Country Studies

Japan, the Global Financial Crisis, and the Stability of East Asia

William W. Grimes
EXECUTIVE SUMMARY

This chapter examines how the global financial crisis is affecting the major economic and strategic challenges facing Japan.

MAIN ARGUMENT:
Even before the crisis, Japan's foreign policy faced a difficult challenge. On the one hand, with an economy increasingly oriented toward East Asia, Japan had been seeking to promote regional initiatives, including ones that exclude the U.S. but include China. On the other hand, a rising China has also become a more formidable competitor, moving Tokyo to strengthen the U.S.-Japan alliance. Meanwhile, North Korea's apparent determination to develop nuclear weapons and longer-range missiles has complicated some of the basic assumptions of the alliance.

The global financial crisis exacerbates these challenges. First, the crisis has reduced foreign demand for Japanese products, wiping out many of the meager gains Japan had made in shaking off its long domestic economic stagnation. Second, China is the sole major economy growing fairly healthily, accelerating the closure of the relative power gap with Japan. The crisis has also demonstrated the limits not only of the global financial architecture but also of the regional architecture Japan had been trying to establish.

POLICY IMPLICATIONS:
• To minimize frictions resulting from the inevitable rise of China, Japan and the U.S. should seek to engage China in economic cooperation both regionally and globally.

• With U.S. economic credibility in East Asia severely weakened, Washington should support Japanese efforts to be a leader in creating a regional financial architecture along more or less liberal lines.

• The U.S. government must engage with politicians from all parties in Japan to demonstrate the continuing importance of U.S. bases and operational cooperation.
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Over the last decade, Japan’s position in Asia and the world has shifted considerably. On the one hand, the Japanese economy has increasingly become oriented toward East Asia, with much of the country’s manufacturing tied up in regional production networks. Reflecting this reality, Tokyo has sought to take a leadership position in regional initiatives, including ones that exclude its security patron, the United States. On the other hand, the rise of China has not only made that country an indispensable economic partner but at the same time has also made it a more formidable competitor in political and military terms. In response, Japan has worked to strengthen the U.S.-Japan alliance. Meanwhile, North Korea’s apparent determination to develop nuclear weapons and longer-range missiles has complicated some of the basic assumptions of the alliance.

The global financial crisis exacerbates the major challenges facing Japan. The crisis erupted when Japan was in the midst of a long but tepid recovery from an even longer period of domestic economic stagnation. Given that the weakness of the U.S. economy has significantly reduced external demand for Japanese manufactured goods, the crisis has wiped out many of those meager gains. China, alone among the major economies, is growing fairly steadily, accelerating the closure of the relative power gap with Japan. The crisis has moreover demonstrated the limits not only of the global financial architecture but also of the regional architecture Japan had been trying to establish.

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This chapter will examine the effects of the global financial crisis on the strategic challenges that Japan faces now and in the medium-term future. The first section details the general state of the Japanese economy—including the principles behind Tokyo’s foreign economic policies—on the eve of the recent global economic crisis. The second section examines both the impact of the global financial crisis on the Japanese economy and the policies, at the domestic and international levels, that Japan has pursued in order to contain the crisis. The third section explains how the pressures created by the economic crisis are interacting with the other medium- and long-term challenges facing Japan, including the rise of China, the problematic behavior of North Korea, domestic political shifts, and Japan’s capacity to provide regional and global public goods. The final section considers the impact of those factors on Japan’s leadership capacity and U.S. interests, and offers recommendations for policymakers.

The Japanese Economy: Trends and Policies

Although having been overtaken by China in terms of sheer size (at least on a price-adjusted basis), Japan still has the most productive and advanced economy in Asia. Long known for the quality and productivity of its manufacturing sector, Japan has nonetheless increasingly become a knowledge-based, post-industrial economy. Parts of the manufacturing sector remain highly competitive on world markets, of course, but manufacturing as a share of total production continues to decline as in all the developed economies.

The largest part of domestic Japanese employment and economic activity is in services, a residual category that includes everything from restaurants and entertainment to legal services and finance. Most important from the point of view of both domestic and international impact is finance. For Japan, the impact of the current crisis is mediated through the prism of the long ordeal that followed the collapse of the nation’s real estate and stock market bubble in the early 1990s.1 In some ways, that experience has worked to Japan’s advantage in the current crisis, as banks and financial institutions were well-capitalized and not severely extended into “toxic assets” when

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the crisis took hold. Moreover, the experience has certainly shaped the
government's policy responses, which have been exponentially more
proactive than in the 1990s or early 2000s. At the same time, however, Japan’s
own sustained period of economic stagnation and financial challenge has
significantly complicated Tokyo’s efforts to deal with the crisis. In particular,
the extraordinary run-up in government debt over the last seventeen years
as well as the prevailing near-zero inflation and interest rates in Japan have
cast doubts on the ability of macroeconomic authorities to provide effective
fiscal and monetary support to the economy.

In 2008 the Japanese economy was still in the midst of a long but
tepid recovery that began in 2002. Consolidation, recapitalization, and
large-scale disposal of non-performing loans in the financial sector were
an important part of this story, as bank credit and financial markets
unfroze and resumed their basic function of allocating capital in the
private sector. Some problems remained, however, as even the largest and
most sophisticated financial institutions were not particularly profitable
or competitive compared to their foreign counterparts. Difficulties in
incorporating new business models and applying information technology
also hampered the development of Tokyo as an international financial
market center. At the same time, the conservatism of Japanese financial
institutions kept them from being heavily exposed to toxic assets, such as
subprime collateralized mortgage obligations.

Despite the much-improved health of Japanese financial institutions,
growth remained relatively weak even at the height of the recovery.
Government spending remained a large, though declining, component of
GDP growth, as the Japanese government struggled to reduce deficits in
the face of massive current debts and future liabilities. Business profitability
improved significantly, but real wages fell in every year but one, resulting in
very weak growth in consumer spending. Thus, the major engines of growth
for the Japanese economy as it recovered from its lost decade were growth
of net exports and growth of business investment—much of which was, in
turn, directly or indirectly dependent on exports. The end result was that
Japan’s economic growth was highly dependent on growth in the country’s
major export markets, particularly the United States and China.

Japan’s External Economic Impact

Despite domestic travails, the Japanese economy has continued to
occupy an important position in the regional and global economies. Japan
has been among the top three trading partners for virtually every economy
in East Asia (not to mention the fourth-largest trading partner of the