them.

[5] The effect of contemporary events in Egypt and Turkey on the thinking of the Meiji leaders is described in E. H. Norman, 'Japan's Emergence as a Modern State', in John Dower, ed., Origins of the Modern Japanese State: Selected Writings of E. H. Norman, New York 1975, pp. 223–4.

[6] See Karel van Wolferen's discussion of how the question of the right to rule—'the most fundamental problem of Japanese political life'—has plagued the country's modern history in The Enigma of Japanese Power, London 1989, chapter 12.

[7] The 'alliance' is in fact a protectorate since it imposes no formal obligations on Japan other than to host American military facilities, whereas the US is legally obligated to come to Japan's defence in the event of an attack.

[8] Mikuni Akio and R. Taggart Murphy, Japan's Policy Trap, Washington dc 2002.

[9] Leon Hollerman, 'The Headquarters Nation', National Interest, Fall 1991.

[10] 'Sukyandaru ni yotte Nihon Kenryoku Kikou wa Ikinobiru' [The Structure of Japanese Power depends on Scandals], Chuo Koron, October 1991, pp. 186–94.

[11] Horie was finally released on bail in April 2006.

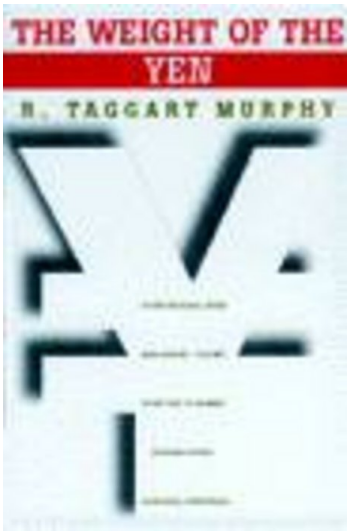
[12] See, for example, Deepak Lal, 'Ending China's Financial Repression: Foreign Exchange Reserves and State Enterprise Reform', Paper for Cato Institute Annual Monetary Conference on 'Monetary Institutions and Economic Development', Washington dc, 3 November 2005.

[13] Mikuni Akio, 'Doru Yasu Koso Nippon no Chiansu' [It is a falling dollar that gives Japan its chance], Voice, August 2006, pp. 196–203.

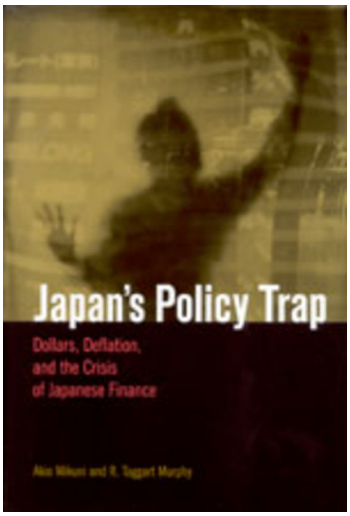
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