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U.S.-Japan Financial-Market Relations in an Era of Global Finance

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THIS CHAPTER EXPLORES THE POTENTIAL for change in U.S.-Japan relations emanating from the financial-market revolution that has swept the world these past three decades. Specifically, I investigate the ways in which the process and product of globalization affect the prospects for U.S.-Japan cooperation and conflict in the financial-issue area. I conclude that although there is ample reason to expect that the United States and Japan will continue to manage their financial-market affairs within a fundamentally cooperative framework, most notably in regard to efforts to maintain basic international financial system stability, globalization has fostered changes in the international and domestic contexts informing these relations that will complicate some aspects of cooperation in the future. In particular, globalization has fostered greater rivalry over whose policies and ideas will influence ongoing market restructuring in Asia, and has led to domestic institutional reforms that are altering the way financial issues are negotiated both domestically and internationally. I begin with an overview of the factors facilitating continued U.S.-Japan cooperation and follow with a more detailed discussion of the ways in which the impact of globalization on both economic and political competition, as well as on domestic institutional structures, is redefining the set of problems associated with various types of cooperation in the financial-issue area.

I preface this examination with two caveats. The first is that while this chapter addresses anticipated changes in U.S.-Japan relations, the part of my argument concerning the impact of domestic policy and institutional change is built predominantly on evidence drawn from the Japanese side of the equation. My reasons for this approach are both empirical and methodological. On the one hand, although the United States is finally moving toward a legislated overhaul of depression-era banking laws, over the past few decades the degree of change in both the domestic regulatory arrangements and the political interactions and institutions that shape national financial policies has been significantly greater in Japan than in the United States.[1] Accordingly, change in U.S.-Japan financial-market relations in the near future is more likely to be explained by these developments in Japan than by the relative continuity of U.S. financial-market policies. On the other hand, in terms of methodology, the arguments I present about the impact of globalization on domestic politics, such as those concerning increased politicization and pressures behind regulatory competition, are generalizable across open economies rather than particular to the Japanese case.[2] A parallel examination of these impacts on the U.S. side of the equation should support rather than call into question my conclusions.[3]

The second caveat is that although financial issues have become quite prominent among international news topics over the past three decades, financial globalization is not the primary factor informing the U.S.-Japan relationship. Broader changes in both nations' economic and geopolitical circumstances continue to set the stage on which the role of financial affairs is played out. In particular, Japan's continued dependence on the United States for national security serves as a tremendous constraint on Japanese leaders' ability to aggressively challenge the United States in other policy areas. In addition, as we enter the new millennium, China's and North Korea's economic and strategic postures, the still nascent face of European unification, uncertainty over the restoration of Asia's economic dynamism, Russia's political and economic fragility, and political instability in much of Eastern Europe, Central and Southeast Asia, and elsewhere are just some of the additional factors that could dramatically limit the relative importance of financial-market affairs in the U.S.-Japan alliance. Nevertheless, financial issues have been at the center of many of the most dynamic and dramatic changes seen in the international political economy over the past three decades and have introduced a number of particularly challenging problems into the U.S.-Japan relationship. This chapter seeks to identify how and in what form the effects of globalization will become manifest in U.S.-Japan financial relations, and thereby encourage policymakers to base future decisions not on the assumption of an unchanging pattern in U.S.-Japan relations but rather with the impacts of globalization in mind.

The Globalization of Financial Markets

The globalization of economic relations refers to the increasingly close integration of domestic markets into a larger international marketplace. The term also suggests increased marketization because, compared with the past, financial-market developments not only are taking place on a much broader geographical scale but also are influenced more by nonstate actors.[4] In short, globalization describes the process creating an increasingly interdependent international political economy that is no longer shaped only by relations between states.

The globalization of finance and the associated increase in capital mobility were promoted through the confluence of several identifiable developments during the past several decades.[5] First came the breakdown of the Bretton Woods system of fixed exchange rates in the early 1970s and the shift to a flexible monetary system, which allows nations to float, peg, or otherwise manage their exchange rates as they see fit. Second, increased institutionalization of savings and investments, combined with considerable growth in international trade facilitated by a series of bilateral and multilateral agreements, led to significantly larger funds pursuing trade and diversified investments across borders. Third, advances in telecommunications technology, as well as in the theory and practice of finance, enabled these increasingly large financial-market actors to take advantage of cross-national opportunities at speeds and levels of efficiency never before possible. And fourth, a powerful wave of financial deregulation affecting virtually all open-market economies significantly reduced government control over capital flows and financial-market developments both within and across national borders. These forces continue to feed off one another and have expanded the internationalization of financial activity and the sensitivity of domestic markets to outside circumstances to such an extent that the financial world appears to be moving towards a fully globally integrated market environment.[6] The effects of globalization are made manifest in shifting opportunity costs arising predominantly from the associated greater potential for capital to move across borders.[7] Some of the obvious consequences of this process include greater volatility in foreign-exchange markets, large international-payments imbalances, and participation in financial markets by not only banks but also a larger number of nonfinancial institutions.[8]

This chapter's exploration of the ways in which American and Japanese interests in the financial-issue area intersect or diverge in the context of the globalization of finance begins with an overview of the factors supporting continued cooperation between the two countries. These include the salience of the financial-issue area, the role of bargaining across types of cooperation, and the institutionalization of cooperation. These factors point to my general conclusion that regardless of the difficulties introduced through globalization, to be discussed below, neither the United States nor Japan is likely to allow future conflicts to escalate to the point where they threaten their fundamentally cooperative relationship.

Globalization and Cooperation

As is well recognized, the globalization of finance has deepened international interdependence, heightened national economies' sensitivity to international market conditions, and amplified political cognizance that these increasingly "free" international markets must be supervised through international cooperation (Bank for International Settlements 1986; Organization for Economic Cooperation and Development 1987; Underhill 1991, 197). Specifically, globalization has led to a shift in the relative focus of cooperative efforts away from the coordination of macroeconomic policies by the Group of Seven (G7) seen in the late 1970s and throughout the 1980s and toward cooperative crisis management and prevention rooted in more marked attention to internationally standardized rules and regulations designed to protect basic financial system stability (Bergsten and Henning 1996, 5). The shift reflects a growing consensus that these formerly somewhat successful means of economic cooperation are no longer feasible because increased capital mobility often precludes governments from effectively influencing currency markets or using fiscal policy flexibly.

Greater attention to ensuring basic stability is required because the shift in monetary systems from the early 1970s onward has introduced tremendous volatility into foreign-exchange rates, enabled the persistence of large payments imbalances, and added currency risk to the many other risks associated with international trade and investment. Advanced telecommunications has further complicated the picture by spreading news and facilitating transactions almost instantaneously, largely negating the role of geography as a buffer against overseas developments. Greater institutionalization of funds means fewer actors can make a larger impact on the market as a whole. And deregulation has generally left individual governments fewer means with which to autonomously manage the impact of financial-market developments on their domestic economy and constituents. Thus, although there is overwhelming evidence that globalization has increased levels of efficiency in many markets, there is equally widespread agreement that many aspects of this process, including the commodification of foreign exchange, the rapid transmission of volatile prices, and the remaining inadequacies of supervisory practices, underscore the extent to which cooperation among financial authorities is crucial for maintaining the soundness and stability of the international financial system. In short, greater internationalization not only increases the likelihood of some forms of crises but also virtually ensures that the effects of crisis will spread farther and faster than before (Portes and Swoboda 1987).

Accordingly, the incentives to cooperate to maintain a healthy international financial system increase with globalization. This is particularly true in the case of the financial centers and economies most deeply integrated into international financial markets. Whether those facing incentives to cooperate actually achieve cooperation, however, depends on a variety of factors. Here we discuss how cooperation between the United States and Japan is facilitated by a strong mutual interest in reaching some cooperative agreement, relatively convergent preferences concerning the general form of that cooperation, and common involvement in institutionalized arrangements that reduce the costs of negotiating and enforcing such agreements (Axlerod 1984; Fearon 1998, Keohane 1984).

Although globalization implies that financial markets span and therefore affect the entire globe, clearly the distribution of both activities and their consequences is far from uniform. The United States and Japan in particular hold unique positions in this network of financial ties that give them unusually large stakes in the international financial system. Most obviously, they are the two largest economies, host two of the world's most prominent financial centers, and are seemingly bound in a symbiotic relationship as major debtor and creditor.[9] In addition to the United States being the largest debtor nation, the U.S. dollar is the world's dominant currency, playing a substantial role in investments, invoicing, foreign-exchange transactions, and foreign reserves and intervention. Japan, the largest creditor nation, serves as the major international financial center for the formerly dynamic economies of Asia, has a currency that is growing in international use, and for many years could claim that its major players dominated nearly every ranking of international financial institutions. Even as Japan is grappling with its own banking crisis, the relationship between its domestic problems and the crisis in Asia, as well as the extent to which both domestic and greater Asian financial reconstruction depend on the coordination of U.S.-dominated International Monetary Fund (IMF)– and Japan-proposed programs, only underscores the tremendous role these two nations play in maintaining international financial stability.

In sum, for both the United States and Japan cooperation designed to maintain international financial market stability is absolutely critical to their achievement of virtually every other political objective. At this point, their economies are so integrated into international financial markets that a breakdown in this system, or a retreat from the international system through the reassertion of capital controls, for example, would inflict inestimable damage on their domestic economies as well as their governments' domestic and international authority. As one U.S. Department of the Treasury official has explained, financial-market relations between the United States and Japan parallel the structure of the MAD paradigm in security studies; both sides are well aware of the mutually assured destruction that would ensue if there were a serious breakdown in their cooperation to maintain international financial-market stability.[10] In short, because both have a large stake in international financial stability and are major players in that system, the United States and Japan have equally high stakes in preserving the cooperative framework of their relationship.

The United States and Japan share a nearly uniform view of this overarching goal of maintaining international financial-system stability through international cooperation: Financial system stability is a necessary condition for sustainable economic development. And because the nature of financial linkages is such that instability in one area can be readily transmitted to others through contagion, financial-market stability is seen as inherently fragile. Finally, since only states or international institutions supported by states have the ability to inject sufficient liquidity or impose needed regulation during financial crises, maintaining stability is virtually uncontested as a worthy objective of U.S.-Japan, as well as broader G7, cooperation. Cooperative efforts over the past three decades readily illustrate the extent to which this goal is shared and aggressively pursued.[11]

Fearon provides a framework for understanding why international cooperation may be more forthcoming in efforts to maintain financial stability than in some other areas. He explains that the difficulties associated with reaching an agreement to cooperate vary depending on how much those involved in the negotiations discount their future payoffs from cooperation. And because the nature of the proposed agreement affects the estimation of future payoffs, the type of cooperation pursued influences the likely success or failure of these bargaining situations. In particular, if the time available for bargaining over the specific details of cooperation is short because the window of opportunity to resolve a particular problem is perceived as very small, or when agreements involve repeated but often short-lived cooperative behavior, then incentives to bargain hard over the distribution of benefits from cooperation are diminished (Fearon 1998, 295). Consequently, we expect quick settlement of bargaining issues and a more rapid move to cooperative action in such circumstances, which encompass a large number of international financial-market cases, including foreign-exchange interventions and crisis-response situations. This framework suggests that, complementing the MAD analogy discussed above, the United States and Japan have responded quickly and cooperatively to a number of financial crises because their governments recognize that if they waste time haggling over the exact distribution of the costs and benefits of their proposed action the opportunity to achieve their shared objective may disappear.

On the other hand, accordingly to the same logic, the incentives for each actor to bargain hard for its preferred distribution of costs and benefits concerning cooperation increase significantly when cooperation involves longer-term commitments and thus less discounting of future payoffs. From this perspective, one can readily understand why U.S. negotiations with Japan over the liberalization of Japan's domestic financial market were so tortuous and largely unsuccessful.

Similarly, studies of the G7 economic summits show that negotiations over the distribution of the costs and benefits involved in macroeconomic policy coordination tend to be particularly difficult (see, for example, Putnam and Bayne 1984, Funabashi 1988, and Bergsten and Henning 1996). Accordingly, we expect that the United States and Japan will continue to have more contentious interactions when pursuing agreements that are expected to have a long-term impact on the distribution of benefits than when forced by circumstances to respond cooperatively to crises and periodic currency misalignments.

There are, however, institutional factors that facilitate cooperation even when agreements are expected to affect payoffs far into the future. The literature on international regimes, and more recently on varieties of institutionalism, highlights the importance of norms, rules, and procedures around which actors' expectations converge and the ways in which institutions that structure interactions bias outcomes. That is, institutional factors, such as established rules and procedures, which can reduce transaction costs as well as narrow the range of possible bargaining outcomes, increase the likelihood of agreement among members who have accepted those institutions as legitimate. Clearly, in the field of international finance there already exist a number of well-established and institutionalized cooperative solutions for a variety of financial-market issues, such as using IMF funding to restore liquidity. These institutions were themselves once the object of negotiations, but now policies pursued through these forums stand as institutionalized bargaining solutions and constrain any actor trying to deviate from the behavior prescribed through them.

One additional aspect of institutionalized cooperation that should be mentioned is the increasingly multilateral character of these endeavors. Although the United States and Japan are two of the most influential financial-center states, even their governments could not manage the international financial system through bilateral efforts alone. As the Bank for International Settlements (BIS) capital-adequacy negotiations and the limited past success of Group of Five (G5) and G7 agreements illustrate, effective financial-market cooperation requires that at least three major nations agree (Kapstein 1994; Bergsten and Henning 1996), and in many cases, such as regulatory cooperation to limit insider trading or other unlawful activities, far more widespread participation is needed to achieve effectiveness. This increasingly multilateral environment can be expected to affect U.S.-Japan cooperation in two ways. First, it may limit the extremes in either nation's policy prescriptions because the adoption of any proposal will require appealing to a larger number of participants. Second, it may facilitate Japan's playing a somewhat more independent role in international affairs by providing it with an international arena in which to air its own views and participate in coalitions that support alternatives to U.S. proposals. Moreover, if Japan were able to garner substantial support for an alternative proposal through a multilateral forum, any conflict with the United States would look less like a direct challenge by Japan (although it might in fact be) and more like an occasion on which the United States was out of step with the rest of the world.

The United States and Japan participate actively in a growing number of both formal organizations, such as the IMF, the World Bank, and the BIS, as well as less organization-defined assemblies, such as the G7 meetings, regional forums, and numerous bilateral negotiations. For the most part (that is, noting the impact of multilateralism mentioned above), these numerous institutional commitments, as well as the continuous organizational support and ongoing contact they require, reinforce the U.S.-Japan alliance by building a history of successes and fostering shared expectations about future behavior. In addition, and more particular to the financial-issue area, over the past fifteen years the United States and Japan have developed a variety of more mundane and personal relations that can be expected to facilitate cross-national communication and thus shared expectations among financial authorities. Examples include the participation of visiting U.S. Federal Reserve Bank employees in Bank of Japan (BOJ) research activities and the training of BOJ personnel at Federal Reserve Banks in the United States. These contacts are of course in addition to ongoing official communication between the Japanese Ministry of Finance (MOF) and U.S. Treasury staff at the U.S. Embassy in Tokyo and between the New York Federal Reserve Bank staff and the MOF and BOJ officials ensconced in offices just across the street from each other in New York.

These contacts between financial authorities exemplify a postwar shift in the management of U.S.-Japan relations more generally away from the domain of their foreign ministries and toward specialized functionaries (Curtis, introduction to this volume).[12] Recent changes in Japanese bureaucratic practices that are promoting greater specialization by career officials should also facilitate better communication with U.S. financial authorities, who in general have more specialized educational backgrounds or substantially greater practical experience.[13] And finally, to the extent that one believes communication is the foundation of all good relations, there is potential for greater cooperation in U.S.-Japan financial-market relations as careers advance in the generation of younger Japanese officials, many of whom have obtained some higher education overseas, have maintained relationships formed while away, and understand English well enough to keep abreast of U.S. debates and publications. Although the situation has improved significantly since the 1980s, the number of U.S. officials equally capable of reading Japanese and engaging in Japanese-language debates is unfortunately comparatively meager.

Taken together, these various institutional factors are generally expected to increase the likelihood of continued cooperation between the United States and

Japan.[14] Moreover, as discussed above, the United States and Japan have such high stakes in maintaining the international financial system that a breakdown in the alliance because of nonessential financial issues is virtually unthinkable. Accordingly, at this point, one might be inclined to paint a wholly optimistic picture of the prospects for U.S.-Japan cooperation concerning financial-market affairs. That would be a mistake, however. The common pursuit of financial-market stability sets the outer limit on how far each government can push in negotiations, and institutional factors assist efforts once a common objective is defined; neither factor precludes conflict.

Conflict in U.S.-Japan Financial-Market Relations

As we saw throughout the 1980s and 1990s, officials in the United States and Japan can find more than enough financial issues over which to disagree. During the 1980s, for example, U.S. representatives complained about the so-called over-presence of Japanese financial institutions in the U.S. and European markets and repeatedly admonished their Japanese counterparts for not going far enough or fast enough in their approach to domestic financial-market reform. Whenever possible, Japanese negotiators responded with criticism of the U.S. government's inability to reduce its twin deficits and the stresses they were placing on the world economy.[15] And, as if a sequel to a bad first run, the 1990s were similarly fraught with discord between the United States and Japan over the allocation of blame for the Asian and other currency crises and the appropriate prescriptions for recovery, as well as the pace and policy mix that should be used to pull Japan out of its own banking-sector quagmire and economic recession.

As any review of the past decade readily suggests, U.S.-Japan relations concerning financial issues are certainly more contentious now than during the Bretton Woods era, when domestic financial markets were largely isolated through the combination of domestic regulations and the fixed-rate foreign-exchange regime. The politics of finance inspires more heated battles now in large part because globalization has introduced or promoted a number of factors complicating the management of U.S.-Japan relations in the financial-issue area. Among the most salient are that (1) globalization in general, and capital mobility in particular, has created greater competition over the distribution of economic gains accruing through international finance, (2) globalization has opened the door to greater competition between the United States and Japan concerning which nation's ideas and policy proposals will shape the new architecture of international finance, and (3) globalization has led to domestic institutional change in Japan that is restructuring the way financial policies are negotiated both domestically and internationally. We will look at each of these below.

Competition Over Economic Gains

To a large extent globalization is the product of market-led competition. Private actors pursuing economic objectives created new technologies and financial products, forcing governments to respond to the demands of market constituents and the requirements of public policy by adjusting regulatory conditions to the new market environment. Because there was a bias in regulatory reform toward greater liberalization, ever larger numbers of participants joined in these activities, and competition intensified and expanded farther around the globe.

The main reason increased competition between market actors affects U.S.-Japan relations is that while in theory and sometimes in practice competition promotes market efficiencies, competition does not distribute these gains equally or according to any other politically responsive logic. And although U.S.-Japan relations are not predicated on a zero-sum view of the gains from trade, economic success certainly contributes to international political power and prestige; both the United States and Japan would prefer that their firms, financial institutions, and domestic financial centers emerged among the leaders in the financial-market race.[16] In addition, globalization increases conflicts over macroeconomic policies because domestic policy choices affect other states, as well. In sum, two ways in which globalization affects U.S.-Japan relations are macroeconomic policy conflicts and competition between governments as they try to increase their influence over these growing international market developments by enhancing their jurisdiction over international financial-market actors and activities.

To begin with, states disagree over macroeconomic policy mixes because the effects of one state's policies on another state's economy—and on the government's support networks—are not always complementary. Thus we see, for example, a history of cross-national complaints that one government's refusal to change interest rates or cut fiscal deficits is imposing costs on the other. Understandably, governments negotiate cooperative agreements concerning policy coordination based on their calculation of the domestic coalition needed to maintain their position, and agreements are thus reached only when they do not affect important domestic constituents in ways that will threaten an administration's hold on political authority. In cases of macroeconomic policy coordination and the attendant conflicts over whose constituents will best be served by any policy choice, the greater a nation's impact on international financial developments the greater weight its independent policy choices carry relative to those of other governments. Accordingly, even in cases of macroeconomic policy coordination, there are benefits to having greater financial-market power.

In addition, because the high degree of capital mobility and market integration inherent in financial globalization essentially allows market participants to do business wherever the conditions are deemed most attractive, running parallel to the well-examined competition between market actors is an equally important competition between governments trying to maintain jurisdiction over a strong and sound financial center, which in the context of globalization requires that it be internationally competitive (Bryant 1987; Kane 1987). Competition of this sort has been evident throughout the postwar history of the internationalization of finance, beginning with U.S. efforts to recapture jurisdiction over the dollar-denominated banking activities taking place in offshore European markets almost immediately after World War II. These efforts were soon countered by British financial reforms designed to reestablish London as the preeminent international financial center. As internationalization spread, the implicit threat of domestic financial-market "hollowing" if financial-market activities moved to more attractive markets compelled more governments to respond with policies that made them more competitive (Loriaux et al. 1997). Needless to say, over the past two decades the competition among the major centers, New York, London, and Tokyo, has become particularly intense (Moran 1991; Laurence 1996; Helleiner 1994; Dwyer forthcoming).

Although competition among financial centers may have been most evident in the 1980s, the heyday of deregulation, there is little reason for this competitive pressure to subside as long as capital is highly mobile. Thus, as evidenced by the three principles guiding Japan's recent financial-system reform package, even in the 1990s the government acknowledged that domestic financial reconstruction depended on Japan's offering through reforms what mobile financial-market participants found most attractive, namely, free, fair, and global markets (Ministry of Finance 1998, sec. 2, 1-2).[17] Similarly, Japan's recent big push to increase the internationalization of the yen was explicitly designed to increase the attractiveness of the Tokyo market, as well as to counter the dominance of the U.S. dollar in Asia and the increased draw of European markets due to the emergence of the euro (Ministry of Finance 1999).[18]

These two levels of competition have been at the root of U.S.-Japan financial-market tensions for at least two decades but have potentially very different effects on U.S.-Japan financial-market relations. On the one hand, competition to serve domestic interest groups through macroeconomic policies and other means remains intense. The United States in particular has aggressively pressed Japan for a seemingly unending list of financial-market reforms that U.S. officials have felt would improve the competitiveness of primarily foreign (read U.S.) firms. The Yen-Dollar Agreement, the best-known example, also represents a precedent-setting case of one country pressuring another to integrate its financial market with the rest of the world, supposedly to eliminate the severe misalignment of exchange rates seen as the cause of the United States' enormous and growing current account deficit (Frankel 1984). Although the logic of this endeavor was seriously questioned in regard to liberalization's likely exchange-rate effect, since that time the United States has continued to pressure Japan fairly relentlessly to adjust its domestic regulatory structure or monetary-policy stance because these policies have been viewed as providing unfair market advantages to Japanese firms and financial institutions. Until Japan's financial markets and policies perfectly suit the interests of U.S. firms, an outcome one cannot expect to arise soon if ever, this level of US-Japanese tension over the treatment of their respective constituents will continue.

Further encouraging this level of competition between the United States and Japan is an enduring perception by the public on both sides of the Pacific that, despite any arguments concerning mutual gains from exchange, the economic relationship between the United States and Japan is still fundamentally zero-sum. In the mid- and late 1980s, the self-congratulatory airs adopted by some Japanese over becoming "number one" were outdone only by the overreaction of some Americans to Japanese purchases of U.S. banks and "trophy real estate." Thus, we are reminded yet again that voters still identify themselves and their fortunes with their state—regardless of how global the marketplace or how multinational the firms in which they work. Not surprisingly, therefore, with the essential reversal of fortunes over the past decade, the United States riding a long-lasting economic boom while Japan languishes in recession, much bravado has returned to American discussions of Japan's poor performance, and both nationalistic and accusatory language has resurfaced in Japan (Ishihara 1998; Ogawa 1999).

On a more positive note, and somewhat counterintuitively, the competition between international financial centers that takes place in a global environment may eventually reduce the bilateral tensions perpetuated by this zero-sum view of market-level competition if what the United States demands of Japan is in line with emerging market trends. This is because the competitive pressure that capital mobility introduces into the financial-reform process effectively promotes greater cross-national convergence of regulatory environments (Dwyer forthcoming). As was evident in former Prime Minister Hashimoto Ryūtarō's repeated lamenting of the decline in Tokyo's status, the main goal of Japan's "Big Bang" financial-deregulation initiative was to revitalize Tokyo's sagging financial market.[19] Revitalizing the market means making it more attractive to mobile capital. Accordingly, recent reforms have been particularly focused on adjusting the Japanese market to emerging standards of internationally competitive markets. These unilateral efforts to create an internationally attractive market will reduce U.S.-Japan bilateral conflict because the more market pressure prods Japan to adjust domestic regulatory and administrative practices to bring them more in line with developing international standards, the less U.S. officials will feel compelled to do so. In other words, market pressure has been more successful than direct U.S. diplomatic pressure in pushing Japan toward reforms the United States wants.

During the early 1980s, Japanese officials were often unresponsive to U.S. demands for more drastic domestic reforms because they were reluctant to give up the means of influencing Japan's financial affairs that the deregulatory aspect of reform implied, they had to forge political compromises among competing interest groups and balance the costs and benefits of adjustment among their constituents, and they feared the uncertainty and instability that rapid reform might invite (Rosenbluth 1989; Vogel 1996; Dwyer 1997). A crucial factor enabling this incremental approach was that for much of that decade financial-market participants were attracted to Tokyo because of the surplus of available capital, that is, despite its unquestionably less attractive regulatory environment. In the early to mid-1990s, after the bubble had burst and Japan's economic situation had deteriorated, and then briefly recovered, Japanese officials acted as if the slow, incremental approach to reform practiced during the 1980s were still feasible and appropriate. Clearly, U.S. officials felt more dramatic action was needed.[20] The result was a period of considerable tension, primarily between MOF and Treasury, including Japanese complaints about American heavy-handedness and American complaints about the Japanese failure to face unpleasant realities (e.g., Saitō 1998).

By 1998, however, that earlier cushion of popularity and the façade of stability in the financial system had been ungraciously removed with the retreat of foreign corporate and financial institutions, the failure of Japanese financial institutions, and the gradual exposure of the magnitude of the bad-loan problem. Tokyo was quickly losing its reputation as an attractive international financial market, and the government recognized the danger. If the financial-market participants abandoned Tokyo for more stable ground, most hope for Japan's rapid economic recovery would be lost, as well. With this as background, by 1999 the Japanese government had finally begun taking bigger and more appropriate steps toward acknowledging the full extent of the problems, restoring some credibility to financial regulation through the creation of a new regulatory agency and commission, and resolving the banking crisis through the infusion of public funds, nationalization, and facilitated mergers. Although progress still seems slow, the Japanese government has finally recognized that it needs to respond to its problems in ways deemed satisfactory by the international financial community.[21] That is, the Japanese government is seeking to restore Tokyo's place as an attractive financial market by competing with other countries for financial-market share. This competition is evident in the government's adjusting regulatory policies, supervisory practices, and accounting and disclosure standards to replicate or at least approximate more closely those followed in other attractive markets.

This competition among governments trying to attract financial-market activities to areas within their jurisdiction is one new dynamic emerging from the increase in capital mobility that has accompanied globalization. As suggested above, however, in the narrow sense, if Japan adopts more market-responsive reforms that happen to fall closer in line with U.S. "suggestions"—then all the better for U.S.-Japan relations.[22] But this would not be a coincidence. Although financial markets are routinely described as global or at least international, the United States has played an unmistakably privileged role in shaping this environment (Strange 1986; Moran 1991; Helleiner 1994). The question we consider below is whether globalization will also increase political competition concerning who should set the standards for international finance in the future.

Competition over Political Leadership in Financial Affairs

Despite newspaper commentary on unbridled "free" markets, global finance does not take place in a vacuum; structure abounds, and which players win and lose is greatly influenced by the ideas and institutional biases informing the rules of the game. As stated above, for many years the dominant role of the United States in shaping international financial markets went largely unchallenged. Recently, however, more countries seem to be questioning the appropriateness of the existing international financial regime.[23] The reasons for this growing challenge to U.S. leadership are twofold. First, as the spate of financial crises in the late 1990s clearly illustrates, the potential for instability in a global market is great, and increased interdependence implies increased vulnerability, as well. More markets are integrated, more economies are exposed, and more governments want a say in how these powerful forces of economic growth or ruin will be managed. Second, global finance can be a tough game, and many developing nations, in particular, may be exposed to these markets before they are adequately prepared to handle the impact participation may have on their economies and political futures. Even if the so-called playing field is made level through the adoption of similar regulatory standards cross-nationally, the strongest market players tend to come out on top, leaving those less prepared caught off guard and smarting. In short, globalization has not only expanded the number of nations involved in this web of relations but also exposed them to the risks inherent in these markets. As a result, some national leaders are inspired by their bad experiences to think more seriously about alternative "rules" of the game, and there is now a more diverse community of nations involved with which to forge coalitions around these alternatives.

Criticism of a U.S.-dominated liberal market approach to international financial-market relations is not a new development; nor is any popular alternative visible on the horizon. Nevertheless, the extent to which major U.S. allies, including both Japan and Europe, are openly contemplating less radically open market arrangements suggests that this too is an area of potentially greater conflict in the future. A review of U.S.-Japan relations in response to the Asian currency crisis provides glimpses of this competition for influence over both the policies and the ideas shaping future international financial-market affairs.

The Asian currency crisis hit with a vengeance following the devaluation of the Thai baht in July 1997. One after another Thailand, Indonesia, Malaysia, the Philippines, and South Korea were shaken by speculative attacks on their currencies and were forced to expand or abolish exchange-rate bands and move to floating exchange rates. Although Indonesia and South Korea enjoyed better economic fundamentals at the time, their currencies suffered particularly from speculative contagion and continued to weaken through the end of the year. After the onset of the crisis, virtually all these countries experienced a severe credit crunch and associated economic contraction. Although several of these countries have already recovered quite substantially, the Asian currency crisis was a pivotal event informing international financial markets in the late 1990s. Here, however, I am not concerned with addressing the cause but rather exploring, in the contestation between the United States and Japan over the appropriate response to the crisis, the seeds of greater competition for political leadership, especially concerning financial affairs in Asia.[24]

First, as stated at the outset, the conflicts and competition between the United States and Japan concerning financial-market affairs are contained within the broader shared objective of maintaining international financial stability. It would serve neither's interest if financial disputes were allowed to escalate to a stability-threatening level. Thus, not surprisingly, the initial response by the United States and Japan, the two largest stakeholders in the region, was both quick and cooperative.[25] Within weeks, for example, most of the countries involved had requested and received IMF support under the usual conditions, such as fiscal or monetary restraint, financial system restructuring, or real-sector structural reform.[26] From that point on, however, conflicts between the United States and Japan over further steps revealed competition for political leadership. This contest had two dimensions. The first concerned which nation would shape the remaining policy responses to the Asian currency crisis. In this regard, Japan immediately stepped up to take a proactive role rather than simply wait for or defer to presumed U.S. leadership. The second dimension of the contest concerned whose ideas about international financial-market management enjoyed the support of Asian nations. In this regard, too, Japan made substantial efforts to been seen as on the side of its Asian neighbors.

Japan became a major international player in terms of its economic power several decades ago, but Asia remains the only place where Japan can possibly aspire to political leadership. Japan displaced the United States as the dominant economic force in Asia in the late 1980s, having invested more than twice as much as the United States in Association of Southeast Asian Nations (ASEAN) countries, exported and imported equal or greater amounts, and provided three times as much aid (Vogel 1994, 159, 161). Yet the legacy of Japanese behavior in Asia before and during World War II has long thwarted any embrace of Japan as a political leader in the region. Despite this history, Japan's postcrisis involvement in the Asian currency crisis was "uncharacteristically proactive" and displayed a clear intent to take on more political responsibility than usual (Fukui and Fukai 1998, 33). Given that in 1997 Japanese banks held approximately one-third of the outstanding commercial bank debt of the five ASEAN member countries (Pempel 1999, 8), Japanese interest and active participation in restoring financial stability were not surprising. Nevertheless, the behavior of Japanese leaders during this period gave greater credence to the possibility of Japan's challenging the role of U.S. leadership in the region.

During the early stage of the Asian crisis, Japan advocated establishing an Asian Monetary Fund (AMF). The idea for the fund was first publicly presented by Minister of Finance Miyazawa Kiichi during a World Bank–IMF meeting in Hong Kong in 1997 and met immediate and determined opposition from the United States and others (Bergsten 1998). Some Asian nations initially rejected the idea because it hinted at Japanese domination. The United States, meanwhile, used a "two birds with one stone" approach to topple it. U.S. representatives focused their criticism of the planned AMF on its potential to undermine the authority of the IMF. In particular, the AMF was maligned as enabling nations to avoid the discipline imposed by IMF conditionality by providing an alternative source of funds. In addition to these views, U.S. officials saw the proposal as threatening to divide the region down the Pacific, leaving the United States as an outlier.[27] Since their opposition to the plan, based on giving priority to the IMF, provided enough justification to derail the AMF suggestion, and because most other Asian nations did not want or politically could not afford to leave the United States out of the rescue operation, the United States did not have to dwell on its more political implications to topple the plan. In a similar fashion, a Japanese offer to provide substantial aid to Indonesia through a corporate debt rescheduling program was also quashed by staunch U.S. opposition. In this case, however, the reasons were related more to U.S. discomfort with Indonesia's political leaders at the time than with Japan's usurping U.S. leadership in the region.[28]

Clearly, Japan was unable to implement its proposals because of strong U.S. opposition. This failure was in large part due simply and unsurprisingly to the United States' greater influence in international financial-market affairs and Japan's general adherence to U.S. foreign and strategic policy prescriptions because of its dependence on the U.S. security umbrella. Nevertheless, two aspects of this period are worth special note. First, it is revealing that the United States did not greet Japan's more proactive efforts with greater enthusiasm; for many many years Americans had criticized Japan for "free riding" on a U.S.-provided international order and not pulling its weight in international affairs. The United States' abrupt and discouraging response to Japan's greater efforts suggests that Japan's proposals were viewed not as complementing U.S.-led efforts but as conflicting with them. Consequently, following the thread of existing American criticism concerning Japan's apparent inability to resolve its own domestic banking crisis and emerge from its recession, during this time U.S. officials publicly questioned whether Japan could be a responsible party in the global rescue of Asia if it could not even overcome domestic bickering over its own bailout packages.[29] In short, both Japan's uncharacteristically proactive efforts and the United States' unsupportive response reflected the contest between the United States and Japan over political leadership in Asia.

Japan was unable to follow through with the two policy ideas discussed above as originally planned, and thus is clearly not yet more influential than the United States in these matters. Nevertheless, Japan has persistently pursued the broad path set out in these early proposals, and through this perseverance has communicated to Asian leaders its commitment to the Asian cause. As mentioned above, for example, despite initial U.S. opposition to capital controls, the G7 eventually approved temporary controls over short-term capital flows at its summit in Germany in June 1999. In addition, although Japan's AMF proposal was rejected early on and replaced initially by the multilateral "Manila Framework" in December 1997, Japanese officials continued to design a more proactive response. Some are still working toward the eventual establishment of an AMF,[30] and recent news reports concerning the so-called Chian Mai Initiative suggest at least cautious U.S. support for what Asian leaders see as a step towards greater Asian financial cooperation. In the meantime, these efforts have begun to bear fruit through the "New Miyazawa Initiative" of October 1998.[31] Finally, Japan has packaged its promotion of the internationalization of the yen as fostering stability in Asia because Asian states' excessive dependence on the U.S. dollar is considered one of the factors that contributed to the currency crisis. Over time this evidence of Japan's persistence through primarily unilateral policies garnered praise from Asians as well as support from non-Asian members at later IMF meetings ("Japan Wins Praise" 1998; "Japan, S. Korean Lawmakers" 1998).

The importance of these Japanese policy responses for our broader discussion is that although Japan's efforts were initially dismissed by both non-Japanese Asians and Americans as self-interested attempts to improve the economies in which Japan had great exposure, Japanese officials persistently pursued a variety of plans, and some were eventually accepted by both the United States and other states.

Certainly in this process Japan accommodated U.S. interests to a considerable degree. Nevertheless, by creating and following through with these efforts, Japan relatively successfully portrayed itself as committed to contributing policies to the Asian cause in a way that improved its image in the eyes of at least some Asians, especially those unhappy with the IMF-led approach to recovery (Jomo 1998). This leads us to a second level of competition between the United States and Japan.

The second dimension of this competition for political leadership is ideational and was equally apparent in U.S.-Japan interaction during the Asian currency crisis. This competition concerns not which nation has the power to implement its preferred policies but rather which nation promotes ideas that speak to and are accepted by Asia's leaders. In this case, although Japan was surely outshone by the United States in terms of controlling policy for Asia's financial reconstruction, Japan nonetheless presented a set of ideas that identified Japan as being on the side of its Asian neighbors. At times these views clearly portrayed Japan as standing in opposition to the side of the United States and what was seen as its international financial-market policeman, the IMF. Whereas competition for power over policy leadership in Asia is unlikely to result in significant diminution of U.S. influence in the immediate future, competition over who best represents the interests of Asia may reveal the United States to be disadvantaged.

In particular, Japan is involved in a variety of Asian forums that do not include U.S. representatives and shoulders a large share of the burden in those that do. Looking at those most germane to the financial-issue area, one finds, for example, that while the BOJ is deeply involved in ongoing and institutionalized cooperation with Asian central banks, the United States was intentionally excluded from participation in this group from its inception.[32] Also, although Hong Kong is where the Asian BIS office was opened in 1998, Japan bears the major responsibility for managing that organization, just as it does the Asian Development Bank. In short, in addition to the obvious fact that Japan is an Asian nation and the United States is not, institutional arrangements like those mentioned above provide Japanese leaders with greater opportunities to influence the thinking of Asian officials who are looking for new ways to develop their financial markets and integrate them into the global economy. Specifically, Japanese leaders have wooed their fellow Asian counterparts through their profession of an alternative to "Western" capitalism. This competition over ideas is amply evident in the battle of words between two particularly assertive representatives of Japan and the United States, former MOF Vice-Minister for International Affairs Sakakibara Eisuke and Secretary of the Treasury Lawrence Summers.[33]

Sakakibara made a name for himself by being an outspoken proponent of a Japanese style of capitalism, one in which the government has a greater role to play in countering the excesses of free markets. "Mr. Sakakibara has also been a vocal advocate of governments taking more control of international markets to keep financial crises like the one that started in Asia two years ago from spreading around the globe."[34] He argues that the more liberal market approach to financial-market organization proposed predominantly by the U.S. Treasury leaves economies too exposed to "the inherent instability of liberalized international capital markets" (Sakakibara 1999, 2) and is more supportive of some types of capital controls than is his U.S. counterpart.[35] Sakakibara has also criticized parts of the IMF's programs for restoring Asia's economic health by questioning whether the IMF structural policy measures vis-à-vis the currency-crisis states were too ambitious, demanded more reform than was necessary to overcome the crisis, and ran the risk of causing "undue friction in society, because each country has its own traditions, history, and culture, which are reflected in the economic structure" (Sakakibara 1999, 3). Finally, in stark contrast to U.S., IMF, and Organization for Economic Cooperation and Development (OECD) arguments that economic recovery will occur only after substantial structural reform in both the real and financial sectors has taken place (IMF 1995), Japan has taken the position that requiring reform first is not always necessary and can be excessively painful.

In sum, through institutional affiliation, the words of Sakakibara and others, and various unilateral policies, Japan has taken up issues that resonate well among the Asian countries still dealing with both the crisis and the effects of IMF prescriptions: ideas not often expressed by the more free market–oriented U.S. Treasury.[36] If the recovery of the Asian economies does not go well, the frustration some Asians feel about their exposure to international markets may take on even more political expression. In that event, I expect continued tensions between the United States and Japan over how to deal with recalcitrant Asian governments and how fast those national economies should be integrated into the global economy.

This ideational competition or conflict over the appropriate role of government in the economy and the extent to which national circumstances deemed unique or special should be accommodated by other international market players was equally obvious in the tension between the United States and Japan concerning the most appropriate way for Japan to respond to its own domestic banking crisis. While in formal statements U.S. officials presented themselves as supporting Japanese efforts, in other forums it was obvious that many felt Japan was far too slow in identifying and disclosing the extent of the bad debt held by Japanese banks, too hesitant to commit public funds to uphold the banking system and provide domestic stimulus to the economy, and too generous and indiscriminate in sharing these public funds with poorly managed institutions that should have been forced to close. Competition on this ideational level is a good thing, however, and honest debate over alternative approaches among fundamentally cooperative allies may be the world's best hope for keeping up with ever changing markets, maintaining international financial stability, and managing financial crises when they inevitably strike.[37]

In sum, competition for political leadership between the United States and Japan has revealed itself in conflicts over both policies and ideas. As recounted above, Asian states' current dependence on U.S. participation for their recovery, together with Japan's inability to push too hard on these issues given its own dependence on the United States,[38] is likely to preclude these nations from either adopting policies that alienate the United States or ever actually experimenting with Japan's "recover first, reform later" ideas. Needless to say, Japan also has yet to convincingly prove the superiority of this model in its own struggles to recover from a domestic financial crisis. Nevertheless, persistent Japanese efforts to accommodate unique national circumstances rather than fully expose domestic markets to what is often depicted as a largely U.S.-envisioned liberal international economic order suggest that ideational competition between the United States and Japan concerning the ideas on which to base the new international financial architecture and manage domestic and international linkages will continue for the foreseeable future.

In several respects, the currency crisis in Asia provided Japan with one of the greatest opportunities to stand out and take a leadership role in resolving an international crisis. It occurred in Japan's Asian neighborhood, where Japan already had a substantial economic presence; it could be resolved with one of the few resources Japan had an abundance of, namely, capital; and because it concerned financial rather than military commitments, it would be significantly easier to sell to the Japanese public and posed none of the politically complicated moral judgements that many other international interventions involve, such as those concerning military or human-rights issues. Nevertheless, as the saying goes, "timing is everything," and given its own set of financial and economic problems, Japan was unable to present itself as a strong alternative to U.S. leadership. Had the Asian crisis occurred ten years earlier, when Japanese financial institutions were seemingly at their peak and the position of the ruling Liberal Democratic Party (LDP) was more secure, the competition between the United States and Japan might have been more severe. Whether this competition for leadership in Asia will intensify in the future depends on the recovery of Japan's financial sector, revitalization of the Japanese economy as a whole, and stabilization of Japanese party politics.

Finally, as I have said throughout this chapter, the extent to which Japan can promote policies or ideas that directly challenge or conflict with the United States is greatly constrained by the importance of the overall U.S.-Japan relationship. The more likely development is that in multilateral and especially regional settings Japan will seek to play a relatively greater role, but one that is portrayed as complementing rather than conflicting with U.S. interests in the region. Thus, for example, the greater acceptance by the United States of Japan's proposals concerning Asia's recovery after the currency crisis shifted to Latin America, where the United States sees its interests as more immediate, was interpreted as U.S. approval of a burden-sharing arrangement whereby the United States and Japan's common interests would be pursued by leaving the Asian recovery in Japan's hands (Shinohara 1999, 10). Whether Japan can parlay this role as the United States' assistant into something more autonomous remains to be seen.

Globalization and Domestic Institutional Change

One cannot fully understand the ways in which globalization affects the U.S.-Japan relationship without examining the significant influence these developments have had on domestic institutions.[39] As stated in the introduction, globalization has increased the sensitivity of domestic financial systems to international influence and fostered changes in a wide range of domestic policies and institutions in response to this pressure. One result of this domestic policy response to international change is that over time the extent to which domestic institutions can "block or refract" these international pressures also changes (Milner and Keohane 1996, 5). It is especially worthwhile to explore this possibility in the case of Japan because Japanese domestic institutions in particular have been portrayed as robust and slow to change in the face of international pressure.[40] The implication of this argument for U.S.-Japan financial-market relations is that patterns of political interaction both within and between the United States and Japan may change as globalization promotes change in both domestic policy preferences and institutional relationships.

Globalization implies that virtually all nations are increasingly exposed to changing international financial circumstances and many have adjusted domestic policies accordingly. The United States is no exception. In its case, however, domestic financial-market policy changes have not yet produced any major restructuring of institutional organization or financial-market authority. This may change soon, since Treasury and the Federal Reserve Board recently announced an agreement concerning jurisdictional issues that had been holding up any major overhaul of the U.S. financial system (Lebaton 1999). Globalization and the increased salience of financial-market developments for the U.S. political economy have created an increase in the relative political importance of Treasury, especially in matters concerning foreign affairs. This shift in the relative attention paid to Treasury preferences is also evident in U.S.-Japan relations. For many years trade issues dominated the U.S.-Japan agenda, and trade negotiators discussed financial issues as they related to trade. Since the late 1980s, however, financial issues have dominated this forum and have been largely delinked from trade concerns.

One implication of this change, as pointed out in Robert Uriu's chapter in this volume, is that U.S.-Japan relations as managed by Treasury are not influenced by the revisionist school of thought that once dominated trade-oriented relations. Overall, however, the impact of globalization on U.S.-Japan relations caused by domestic institutional change is much more evident when observed from the Japanese side.

In contrast to the United States, Japan is currently experiencing a period of tremendous turmoil and uncertainty, which has at least the potential to challenge and change Japan's political economy in significant ways.[41] Although it is difficult to see the direction in which things are headed from the eye of the storm, as it were, it is equally difficult to imagine that Japan will pass through this period of political and economic upheaval and emerge little changed by the experience. Thus, based on what we know today, and with the necessary caveats concerning predictions during periods of transition, I consider below some of the ways in which current political and economic circumstances in Japan can be expected to affect U.S.-Japan financial relations.

To summarize the turmoil, for most of the 1990s Japan's so-called ruling triumvirate, comprising the ruling LDP, the bureaucracy, and big business, was in disarray. At no other time in the postwar period had all three of the dominant forces shaping Japan's political economy been so unsettled at the same time. With the bursting of the so-called bubble economy at roughly the turn of the decade,[42] the economy, and therefore the big-business part of the triumvirate, experienced spectacularly less economic success; there was also a continued weakening in the commonality of interests within this broadly defined big-business group. Of particular relevance to this chapter is the increased dissatisfaction with government intervention and the greater divergence between the large and multinational corporate sector, with its preference for more rapid deregulation of financial markets, and the financial sector, in which conflicts of interest continue to hinder more proactive approaches to reform. In conjunction with a broad economic recession, Japan is struggling to manage the most recent in a series of spectacular financial-market crises, this one involving bad loans throughout the financial system that may account for as much as 10 percent of all loans outstanding ("Japan Banks" 1999). As a result, for the first time in decades Japanese financial institutions of all types have begun to fail. Given these events, confidence in Japan's economy as a whole, and in the financial system in particular, is extremely low.[43]

To this economic turmoil one must add significant political uncertainty. Since the early 1990s, when politicians began abandoning the LDP and in 1993 successfully seated the first non-LDP prime minister in almost four decades, the political situation in Japan has been unstable. The pace of the creation and dissolution of new parties and coalitions seen during the 1990s was extraordinary, especially when compared with most of the postwar period. Despite the LDP's having at times regained some semblance of effective rule by pulling in defectors from smaller parties or forming "alliances of convenience, it has not recouped its once unchallenged dominance and the threat of continued political uncertainty is great" (Fukui and Fukai 1998, 25).

Finally, Japan's bureaucracy is being reorganized and reconceived.[44] The financial bureaucracies (MOF and to a lesser extent the BOJ) in particular have been unceremoniously knocked off their pedestals and are under attack from the general public, politicians, and business in ways virtually unimaginable two decades ago. The public lost confidence in the capabilities of Japan's financial authorities after the asset-inflation bubble of the 1980s burst and eventually revealed the fragility of the financial infrastructure supporting the economy, first through the *jūsen*, or housing-loan company, crisis and more recently though the banking-sector crisis. Moreover, they lost respect for these officials as one scandal after another in the financial-services industry revealed bureaucrats' indifference, complacency, or even complicity and resulted in more than one official's being led from his office by prosecutors.[45]

Business groups, for their part, saw these events as creating an opportunity to further reduce bureaucratic intervention in the economy. Understandably, given the instability of political coalitions and the resulting overwhelming reelection imperatives, politicians from virtually all parties responded to this shift in business and public opinion and supported reorganization of MOF to varying degrees.[46] Thus, in 1998, after three years of debate, MOF, long considered one of the most powerful ministries in Japan, was formally relieved of a good portion of its regulatory and supervisory responsibilities. This major reorganization took effect just twelve months after the Bank of Japan Law was revised to provide the central bank with more open and formal independence from MOF. In short, the bureaucratic part of the financial-politics equation has also changed drastically in the past few years.

These changes in the fortunes and cohesiveness of the ruling party, the bureaucracy, and big business are expected to threaten the viability of long-standing patterns of politics. The extremely high level of uncertainty may well also call into question the government's future leadership capacity, both within Japan and internationally, as well as the continuity of financial policy and the credibility of commitments vis-à-vis the United States. The ramifications of all these domestic challenges may be extensive. Below I address only two of the ways in which the more indirect effects of globalization on domestic politics may influence U.S.-Japan relations in the financial-issue area: greater politicization of financial issues and decentralization of financial authority.

Politicization of Financial Issues

Globalization affects domestic politics because it increases the exposure of domestic constituents to international market developments (Milner and Keohane 1996, 16). Moreover, given the role deregulation has played in promoting globalization, governments now have less policy autonomy and fewer means to shield their constituents from overseas shocks (Bryant 1980; Goodman and Pauly 1993; Andrews 1994, Keohane and Milner 1996).[47] Specifically, in an increasingly global environment with extensive capital mobility, redistributive policy tools once commonly used to protect or compensate politically important groups (such as protective regulations and taxation) often conflicted directly with more competitive actors' interests and were eliminated in response to pressure to create a more internationally competitive economic environment (Stenmo 1996; Webb 1995). Accordingly, a common refrain of the internationalization literature is that governments can please voters or internationally mobile investors, but not both. That being said, fewer policy options do not mean fewer political obligations.

Domestic actors discontent with the distribution of the costs and benefits of international economic integration have commonly used political pressure on the government to try to change the terms of competition—or at least the distributive outcomes. In the context of globalization, as the domestic buffers against international shocks deteriorate, financial issues take on greater salience for a larger segment of the domestic population. In the case of Japan, the public has become painfully aware of the cost of accommodating mobile capital, as evidenced in fiscal policies, such as those increasing the consumption tax while reducing corporate and financial transaction-related taxes,[48] and of failed financial supervision, through the closure of financial institutions and the huge sums the government has pledged for the bailout of those remaining. Financial issues have been near the forefront of the political agenda in Japan for at least nine years now, and unlike the early 1980s, when financial reforms were debated almost exclusively among industry representatives, a handful of academics, and key politicians, these days financial policies influence party politics and public opinion matters. In short, globalization has pushed financial issues from the realm of "high politics," in which primarily sophisticated political actors or those with strong vested interests participate, into the realm of "low politics," in which the public is concerned and engaged.

Decentralization of Financial Authority

Three factors have fostered greater decentralization of financial authority in Japan. The first is the more active and overt role of politicians fostered by the politicization outlined above, the second is the revision of the Bank of Japan Law, and the third is the reorganization of MOF. Below I simply describe these changes. In the next section, I explore the implications of both politicization and decentralization for U.S.-Japan relations.

In 1993, the LDP's reign as one of the longest-running ruling parties in any contemporary democracy ended. This stunning loss of leadership was not caused by any single factor, but did take place at a time when public concern about political corruption and financial and economic mismanagement was intense. In fact, the early 1990s were a time in which both politicians and financial-market officials were near their nadir in terms of public support. In this environment, the opposition parties put forth a variety of proposals concerning reform of both the political system and the financial bureaucracies. Both political and financial reform were old issues in Japan and in their various manifestations had been debated but largely defeated numerous times over the years. Under these circumstances, however, a weakened LDP was barely able to save itself, let alone its longtime partner in economic management, MOF.

Given the myriad problems facing Japan and the LDP at the time, it was unclear whether the party would soon return to power or a new era of non-LDP administrations was just beginning. Faced with this uncertainty, some MOF leaders cooperated with the new leadership to an extent that antagonized their longstanding partner in governance, the LDP (Mabuchi 1998, 15; Brown 1999, 209–211). When the LDP did return to power, first in a coalition (1994) and then seating its own prime minister (1996), the party leadership was possibly less willing, and certainly less able, to defend MOF when pressured for reform. This is because the LDP's new dependence on coalition partners required that it consider, rather than simply dismiss, the more radical ideas to reform MOF proposed by less forgiving coalition partners.

This breakdown in the mutually supportive network between the LDP and MOF took place in the context of not only growing public criticism of MOF but also a broad financial reform process already in progress and propelled in large part by MOF itself. As a result, when the Hashimoto administration (1996–1998) promised it would curb the size and influence of the bureaucracy, it was both responding to global financial-market trends concerning financial liberalization and accommodating proposals that MOF be stripped of substantial power made by the two opposition parties in Hashimoto's coalition government (the Social Democratic Party and New Party Sakigake). In short, a supposedly all-powerful ministry, one that had withstood even the Supreme Commander for the Allied Powers' efforts at reform during the Allied occupation following World War II, was dismantled not by a strong LDP but, rather, by a seemingly weak and coalition-dependent one ("Under Attack" 1996; Mabuchi 1998; Hiwatari 1999).

The politics behind the reform process demonstrates that within a more politicized environment politicians, who are more desperate to please voters, and coalition members will more readily and more actively address areas of bureaucratic authority formerly left unchallenged. The postwar National Diet has always had ultimate authority to restructure ministries as its members see fit. Nevertheless, the extent to which politicians have been taking advantage of this power as it concerns the financial agencies is unprecedented, at least in the postwar period. Thus, while political intervention itself is a not a new factor in the political economy of financial policy making in Japan (Rosenbluth 1989), the past several years suggest that the Diet may become a more proactive and volatile source of decision making concerning financial policy than ever before.

The impact of this reform on MOF itself is obviously also critical to our story and clearly reflects the extent to which MOF is viewed as having mismanaged Japan's financial system.[49] The June 1998 reorganization of the ministry transferred authority for the inspection and supervision of financial institutions to a new Financial Supervisory Agency (FSA).[50] Within MOF, the Financial Inspection Department was eliminated and the Banking and Securities Bureaus were merged to create a new Financial Planning Bureau. Although MOF leadership failed in its efforts to have the FSA located within the ministry, as was the Securities and Exchange Surveillance Commission when it was created in 1992, the relationship between MOF and the new FSA is complicated, particularly in regard to personnel exchange, crisis management, and financial planning (Mabuchi 1998, 3–4).[51]

To begin with, over 90 percent of the FSA's starting staff came from MOF, and all but those reaching the position of department chief in the FSA will be eligible to return to MOF posts after two years at the new agency. This suggests that developing a cadre of FSA officials who do not feel beholden to MOF for career advancement may be difficult and thereby increases the FSA's susceptibility to MOF influence. In addition, while the FSA is charged with dealing with the failure of individual institutions, MOF must be consulted in cases where the repercussions of failure may cause system instability or require publicly funded assistance. Similarly, while the FSA was created in large part to reduce MOF's opaque administration based on close ongoing relationships with financial institutions' representatives, MOF is still able to maintain an open line to these institutions by requiring information from them for purposes of "planning." The extent to which MOF will use these last two ties to financial institutions as a way to emasculate the new FSA or pull it under its wing is something only time will tell.

Similarly, the revision of the Bank of Japan Law in June 1997 was designed to increase the central bank's independence, primarily vis-à-vis MOF.[52] The postwar relationship between the BOJ and MOF brought both costs and benefits to the central bank. On the one hand, many BOJ officials and economists considered MOF's influence over BOJ policy detrimental to both the central bank as an institution and the economy as a whole. The BOJ's ability to resist MOF influence was limited, however, because the old Bank of Japan Law provided MOF with significant legal influence. Moreover, the BOJ was beholden to MOF for "protection" from Diet pressure. That is, both MOF and BOJ officials recognized that one of MOF's roles was to stand between the Diet and the BOJ and buffer political demands regarding monetary policy and other financial affairs.

Given these preferences and institutional circumstances, over the years the central bank tried to resist MOF influence to the extent that its institutional capabilities allowed.[53] That is, BOJ officials pursued and achieved some level of de facto independence even though de jure the BOJ was one of the least independent central banks. For example, BOJ officials considered it a success that MOF was excluded from any participation in the formation of the Executives' Meeting of East Asian and Pacific Central Banks.[54] In addition, growing international agreement among scholars and policymakers concerning the economic benefits of central bank independence (Henning 1994)[55] were used to add credence to the BOJ's own pursuit of this goal and were brought to the public's attention through press accounts of various committee reports on central-bank reform (Brown 1999, 174–75; Mikitani and Kuwayama 1999, 2–3).[56]

In particular, supporters of greater BOJ independence focused on a body of economic literature examining the importance of central-bank independence in signaling to the international community a government's ability to uphold monetary-policy commitments.[57] This literature saw Japan as an anomaly because, although the BOJ ranked as one of the least independent central banks, Japan enjoyed one of the lowest inflation rates, which is an outcome expected only from countries with very independent central banks. This empirical outcome was explained by either the overwhelming influence of domestic interest groups that gain from low inflation or the BOJ's association with MOF, which was viewed as having enough autonomy from political forces that it could in turn protect the BOJ, thereby creating the same effect as BOJ independence.

While neither of these views is fully satisfying, it is true that the relative stability and constancy of political, bureaucratic, and business relations in the postwar period greatly reduced the pressures for drastic changes in monetary policy that often accompany changes in administrations or swings between left- and right-wing coalitions in other countries. Thus, as Lohmann argues, Japan's ability to maintain low inflation was a function of "non-institutionalized reputational means" rooted in the stability of the relations between a long-dominant ruling party, big business, and the bureaucracy (1997, 77). By implication, the extensive turmoil seen in each of these three sectors of Japan's political economy in the 1990s meant that the BOJ's commitment to price stability could no longer be assured by its political context; therefore, that commitment needed to be signaled through institutionalized means. This explains the logic behind the BOJ's continued efforts to "regularize" Japanese monetary institutions in line with other respected central banks, most notably the U.S. Federal Reserve Board. BOJ preferences do not necessarily explain policy change, however, and some have even argued that the BOJ did not play a large role in mobilizing support for the new Bank of Japan Law (Mikitani and Kuwayama 1999).

Revision of the law appeared on the political agenda more than once in Japan's postwar history but was always shunted aside, whether through MOF opposition or Diet indifference. This time, however, three circumstances contributed to its successful passage. First, BOJ reform came up as part and parcel of discussions of system-wide financial reform and, despite considerable opposition and some concessions to MOF, was pushed through by politicians as a critical part of Prime Minister Hashimoto's commitment to reform in response to the tremendous public outcry against government corruption, the government's (taxpayers') bailout of the *jūsen*, and other evidence of general financial-system mismanagement.[58] In other words, it was presented as part of a comprehensive plan for improving Japan's financial structure and not simply as a move by the BOJ to improve its status. Second, because MOF's reputation had been smeared by its involvement in various scandals and its apparent inability to pull Japan out of its financial morass, MOF officials were in no position to staunchly defend their continued influence over BOJ affairs. Many in fact blamed excessive MOF influence for the central bank's easy monetary policy in the late 1980s, which had contributed to the asset-inflated bubble economy and the later banking crisis (Ueda 1998).[59] For this reason, some see the passage of the revised Bank of Japan Law as simply another way to punish MOF. Considering the apparent willingness of LDP politicians to allow MOF to be the scapegoat for Japan's many woes, some have suggested that MOF officials' eventual lukewarm support for the new Bank of Japan Law was a diversionary tactic designed to deflect criticism and appease opposition politicians interested in more radical dismemberment of MOF (Cargill 1998, 19; Sapsford 1999, A14).

On the other hand, BOJ officials were not all behaving like angels, either. Several had been caught in a bribery scandal, and there was political pressure independent from anti-MOF sentiment to improve the central bank's transparency and public accountability. As one article put it, "The price of independence would be openness"(Sapsford 1999, A14). At this point, one must consider politicians' incentives for revising the law. The new law was discussed primarily in terms of how it would change the BOJ's relationship with MOF. But it would change the BOJ's relationship with the Diet, as well.

One expected implication of the new law was that less MOF influence meant more Diet influence. And the BOJ did recently create a new section to manage BOJ relations with the Diet, suggesting that the bank too expected it would have to deal with pressures from politicians once managed by MOF. But BOJ independence from MOF need not mean greater Diet influence. As Goodman (1991) has argued, politicians representing strong conservative social coalitions will vote to increase central-bank independence if they expect to lose their hold on political power.[60] The logic of this argument is that by granting the central bank independence while in power, the existing administration can essentially institutionalize its preferences for low inflation or price stability and effectively tie the hands of successor opposition parties, especially more liberal ones, that might prefer to use monetary policy to achieve more redistributive objectives. The underlying assumption is that politicians expecting to maintain their hold on power want freedom to intervene in monetary policy as they see fit but do not want to give those with different preferences the same opportunity. Although it may be an exaggeration to say the LDP *expected* to lose control of the Diet in the near future, certainly the political turmoil experienced in Japan over the previous eight years made that a much more likely scenario than at almost any time in the postwar period. Moreover, this argument explains why the LDP would not have felt compelled to grant the BOJ greater independence at earlier times.

As with the creation of the FSA, the impact of the new law on BOJ effectiveness and on the BOJ-MOF relationship is still far from clear. On the one hand, in their early analysis Mikitani and Kuwayama find the new law lacking. They point in particular to the law's impractical separation of monetary policy from other responsibilities and the several ways in which MOF might still wield influence over the BOJ, including BOJ responsibilities to keep "close contact" with MOF and submit parts of its budget for MOF approval, attendance by the minister of finance or his representative at meetings of the Policy Board, and continued treatment of the BOJ as the government's "agent" when conducting foreign-currency transactions. They summarize: "The muddying of the line between central bank and government responsibilities is unfortunately characteristic of the entire spirit of this law, which thus perpetuates exactly the kind of ambiguity that has kept the Bank of Japan from establishing its independence and accountability in the past" (1999, 11). On the other hand, despite these and other criticisms that the new law does not go far enough in ensuring BOJ independence, several commentators conclude that in the end it is not the legal institutional structure that will determine the extent of BOJ independence but rather BOJ policy practice.[61] In this regard, the BOJ is now in a better position to earn the public's trust and use greater transparency and accountability to its advantage as a means to reveal to the public any inappropriate efforts by politicians to intervene in BOJ affairs (Mikitani and Kuwayama 1999, 21). Although still very early, it is telling, therefore, that the BOJ has already publicly refused both MOF's and the prime minister's request that the BOJ raise interest rates or print money to reduce the value of the yen (Zaforin 1999).

Implications of Increased Politicization and Decentralization

Above I have outlined some of the changes in Japan's domestic economic, political, and bureaucratic circumstances that have affected financial politics. To reiterate, the most important of these 1990s developments were the decline in Japan's economic and financial health, volatility in political leadership, and reorganization of the financial bureaucracies. Here I consider some of the possible implications of these developments for U.S.-Japan financial relations.

First, increased politicization and decentralization are bound to complicate the policy-making processes in Japan and by extension any negotiations between the U.S. and Japanese governments. The reorganization of bureaucratic authority outlined above has increased the number of at least relatively independent institutional actors involved in financial policy making. Thus, whereas MOF was essentially in charge of managing the entire official response to failed institutions in the past, the FSA, MOF, and the BOJ may all bring different institutionally defined approaches to resolving such problems in the future. The unfortunate absence of clearer demarcation among these agencies' responsibilities further encourages their staffs to fight over jurisdiction and possibly feel compelled to participate in more types of negotiations than might otherwise be necessary. That is, if multiple jurisdictions are involved, conflicts among at least ostensibly independent Japanese agencies are sure to equal if not surpass those seen between MOF bureaus before the restructuring.

When one adds to this increase in institutional actors more intense competition among politicians, who are more motivated to respond to a wider range of opinions as they seek to solidify their voter base, the domestic politics of financial policy making looks much more contested than it did just a decade ago. Given the Japanese tradition of consultation and consensus building in policy formation, an increase in the number of powerful actors with a vested interest in the outcome almost ensures that resolving the domestic conflicts informing national policy decisions will become more difficult and time consuming.[62] The exception that proves the rule is that during times of crisis, such as Japan has experienced repeatedly in the past few years, surprisingly swift and radical policy change is sometimes possible.[63] Nevertheless, once a crisis has abated and the new institutional arrangements have fallen into place, only extraordinary leadership from the Diet prevents Japanese policy making from reverting to the incremental style that so often frustrates Americans. Given the unlikelihood of any radical change in Japan's policy-making style, the United States will just have to be patient with its often slow-moving ally. Fortunately, thus far the United States has been able to afford to be.

Although one would not generally characterize the U.S. government's standard approach toward Japan as gracious and patient, given the extent of the financial troubles Japan has faced over the past five years American officials have been less aggressive toward Japan than past relations would lead one to expect.[64] This greater patience with Japan is largely a function of the good fortune of a strong American economy.[65] In the words of the usually understated Federal Reserve Board Chairman Alan Greenspan, the performance of the American economy over the past seven years has been "truly phenomenal" (1999, 11). Its strength has been particularly pronounced in relation to the rest of the world, with the excess of U.S. growth over foreign growth in 1998 the largest in two decades and U.S. domestic demand–led growth accounting for almost one-third of the world total since 1996 (Greenspan 1999, 1; Meyer 1999, 2). Needless to say, this economic strength has also imposed on the United States the burden of pulling along the weaker economies almost single-handedly.[66] That role is quite clearly manifest in the United States' growing current account deficit, which reached nearly US$225 billion at the end of 1998 (Higgins and Klitgaard 1998, 1).

Although the current account deficit is a perennial sore spot in U.S.-Japan relations, for the time being the imbalance is not being highlighted as the most pressing problem. One reason is the U.S. government's recognition that attempts to crack down on imports now could threaten the fragile recovery taking place around the world and would thus prove to be a step backward over the long run. In addition, strong employment in the United States has virtually eliminated the usual channel of political complaints about the deficit. Formerly, the current account deficit was reviled as jeopardizing American jobs, because competitive imports meant U.S. exporters were hurting and might shut down or shift production overseas. During the 1990s, however, the current account deficit proved not to be a threat to overall employment in the United States, where the unemployment rate declined to a twenty-five-year low, in part because of capital investment from Japan.[67]

In this instance, the complementary aspects of the U.S.-Japan debtor-creditor relationship created a temporary buffer around the potentially strife-ridden topic of payments imbalances. But no one knows how long this buffer will last. For years Americans have insisted that the continuing current account imbalance could not be sustained without severe consequences, and yet it has lasted for quite some time and apparently without catastrophic effect. Nevertheless, economists and policymakers seem virtually unanimous in proclaiming that at some point the burden of the deficit, which of course represents foreign claims on the United States, will become too great and too destabilizing for the United States and the world economy to bear. One can only hope that currently favorable economic circumstances will sustain American patience long enough to facilitate Japan's economic recovery.

A second implication of increased politicization and decentralization is that communication and cooperative efforts between the United States and Japan may take place through new channels. Although this is purely speculative at this point, it is possible, for example, that continued politicization of financial issues in Japan will lead U.S. representatives to spend more time with their Japanese counterparts as Diet participation in policy debates becomes more visible. More likely, however, is an increase in what Keohane and Nye describe as transgovernmental relations (1977, 33–34), which is when bureaucrats or other government agents cooperate directly with their counterparts in other countries in ways that reflect their institutional complementarity of interests, as opposed to more all-encompassing national interests.[68] When power is decentralized and institutions become more specialized, as is happening through reform in Japan, the prospects for this process to take root also increase.

Looking at the U.S.-Japan case specifically, there has long been a great divide between the career generalists who reach the top of a Japanese bureaucracy charged with a broad agenda of responsibilities and the professionals with more hands-on experience running more narrowly charged U.S. financial agencies. Because of reform in Japan, however, this contrast has diminished somewhat in the past few years, and further changes in this direction are expected. Both globalization and decentralization have demanded greater expertise of financial supervisors and other officials, and since the late 1980s Japan's financial bureaucracies have been making career-track adjustments accordingly. The implications of decentralization and specialization for U.S.-Japan relations will depend on how far these two trends are carried (that is, whether the private-sector accountants recently hired to help out the primarily MOF-derived staff of the FSA will promote the development of FSA-specific expertise). In general, however, as officials on both sides of the table share an increasingly similar background and vocabulary in regard to financial matters, agreement among American and Japanese *specialists* should become much easier.[69] For example, one can readily anticipate that an official from the U.S. Security and Exchange Commission is more likely to find common ground discussing regulations to limit churning (the unnecessary trading of securities) with a similarly trained specialist in securities supervision working at Japan's new Securities and Exchange Surveillance Commission than he or she would have found with a MOF generalist whose institutional concerns ranged from securities supervision to the balance of regulatory burdens vis-à-vis banks and the impact of reduced transactions on the revenue gleaned from the securities transaction tax.

As the epistemic-community literature suggests, cross-national communities of specialists can often reach agreement more readily than can national representatives. Moreover, negotiators can at times use an internationally cooperative base as leverage to move their governments in the agreed upon direction (Moravcsik 1994). The greater efficiency of negotiations among more narrowly interested parties and their ability to pull governments into line is exemplified by the greater success of such groups as the BIS Committee on Banking Supervision than more broadly based efforts at macroeconomic policy coordination (Bergsten and Henning 1996). Thus, as long as the U.S.-Japan relationship continues to be strengthened through the resolution of many small specialized issues, decentralization accompanied by specialization and greater transgovernmental relations should contribute to overall financial-market cooperation.

In sum, politicization, and decentralization accompanied by greater specialization, can cut both ways, depending on the type of issue addressed. In the case of broad national policies with distributive effects obvious to the voting public, politicization and decentralization can be expected to complicate the process of reaching a domestic consensus and slow down the policy-making and policy-implementation process even more—unless, of course, political stability returns and the Diet proves able and willing to provide decisive leadership. On the other hand, in the context of the more technical and seemingly apolitical issues often associated with developing cooperative financial-market approaches in particular, decentralization accompanied by specialization should improve the chances of the United States and Japan reaching agreement more readily.

Conclusion

In this chapter, we have reviewed a variety of factors associated directly or indirectly with the globalization of finance and considered how they might shape U.S.-Japan financial-market relations in the future. It is far too early to tell whether the need for greater international financial-market supervision will be met by adequate cooperative efforts. Similarly, it is impossible to know with any certainty how the domestic turmoil in Japan's economic, political, and bureaucratic systems will play out over the next few years. Nevertheless, globalization is clearly a factor that will continue to influence the policy options available to both the United States and Japan.

Globalization is binding the two economies ever closer together and making each more sensitive to changes even in what were formerly considered small, and in terms of market share insignificant, financial markets. Due to their unique positions in international financial-market affairs, however, both the United States and Japan have a tremendously high stake in maintaining basic stability. Accordingly, I am confident that other conflicts will not be allowed to undermine this fundamental common interest.

One should not expect, however, that globalization will eliminate political competition to shape the rules of financial-market competition or the distributive outcomes these markets produce. As discussed above, sometimes the terms of financial-market competition can be adjusted in one's favor through unilateral regulatory or other policy adjustments. Both the Big Bang of financial reforms in London years ago and the ongoing Big Bang of financial reforms in Japan provide clear examples of governments taking unilateral steps to recapture lost international financial-market competitiveness. Sometimes, however, forcing other nations to adjust to terms more favorable to oneself seems the best, or at least the most politically expedient, route. The history of U.S.-Japan trade relations offers a seemingly endless parade of such occasions, with the list of bilateral demands embodied in the yen-dollar talks providing an obvious financial market counterpart (Frankel 1984).

Finally, economic conflicts between the United States and Japan in the past have been closely associated with payments imbalances, and financial politics cannot be permanently delinked from this issue. Thus, one should expect that significant changes in the balance of payments will change the context of the U.S.-Japan discourse in financial affairs. It is possible that this imbalance will lessen if the United States continues to make gains in regard to its fiscal deficit, the aging of Japan's population encourages more spending relative to savings, and Japan continues to welcome foreign direct investment. This scenario, however, is still years down the road.

Regardless of these possibilities, globalization will continue to affect U.S.-Japan relations. We have seen that it increases the importance of international cooperation for these uniquely positioned nations, especially in regard to financial-system stability. This basic level of cooperation, however, will limit but not eliminate the competition between the United States and Japan over the distribution of economic gains and over political leadership in Asia. In addition, the many changes taking place within Japan's political economy will continue to affect the political processes involved in U.S.-Japan negotiations. My prediction is that absent rarely seen commanding leadership by Japanese politicians, politicization and decentralization will make cooperation over broad financial-market issues more difficult because it will involve a larger number of actors and institutions, each with more narrowly defined interests. On the other hand, frank discussion of contending financial-system arrangements, greater institutionalization of existing cooperative arrangements, more transparent financial-market governance, and increased contact between similarly focused specialists will contribute to better management of the financial-market conflicts that will inevitably arise.

The conclusion I draw from this examination of the impact of globalization on U.S.-Japan relations is that cooperation in regard to stability-threatening issues will continue and develop further over the next decade. Continued cooperation designed to maintain international financial stability is well recognized as a first-level priority by both nations, and over time their repertoire of coordinated policy responses is expanding and becoming institutionalized through the IMF and other forums. On the other hand, cooperation involving agreements with longer-term distributional implications will remain difficult. Efforts aimed at this type of cooperation were clearly among the most contentious during the 1980s and included virtually all discussions concerning the regulatory, accounting, and other supervisory practices that ultimately define a new international standard. These issues, which are already difficult to settle because of their distributional and long-term implications, are expected to become even more difficult to negotiate. In addition to the problems that arise because of the competition between New York and Tokyo over financial-market jurisdiction and influence, distributional issues will become more difficult to resolve because of the increased politicization of financial-market issues at the domestic level and the restructuring of financial authority in Japan. In the long run, however, many of the issues in the latter category may essentially sort themselves out.

Today, many financial markets are in an awkward stage, and the politicians and financial authorities managing their development are still figuring out the proper balance between largely domestic markets with limited international exposure and more internationally integrated markets with some purely domestically oriented institutions. Accordingly, distribution-driven disagreements over what standards international market participants should follow are severe and concern a large number of issues. Of course, given the ever changing nature of markets, one cannot expect that even the standards worked out during this transitional phase will last forever. Adjustments will be ongoing. Nevertheless, over time the negotiation of standards will also become institutionalized and changes are more likely to be at the margin and affect all actors more equally than do contemporary agreements that are essentially defining international standards for the first time.

In addition, to the extent that market forces continue to pressure market actors, and through them government policies, to adapt to new market trends, whether this be through the offering of new products, new practices, or new organization forms, the number of issue areas requiring bargaining between governments may diminish, as well. That is to say, with the increased liberalization that has accompanied globalization, market actors themselves now play a larger role in defining international standards, and government agreements, while still very necessary, will concern more the market sustaining, supervisory, and crisis-management issues, where cooperation has proven to be more easily achieved.

The above conclusions are based on a broad view of the ways in which globalization is affecting the issues and institutions through which agreements concerning international financial issues are pursued, but should inform the U.S.-Japan relationship as well. To this broad perspective, however, we must add two factors unique to the bilateral relationship. First, for the time being Japan is the only nation in Asia that can support a regionally oriented alternative to a U.S.-based "Western" interpretation of how the globalization of finance should proceed.[70] Thus, as discussed above, disagreements between the United States and Japan over how best to integrate Asian economies into the global financial system may increase the ideational level of tension between the two nations over financial-market affairs. Yet a more straightforward exchange of ideas may ultimately strengthen U.S.-Japan understanding rather than threaten it.

Finally, throughout this chapter I have treated the common interest of the United States and Japan in maintaining international financial-market stability as defining the boundary limiting financial-market conflict between them. As stated in the introduction, however, without question the U.S.-Japan security relationship will continue to constrain the form of Japanese aspirations concerning Asian leadership, as well as the degree of assertiveness with which Japan can confront the United States over any financial issue. I am not in a position to guarantee that this security relationship is so central to each nation's national interest that neither government would breach it regardless of the severity of financial-market disagreements. But all obvious indications are that it is. Morever, most conflicts are of a much more limited nature. Accordingly, I conclude that even in the face of increased globalization the U.S.-Japan security relationship and the two nations' common interest in avoiding an international financial-system meltdown will provide ample assurance that while conflict and competition over financial issues will continue, they will be managed within an ongoing and fundamentally cooperative relationship.

Notes

1. Much of this variation in degrees of change is explained by the simple historical fact that the U.S. financial system was more open and exposed to international pressure from an earlier time, whereas the Japanese financial system was largely insulated from international pressures until the 1980s. Explanation of this variation is beyond the scope of this chapter.

2. This approach runs the risk of underrepresenting the role played by culture, history, and other variables closely tied to national identity, but puts us in a better position to understand how domestic political and institutional variables identified as causing patterns in national policy making in the past may themselves be subject to change.

3. This chapter only introduces these arguments. Testing the validity of the assumptions and causal inferences would, of course, require more rigorous examination, including a larger number of cases.

4. The literature on the causes, limits, and impact of financial globalization is vast and growing. A sense of this literature can be gleaned from Cohen (1996), Rodrik (1997), and Germain (1999).

5. As illustrative examples of financial globalization, by 1998 cross-border bank claims

had increased over five times the level fifteen years earlier, equaling more than 40 percent of the combined gross domestic product (GDP) of the Organization for Economic Cooperation and Development (OECD) countries. The annual issuance of international bonds more than quadrupled between 1988 and 1998, and between 1983 and 1998 securities transactions expanded from about 10 percent to around 70 percent of GDP in Japan and to "well above" 100 percent of GDP in the United States (Federal Reserve Bank of New York 1998).

6. The world has not yet seen, and may never see, a fully global market. Nevertheless, the trend in financial markets over the past several decades has unquestionably pointed toward greater interdependence.

7. Although Thomas (1998) provides an excellent argument concerning the equal importance of foreign direct investment in shaping the impact of increased capital mobility, this chapter focuses primarily on financial investment and portfolio forms of capital.

8. On the process and measurement of capital mobility and the internationalization of finance, see Cross (1998); Frankel (1991); Turner (1991); Goodman and Pauly (1993); and Bank for International Settlements (1998).

9. At the end of 1992 the net liabilities of the United States were approximately US$611 billion and the net foreign assets of Japan were approximately US$513 billion. Moreover, since the beginning of the 1980s a very substantial portion of Japan's current account surplus has been vis-à-vis the United States, which implies that Japan has been lending directly or indirectly to the United States (Hamada 1996, 79).

10. Interview, U.S. Embassy, Tokyo, June 1999.

11. One might begin a history of this type of cooperation with the establishment of the Basle Committee in 1974. Officially named the Standing Committee on Banking Regulations and Supervisory Practices, it was created after the failure of Franklin National Bank in the United States and, seven weeks later, the collapse of Bankhaus Herstatt in West Germany revealed how the failure of even a small institution conducting international (in these cases foreign-exchange) business could have significant and cross-national effects. Since that time, multilateral responses to financial crises have become if not routine, at least clearly expected, whether concerning Latin American debt in the 1980s or the recent currency crisis in Asia. As illustrative contrast, Eichengreen and Portes (1987) and Eichengreen (1996) examine financial crises before World War II.

12. The extent to which this serves or detracts from stable U.S.-Japan relations overall is discussed below.

13. A number of these changes are discussed in Dwyer (forthcoming). Brown has also pointed out, for example, that the recent routinization of the promotion of the director of the International Finance Bureau of MOF to the post of vice-minister for international affairs reflects greater recognition that this official should have expertise in not only international finance and English but also management of U.S. pressure (1999, 21).

14. This holds true whether one adopts a rational-actor model in which institutions embody repetition in strategic games, reduce transaction costs, and enhance the credibility of commitment; whether one focuses on the organizational characteristics of institutions that allow members increasingly to solve problems through standard operating procedures; or whether one highlights the importance of ideas and the role of institutions in facilitating the transmission of ideas, learning, and the development and empowerment of epistemic communities.

15. These cross-national complaints were amply evident in the Yen -Dollar Agreement (Frankel 1984).

16. In addition to the less tangible benefits of increased international prestige and power, there are very practical domestic benefits including tax revenues, employment opportunities, and greater influence over the players who shape international market developments.

17. For further discussion of what attributes market participants prefer and why competition does not lead to a "race to the bottom," see Kane (1988); Dwyer (forthcoming).

18. Interviews, BOJ, 1998. Numerous illustrations of the comparative decline of Tokyo vis-à-vis not only London and New York but also Singapore and Hong Kong can be found in Itō (1999).

19. See the Foreign Press Center newsletter *PressGuide*, March 1997, for details. To achieve this goal, the government is even moving to eliminate the long-standing ban on holding companies so that Japanese companies will be able to offer the range of financial products standard elsewhere.

20. Criticism of the Japanese approach to restructuring came not only from the United States but from most of the rest of the world, as well. A recent OECD report is particularly critical of the lack of rapid and forceful action in Japan. See "Japan Must Deregulate" (1999). Similar criticisms were well publicized in an earlier IMF report (International Monetary Fund 1995).

21. The interaction through which these evaluations are made is quite obvious. In addition to filling newspaper articles with quotations concerning whether the financial community considers a Japanese policy good or bad, these market actors make their preferences clear by moving funds out of Japanese investments when they do not like a government proposal and moving them back once sufficiently credible steps are in place. Thus, for example, the international financial community signaled its disapproval of the government's initial plan to disclose bad loans only on an aggregate basis, as opposed to bank by bank, by charging all Japanese banks a significant premium over and above market rates. More recent policies requiring disclosure at levels imposed in the United States and the United Kingdom are being well received, as were the aspects of the bridge-bank proposal modeled on the U.S. Resolution Trust Corporation. See, for example, *Wall Street Journal* Interactive Edition, 2 July 1998.

22. As one Department of State representative suggested, the United States does not have to push Japan to make these adjustments; it knows from the market what needs to be done (Interview, U.S. Embassy, Tokyo 1998).

23. This coincides with greater reluctance to follow the U.S. lead more generally (Huntington 1999).

24. Detailed discussion of the East Asian crisis already abounds and is beyond the scope of this chapter. It is often argued, however, that Japan helped create the Asian currency crisis, because the endless decline of the yen hurt the competitiveness of Asian countries, and is prolonging the crisis through its failure to address domestic reform and recovery aggressively enough.

25. Since the Asian financial crisis began in July 1997, Japan has contributed more than any other nation to the cause of East Asia's recovery (Castellano 1999, 1). Japanese exposure to the Asian region was estimated at US$100 billion in December 1998 ("Recessions in

Asia Mutually Reinforcing" 1998).

26. This assistance included pledges from not only the IMF but also the World Bank and the Asian Development Bank, as well as from individual countries, including Australia, Brunei, China, Japan, and other East Asian countries.

27. Interviews, U.S. Embassy, Tokyo, June 1999.

28. Interview, senior advisor, International Division, BOJ, June 1998.

29. See, for example, reporting on the summit between U.S. President Bill Clinton and Japanese Prime Minister Obuchi Keizō in the *Nihon Keizai Shimbun* 22 September 1998.

30. Not surprisingly, Sakakibara Eisuke, MOF vice-minister for international affairs at the time the AMF idea was broached, continues to tout the idea ("Mr. Yen Says" 2000). In addition, Japanese central bank officials are working on a payments system for Asian nations that could serve as the operational network for the AMF (interviews, June 1999).

31. Through this program, officially titled "A New Initiative to Overcome the Asian Currency Crisis," Japan committed itself to providing a package of support measures totaling US$30 billion to finance short- and long-term capital needs in Asia. The second stage of this program, called "The Resource Mobilization Plan for Asia," was established in May 1999, and "The New Miyazawa Initiative Short-term Financing Facility" was established in July of the same year.

32. Interview, senior advisor, International Division, BOJ, July 26, 1998. The group is the Executives' Meeting of East Asian and Pacific Central Banks (EMEAP). It has a three-tiered structure including regular governors' meetings, deputies' meetings, and working groups. Participants include representatives from Australia, China, Hong Kong, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Singapore, South Korea, and Thailand. For details, see Oritani (1998) or visit the EMEAP website at <http://www.emeap.org:8084/>.

33. It should be noted that both Sakakibara and Summers have reputations of being more outspoken and blunt, and therefore less diplomatic, in their public comments than many of their predecessors. Consequently, their exchanges should not be viewed as representative of the usual tone of U.S.-Japan diplomacy.

34. Associated Press, New York, 28 June 1999.

35. This is an area in which the Japanese view actually won out, since the G7 countries later agreed to allow capital controls by developing nations in some instances.

36. Although U.S. representatives do not like Japanese criticism of the IMF, they run the risk of seeming too harsh if they aggressively counter these claims. With Japan poised to take the role now, and China expected to emerge someday as an Asian leader, the United States would not benefit from being seen as overbearing or unsympathetic in Asia.

37. A senior Japanese financial official who has accompanied Sakakibara on many occasions and defines him as a "close friend" has repeatedly described him as someone who just prefers straightforwardness and "would never take the chance of breaking with the United States." This description is based on numerous discussions between 1988 and 1999. The quote is from June 24, 1999.

38. One senior BOJ official recounted to me a discussion between Chinese and Japanese central bankers in which the Chinese asked why Japan backed down so readily in the face of U.S. opposition to its proposals concerning the Asian financial crisis. His comment to me was that the Chinese, being in a different position, just do not understand that Japan's dependence on the United States for security is in the background of every policy

decision (interview, 24 June 1999).

39. While some of these changes may not have obvious ties to the process of globalization per se, they all relate to financial-market developments, which cannot be taken out of their global context.

40. Most of the literature viewing the Japanese bureaucracy as the dominant player in Japan's political economy falls within this category (e.g., Vogel 1996), but even those who identify politicians as dominant have pointed out the political system's slow response to signals for change (e.g., Rosenbluth 1996).

41. For a broad examination of this transition, see Pempel (1998).

42. Although this chapter is not the forum in which to adequately analyze the causes of either the bursting of the asset-inflated bubble economy or the banking crisis that unfolded thereafter, there is no question that the globalization of finance was a factor in shaping the events of the 1990s in Japan. Increased pressure, thanks to globalization, for greater domestic deregulation, which was not always met with adequate reregulation; the BOJ's sacrifice of domestic monetary stability under pressure from the government, ostensibly to uphold its promises made in the context of G7 macroeconomic cooperation; and BIS agreements on capital adequacy, a cooperative response to globalization—all were factors in Japan's current financial morass (Ueda 1998).

43. Dentsu's bimonthly public opinion poll found that 80 percent of respondents described the economic situation as "bad," as reported in the *Asahi Shimbun* (19 November 1997, 10).

44. On administrative reform more generally, see Carlile (1998).

45. Scandalous activities plaguing the financial sector and MOF over the past decade are legion, including loss compensation by securities firms to important clients, fraud and failure to disclose enormous trading losses by Daiwa Bank in New York, payoffs to corporate racketeers by a variety of financial institutions, financial officials being disciplined for accepting lavish entertainment from clients seeking inside information, and the general crisis in the financial sector, which MOF was expected to prevent.

46. Not surprisingly, proposals from the LDP, which for so long governed in tandem with MOF, were less radical than proposals put forth by opposition-party members. As Hiwatari explains, "the splitting of MOF came only as a concession to its coalition partners" (1999, 1).

47. Keohane and Milner (1996) provides an excellent overview of the way internationalization affects domestic political economies through exposure to changes in terms of trade, as well as the way domestic institutions can shape the extent and quality of these influences.

48. The initial imposition of the consumption tax in 1988 drew much attention because it had been successfully defeated for so long. Nevertheless, it was only one part of a larger tax package that was designed to promote competitiveness through greater capital investment and included a reduction in corporate tax and a lowering of the securities transaction tax. Similarly, the increase in the consumption tax in 1996 was coupled with a large push by Japanese corporations to lower the corporate tax rate to a level similar to that in the United States (Okada 1996).

49. See Mabuchi (1998) for discussion of the role of the media in perpetrating this attack on MOF.

50. The FSA currently reports to a newly created Financial Reconstruction Commission (initially called the Financial Revitalization Commission) chaired by a cabinet minister but in April 2001 is expected to stand alone as the Financial Agency, with its own cabinet minister and at a level equal to MOF (MOF handout, June 1999).

51. As one BOJ official wrote recently, "The relationship between the MOF and the FSA is so complicated that it is very difficult to describe" (personal correspondence, 14 May 1999).

52. While the new law does not use the word *independence*, it does stipulate that the autonomy of the bank should be respected and transparency ensured (art. 3, par. 1, 2). Details concerning the Bank of Japan Law and the reorganization of the Bank of Japan can be found at the BOJ website: <http://www.boj.or.jp>.

53. Details of conflicts between MOF and the BOJ over money-market management and monetary policy can be found in Dwyer (1997, chap. 7).

54. Interviews, BOJ, 28 July 1998.

55. Taking exception to this commonly accepted view, Berman and McNamara (1999) argues that central-bank independence does not necessarily produce better economic outcomes and that central banks should be more responsive to politics.

56. The relevant committees were MOF's Financial System Research Council and the prime minister's Central Bank Study Group (the Torii Committee).

57. This discussion is based in large part on Lohmann (1997).

58. Interview with Shiozaki Yasuhisa, parlimentary vice-minister of finance at the time, June 1999. See also Brown (1999, 174–175) and Mikitani and Kuwayama (1999, 2).

59. The logic is that because of commitments the Japanese government had made concerning foreign-exchange rates in the Plaza Accord of 1985 and the Louvre Accord of 1987, the BOJ was pressured by MOF to place undue emphasis on the foreign-exchange implications of its monetary policy rather than attend primarily to domestic circumstances.

60. Boylan (1998) makes a similar argument.

61. Cargill in various publications has gone the furthest in arguing that despite its institutional dependence the BOJ began enhancing its political independence when it first successfully fought inflation in 1973 and "had achieved a considerable degree of political independence by the 1980s" (1998, 18.) See also Cargill, Hutchinson, and Itō 1997.

62. This statement obviously assumes that what I have characterized as typical Japanese policy-making style is a function of deeply embedded sociocultural traditions, as opposed to only institutional constraints, and thus is less likely to change quickly in response to institutional changes, such as administrative or electoral reform.

63. In the words of Gourevitch, crises create "open moments when system-creating choices are made" (1986, 34).

64. The relative lack of U.S. attention in the traditional form of "Japan bashing" even raised some concern in Japan and came to be known as "Japan passing."

65. This is not to suggest that the United States has not been critical of Japan's slow progress, just that, given the extent of the damage, the United States has been relatively restrained in its criticism of Japan in public, compared with U.S. posturing in the 1980s.

66. Europe's gains in GDP have been only modest; nevertheless Europe has also contributed to world economic recovery.

67. Japan's recession reduced domestic investment opportunities, pushing Japanese surplus funds into overseas investments. This flow of funds put downward pressure on world—and U.S.—interest rates, which in turn spurred investment and job creation in the United States to an extent that more than compensated for export-related job losses (Higgins and Klitgaard 1998, 1, 4).

68. Transgovernmental networks support bureaucrats' efforts to avoid politicization of issues under their jurisdiction (Keohane and Nye 1977, 33), a well-noted objective of MOF bureaucrats in particular (Horne 1985; Rosenbluth 1989; Vogel 1996).

69. This commonality of experience is already increasing as more Japanese officials attend graduate school in the United States.

70. Obviously China may someday take on this role, but not in the near future.

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