
US-Japanese Economic Policy Conflicts and Coordination during the 1990s

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World capitalism since the early 1990s has been experiencing a dramatic transformation because of the information and telecommunications revolutions and accelerating globalization. As a result, the economic interdependence of the world's countries—in particular, the relationship between the United States and Japan—has deepened significantly. Thus, US policy vis-à-vis Japan, whether overt pressure or benign neglect, has had conspicuous effects on the Japanese economy and political structure. There are various channels of influence for US policy toward Japan—political pressure, public relations campaigns, economic sanctions, and trade negotiations—but what characterized the 1990s was the importance of markets, especially the foreign exchange and equity markets, which transmitted US policy toward Japan.

We can perhaps subdivide the 1990s, or more precisely the Clinton years, into three periods. The first period was from January 1993, the month of the president's inauguration, to January 1995, when Robert Rubin became secretary of the Treasury. This period's Japan policy was heavily influenced by the US trade representative (USTR) and the US embassy in Tokyo, notably by USTR Mickey Kantor and by James Foster, counselor in charge of public relations at the US embassy. The period was characterized by trade frictions and aggressive US criticism of the Japanese old guard, the Liberal Democratic Party, and bureaucracy.

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The second period lasted from January 1995 until September 1998. During these years, more emphasis was rightly placed on markets and coordination within markets rather than on political or trade confrontation. Rubin and his team took the reins of economic policy in the United States, while Japanese political turmoil calmed down somewhat. Toward the end of this period, Japan plunged into an unprecedented financial crisis, and the United States insisted on market solutions to the problem. In particular, the United States took the position that easy infusion of public money into the financial system was unwarranted.

It was not until the third period—between September 1998 and the present—during which the Asian financial crisis spread to Russia, Brazil, and finally Wall Street, that the US government started to take a more pragmatic, less ideological approach. In this period, coordination to avert a potential global crisis was fully implemented.

Viewed in this context and in these periods, we can see some substantial improvement in US-Japanese economic policy coordination during the 1990s as the United States restored its own confidence and as the crisis deepened in the late 1990s. Whether this will continue during the election year 2000 is as yet uncertain, but it is clear to almost everybody involved that the contentious trade negotiations of the early 1990s ended up serving, in the words of Bowman Cutter, then White House aide on economic policy, “neither US national interests nor Japanese interests.” As Cutter later confided, however, open bickering between Japan and the United States in the mass media might somehow have worked to the advantage of certain politicians.

Trade Pressure and the Rising Yen: January 1993-95

It is often said that the Japanese economy was stagnant throughout the decade after 1992 following the bursting of the bubble, but this is incorrect. The economy did recover in fiscal 1995 and 1996. Real GDP growth was 3 percent in fiscal 1995, and 4.4 percent in fiscal 1996, the highest rate at that time among the Group of Seven countries.

Masaru Yoshitomi, managing director of the Asian Development Bank Institute, usefully divides the development of the Japanese economy during the 1992-98 period into three stages—recession caused by falling plant and equipment investment, from fiscal 1992 to 1994; recovery, from fiscal 1995 to 1996; and a surge in deflationary pressures resulting from the destabilization of the banking system, from fiscal 1997 to 1998.¹ If I might add to this classification of periods, fiscal 1999 will probably be remembered as the year that the subsequently long-lived recovery began.

1. Yoshitomi, Masaru. 1998. *Nihon Keizai no Shinjitsu* (in Japanese). Tokyo: Toyo Keizai.

These three periods describe the evolution of the Japanese economy, and correspond somewhat with changes in US economic policy toward Japan. This is no coincidence. Throughout these three periods, Japanese-US relations and foreign exchange and equity markets played a very important role.

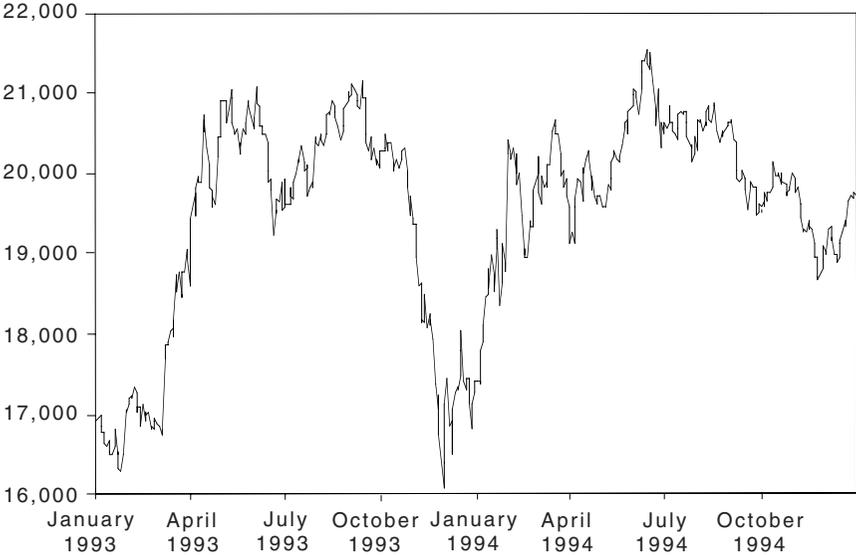
The recession years 1992-94 in Japan were also the period of transition from the Bush to the Clinton administrations, and the first 2 years for Clinton's new team. At the time the new team took over, there was a strong legacy of the Bush-Armacost policy geared toward structurally changing the Japanese economy and political system. During the late 1980s and early 1990s, there was a persistent perception in the United States that the strength of the Japanese economy, which seemed at that time rather permanent, was derived from a somewhat closed hierarchical structure, often called Japan Inc.

At the top of this Japan Inc. hierarchy, it was perceived, big keiretsu companies—centering on banks, the bureaucracy (the Ministry of Finance in particular), and the ruling political party (the Liberal Democratic Party, or LDP)—skillfully ruled the country. Although too broad a generalization and inaccurate in many respects, this Japan Inc. theory was very popular not only among Americans but also among many Japanese, partly because of its simplicity and partly because conspiracy theories always appeal to those mystified by incomprehensible facts. US-Japanese negotiations on Japanese structural impediments thus became the focal point of the economic relationship between the two countries during the Bush administration. Implicit targets of the United States were, among others, the LDP and the Ministry of Finance as headquarters of Japan Inc.

This legacy of 1988-92 was inherited by the Clinton administration in its early years. An inclination toward populism, which was conspicuous in the early Clinton years, also contributed to contentious trade policy that centered on Japan's structural problems as related to its current account surplus. Key Clinton advisers included former election campaign staff members, such as White House spokesman George Stephanopoulos and USTR Mickey Kantor. Robert Rubin, who later became the US Treasury secretary, was then chairman of the National Economic Council, and the present Treasury secretary, Lawrence Summers, was then Treasury undersecretary for international affairs. During this first period, the populist group represented by Kantor and Stephanopoulos held more sway than the macroeconomists, who included Rubin and Summers.

In 1993, when the Japanese economy was still in recession caused by declines in plant and equipment investment, the Tokyo Stock Exchange showed some signs of an upturn. The April Nikkei average topped 20,000 points and was approaching 21,000 (see figure 8.1). However, under pressure from the tough US stand toward Japan, the dollar, which traded around ¥125-126 when Clinton first took office, depreciated rapidly

Figure 8.1 Nikkei stock average, 1993-94 (points)



Source: Author's calculations.

against the yen. At the press conference following a summit with Prime Minister Kiichi Miyazawa on 16 April, Clinton said that a strong yen would effectively cut Japan's trade surplus. His comment triggered the dollar's fall toward 110 yen (see figure 8.2).

Rubin and Summers were understandably concerned about the rapidly depreciating dollar, because a weak dollar could lead to a rise in long-term interest rates and inflation, which they feared could delay the recovery of the US economy. The Japanese government intervened to buy US dollars in April 1993 for the first time since 1988. On 27 April, the US government also stepped in to buy the dollar. The joint US-Japanese intervention in the foreign exchange market continued, on and off, until June. However, the focus of the Japan-United States relationship continued to be trade problems, which reduced the effectiveness of these foreign exchange interventions.

During the 10 July Clinton-Miyazawa summit, a comprehensive agreement on a new Japanese-US trade framework was reached, which gave the impression to market players that Japan had promised to keep its current account surplus within 2 percent of its GDP, further boosting the strength of the Japanese currency, even though Japan flatly refused to comply with the US demand during the summit. On 20 July, Miyazawa said he would resign, following House of Representatives election results that ended 38 years of Liberal Democratic Party rule. On 6 August, seven former opposition parties and a parliamentary group joined an adminis-

Figure 8.2 Yen-dollar exchange rate (yen per dollar)



Source: Author's calculations.

tration led by Morihiro Hosokawa. While Japan-US relations were growing tense, the domestic political scene was becoming fluid.

On 17 August, the yen-dollar exchange rate closed at 101.2 yen, a gain of nearly 25 yen since the beginning of the year. The appreciating yen was basically brought to a standstill when Summers said on 19 August that a rapid appreciation of the yen was not desirable for the US economy, and Tokyo and Washington intervened in the market once more to strengthen the dollar. The sharp plunge in the dollar's value, however, severely hampered the pace of economic recovery in Japan. This was because the strong yen dampened the nation's business confidence, in addition to hurting exports.

The Clinton administration did not have well-defined trade and currency policies in its first year, because of the conflict between the populists and the macroeconomists, as highlighted in the book *The Agenda* by US journalist Bob Woodward.² Summers made his 19 August announcement alone, suggesting that he had perhaps taken the initiative to rally against the populists on the foreign exchange rate issue. Tokyo did not issue any statement, but Finance Minister Hirohisa Fujii said the next day that he welcomed the announcement.

2. New York: Simon & Schuster, 1994.

Japanese-US cooperation fell to pieces after the Hosokawa-Clinton summit on 11 February 1994 failed to reach a comprehensive trade agreement. I took part in the talks as senior deputy director general of the International Finance Bureau of the Finance Ministry. During the talks between Foreign Minister Tsutomu Hata and USTR Mickey Kantor on 10 February, before the Hosokawa-Clinton summit the next day, the US side demanded that Japan commit to numerical targets in certain trade areas, such as automobile exports to the United States, government procurement, and opening the domestic insurance market to more foreign competition. Japan refused the US demands on the grounds that numerical targets could lead to managed trade, which ran counter to the principle of free trade.

In preliminary meetings that were held on and off from around 5 February, US officials appeared unsure whether to seek numerical targets. In a 9 February meeting between Deputy Foreign Minister Koichiro Matsuura and White House aide Bowman Cutter, Cutter proposed easing the demand for numerical targets, but the US team did not adopt his proposal. The Treasury team, led by Summers, was not sure about setting numerical targets for US access to the Japanese insurance market, and was trying to reach a compromise agreement that would credit Japan's macroeconomic policies.

President Clinton, however, when he returned to the White House on 8 February from a stump tour, sought a clear-cut settlement to the bilateral trade dispute. The Treasury was strongly dissatisfied that Japan's ¥6 trillion tax-cut stimulus package announced 8 February was to last only 1 year. Consequently, Clinton decided in favor of the tougher policies toward Japan that were sought by officials close to Kantor. In his talks with Hata, Kantor apparently thought that he could convince Hata to accept numerical targets. Three Kantor-Hata talks took place, with the final session held in the early morning hours of 11 February. The talks eventually became a four-man meeting, also involving Cutter and Matsuura. Hata remained opposed to numerical targets.

At a press conference later the same day, Hosokawa said that instead of having an ambiguous agreement that could lead to misunderstanding in the future, "It's better to admit what Japan cannot afford to do." Such straightforwardness, he added, represented a "mature relationship" between the two countries. It was probably unprecedented that a Japanese prime minister had said "no" so bluntly in talks with a US president. Almost all of the Japanese negotiating team, including myself, felt happy about his remark, but Takakazu Kuriyama, the Japanese ambassador to the United States, appeared depressed following the prime minister's statement.

At first, Japanese business leaders and media credited Hosokawa for talking of a "mature" relationship with the United State. However, as the yen subsequently entered another round of appreciation, with the

dollar falling to the ¥101 level on 15 February, the atmosphere changed. Critics said that Hosokawa's remark was absurd in light of failure to reach an accord at his summit with Clinton. They held that the failure of the summit was the cause of the yen's appreciation and declines in stock prices, despite the implementation of a large-scale pump-priming package. Hosokawa's Washington advisers, including myself, therefore came under fire. We returned from Washington feeling mystified as to whether we should have accepted the US demand for numerical targets, which the *Financial Times* had called unreasonable, simply for the sake of maintaining good relations with the United States. We were unhappy that populist US officials had used foreign exchange rates as leverage in trade negotiations.

The Background and Effects of Federal Reserve Tightening: February-April 1995

On 4 February 1995, one week before the Japan-United States summit, US Federal Reserve Chairman Alan Greenspan issued a rare statement announcing an imminent federal funds rate increase from 3 to 3.25 percent, the first belt-tightening monetary step in 5 years. This was a precautionary step taken to prevent the US economy from overheating after it was reported that the real GDP in the fourth quarter of 1993 grew at an annualized rate of 6.3 percent over the same period in 1992 (compared with 2.7 percent year-on-year growth in the third quarter of 1993). Right after the federal funds rate was raised, US Treasury Secretary Lloyd Bentsen and Treasury Undersecretary Lawrence Summers made it clear that the United States had no intention of guiding the yen higher. The breakdown of trade negotiations on 11 February led the dollar to plunge further, and the yield on benchmark 30-year Treasury bonds, which had leveled off after gradually increasing, rose again, exceeding the 6.5 percent mark. The Dow Jones industrial average on the New York Stock Exchange began to slide during the latter half of February and recorded its lowest level for 1994 at 3,593 points on 4 April.

Actually, there were stormy discussions within the Clinton administration over the need for tightening monetary policies by the Federal Reserve. About two weeks before the federal funds rate was raised, Greenspan, Clinton, and his administration's secretaries in charge of economic affairs gathered at the White House to discuss the issue. Greenspan argued for a modest interest rate increase as early as February to prevent the yield on 30-year Treasury bonds—which stood at 6.3 percent—from rising on fears of inflation. Clinton, who had a keen interest in the movement of long-term interest rates, was in favor of raising the key short-term rate if it was deemed necessary to lower the long-term rate. Bentsen and Rubin, then chairman of the National Economic Council, supported Greenspan, but Vice President Al Gore and Laura Tyson, chairwoman of the Council

of Economic Advisers at the White House, were opposed to an immediate interest rate increase.

The Federal Reserve, which was nervous about the movement of long-term interest rates, raised the federal funds rate again by 0.25 percentage point on March 22. That sent long-term interest rates plummeting temporarily, but the Treasury bond yield soon rebounded and rose to surpass the 7 percent mark. The third hike of the year in the federal funds rate on April 18 was not sufficient to stop the rise of long-term interest rates; the Treasury bond yield rose above 7.4 percent, continuing the upward trend since Clinton's inauguration. Clinton was apparently irritated by the situation. But Bentsen told the president that it would take about a year to see the effects of interest rate hikes on the economy, and that it would be wise to cool the economy down immediately, rather than raising interest rates in 1995, just before the presidential election.

During 1994, the federal funds rate was raised further in May, August, and November, reaching 5.5 percent, which was 2.5 percentage points higher than the January level. Despite the increase in the short-term rate, the Treasury bond yield rose to 8.16 percent in early November. At the end of that year, the yield stood at 7.89 percent.

In theory, a 2.5 percentage point hike in the federal funds rate and a rise of about 2 percent in the yield on 30-year Treasury bonds should result in a stronger dollar and diminish inflationary pressures. But it had the opposite effect in 1994. On 1 November 1994, the dollar plunged against the yen to an exchange rate of ¥96.68, despite joint interventions by the Japanese and US monetary authorities to hold the dollar at the ¥100 level.

The anomalies in the exchange rate and in macroeconomics undoubtedly resulted from the fierce trade war between Japan and the United States. The "Framework Talks," which were suspended on 11 February, resumed on 24 May. Although some progress was made in the areas of government procurement and insurance by that autumn, major conflicts over the key areas of automobiles and automobile parts could not be resolved in 1994. Bickering over trade between Japan and the United States, which was intensively covered by the mass media, regrettably helped convince market players that the yen's surge would not be halted unless Japan's current account surplus was brought down.

Precautionary tight-money measures undertaken ahead of the 1996 US presidential election, including a steep rise in interest rates, together with overheated economies and rising interest rates in other member states of the Group of Seven industrial nations—particularly among the European members—became major factors that drastically changed the international flow of capital. Increasing demands for capital and tight-money policies adopted by the industrial powers pressed many investors to review their investment exposure in Mexico and other emerging economies.

Mexico's agreement to the North American Free Trade Agreement (NAFTA) in November 1993, and the implementation of NAFTA on 1 January 1994, boosted foreign investment in Mexico, and the fundamentals of the Mexican economy rapidly improved. Its real growth in GDP stood at 3.5 percent in 1994, easily surpassing the 0.6 percent registered the previous year. Consumer prices rose at a rate of 7.1 percent in 1994—the lowest in 10 years.

Reflecting its good economic performance, Mexico's imports increased, swelling its current account deficit to \$29.5 billion in 1994 from \$23.4 billion in 1993. But it had foreign exchange reserves of more than \$25 billion, and if the inflow of capital had been about \$30 billion—the same level as 1993—its current account would never have been in a critical state. Social unrest, however, caused by the assassination of presidential candidate Luis Donaldo Colosio on 23 March 1994, suddenly reduced capital inflows from abroad. The Mexican government was forced to shore up the peso, using \$11 billion of its \$28.3 billion foreign reserve funds.

The first wave of the crisis was mitigated by the provision of a short-term credit line of \$6.75 billion by NAFTA members and an increase in interest rates. To stop capital outflow, peso-denominated debts worth \$13 billion were swapped with US dollar-denominated short-term debts over the course of 8 months from March to October 1994. The second wave of the Mexican crisis hit the nation right after its new president, Ernesto Zedillo, took office on 1 December 1994. Triggered by political confusion in the state of Chiapas, where rebels and military troops clashed, capital flight spread even among Mexican residents, reducing the country's foreign reserves to \$10.5 billion.

On 22 December 1994, Mexico adopted a floating exchange system, which saw the peso plunge by more than 40 percent in just over a month. Foreign reserves further shrank to \$6 billion as of 22 December, and the country had accumulated \$28 billion worth of dollar-denominated debts that were due in a few months. The situation was highly alarming. Mexico's economic fundamentals were relatively healthy, and its debts did not exceed its assets. But the shortage of foreign capital inflows saw Mexico on the verge of default and bankruptcy in early 1995.

The situation in Mexico was a new type of crisis that was triggered by rapid fluctuations in capital flows, resulting from changes in the capital market or from domestic political turmoil. This type of crisis was also seen in Asia in 1997 and 1998. Michel Camdessus, managing director of the International Monetary Fund, called it a crisis of the capital account balance, as opposed to the more traditional current account balance crisis. Confrontation between the US government and Congress stalled efforts to put together a bailout package for Mexico. But with an administrative order issued by President Clinton on 31 January 1995, which required no approval from Congress, a \$52.8 billion bailout package, centering on

loans from the International Monetary Fund and the United States, was finally announced, paving the way for the reconstruction of the Mexican economy.

The following day, 1 February 1995, the US Federal Reserve raised both the official discount rate and the federal funds rate by 0.5 points, to 5.25 and 6 percent, respectively, in a bid to halt the dollar's slide, which was the result mainly of financial unrest in Central and South American economies. Despite the efforts of the US government, the dollar continued to drop, keeping up inflationary pressures caused by the weaker dollar and the overheated economy.

Following Mexico, Argentina fell into a panic in the wake of the capital outflow, putting a number of Argentine financial institutions on the verge of bankruptcy. This only accelerated the dollar's slide. Argentina was able to avert the collapse of its financial system after the International Monetary Fund and others worked out a bailout package on 6 April 1995.

During this period, the dollar plunged against the yen and the German mark. On 3 March, the Japanese and US monetary authorities jointly intervened in the currency market, but this had little effect on the falling dollar. On 19 April, the yen-dollar exchange rate broke the ¥80 mark, reaching ¥79.75. The excessively strong yen during this period has often been referred to as a crisis for Japan, but it was also the biggest crisis during the first term of the Clinton administration, which used foreign exchange as a trade policy tool.

Looking back, it could be argued that the combination of contentious US trade policy toward Japan and precautionary tight monetary policy—which was at least partially responsible for having sent Mexico and Argentina deeper into crisis—had caused the dramatic decline of the US dollar from around ¥125 per dollar during the early part January of 1993 to ¥79.75 on 17 April 1995. As a result, prospects for a Japanese recovery that existed during 1993-94 were dashed as the strong yen canceled out the initially favorable signs of an upturn in domestic demand. Also, the loss of business confidence due to a too-strong yen, the so-called Yendaka syndrome, had had lingering negative effects on the economy. The Japanese recovery thus was delayed by as much as a year or a year and a half because the yen was too strong, which was the result, to a significant degree, of tough, populist, election-conscious US policies.

The Rise of the Dollar and Japanese Recovery: April 1995-December 1996

When Robert Rubin took over from Lloyd Bentsen as Treasury secretary in January 1995, the United States had undergone a major policy shift in its foreign exchange and trade policies. At the 10 January hearing of the US Senate Finance Committee, which approved the appointment of the

new Treasury secretary, Rubin stated clearly that a strong dollar was in the best interest of the US economy. His support for a strong dollar formed the backbone of his macroeconomic policy right up until his resignation on 2 July 1999. The idea was to achieve sustained growth in the US economy by bringing down long-term interest rates and encouraging the flow of capital from abroad on the strength of a stronger dollar. These actions would reinvigorate Wall Street and curb inflationary pressure that would have built if import prices had risen due to a weak dollar. Rubin's position that a strong dollar was a good thing was also upheld by Federal Reserve Chairman Alan Greenspan and then-Deputy Treasury Secretary Lawrence Summers.

This position contrasted starkly with that of former USTR Mickey Kantor and a group of populists in and close to the White House, who throughout 1993-94 supported a weak dollar as a way of trimming the country's current account deficit with Japan. At the same hearing, Rubin also said, "We [the United States] should not use foreign exchange as an instrument of trade policy," adding that exchange rates would in the long run reflect underlying economic fundamentals. He also made clear his view that the fundamentals of the US economy were very strong and would remain so were the dollar to rise in value in the long run.

From that time onward, Rubin took every opportunity to reiterate that exchange rates should not be used as an instrument of trade policy. His remarks probably stemmed from his strong objection as a financial expert to the fact that exchange rates were greatly distorted in 1993 and 1994 by individuals who he believed knew little about financial and money market affairs but who were keen to cut the US current account deficit.

In the wake of the economic crises in Mexico and Argentina—set against the backdrop of a US weak-dollar policy—and Rubin's appointment, US macroeconomic policy shifted from approving of a weaker dollar for the sake of trimming current account deficits to one of promoting a stronger dollar, lower interest rates, and sustained, noninflationary economic growth. However, the shift in US currency policy failed to draw the market's attention in spring 1995, largely because the economic crises in the United States' backyard—Mexico and Argentina—were not yet over. Furthermore, the foreign exchange market was becoming volatile because of derivatives transactions, such as the "knockout" option. As a result, economic turmoil continued to build up.

Partly due to US concerns over the sharp drop in the value of the greenback, Japan and the United States made a coordinated effort to intervene in the market and buy dollars on 3 March and 3 April. However, the move failed to check the dollar's fall against the yen. Finance ministers of the Group of Seven major industrial nations then met in Washington on 25 April 1995, with Rubin chairing the discussion. The Group of Seven (G-7) finance ministers confirmed that the currency movement had "gone

beyond levels justified by underlying economic fundamentals” and declared in a joint statement that “an orderly reversal of those movements is desirable.” It was extraordinary for these G-7 ministers to refer to foreign exchange levels.

At about that time, the dollar began to experience a gradual rise against the yen and the German mark, although the market paid little attention to the G-7 joint statement, probably because it did not outline any concrete steps for G-7 nations to coordinate monetary and fiscal policies or market intervention efforts to prop up the dollar.

The prevailing view in the market, then, was represented by such economists as Richard Koo of Nomura Research Institute, who argued that as long as Japan continued to post large current account surpluses, the yen’s rise would continue. He advocated viewing this instance of the Yendaka syndrome as an opportunity to quickly implement necessary structural reforms. There was an element of truth in this, but the rise of the yen—which even hit ¥80 against the dollar at one point—was undoubtedly excessive and unusual. It was also obvious that the yen’s rise was caused by factors related to derivatives transactions, including “delta hedge” and knockout options, which many market players could not predict. Even leading international investor George Soros said that such transactions as knockout options should be regulated by financial authorities.

The joint statement issued by the G-7 finance ministers on 25 April 1995, calling for an “orderly reversal of currency movements,” was gradually put into effect in the following months. On 31 May 1995, a group of 12 nations, including Japan, the United States, and a number of European states, coordinated foreign exchange interventions to buy US dollars. On 7 July, Japan and the United States bought dollars again, following a coordinated lowering of federal fund rates the previous day. Nevertheless, the market took these interventions for granted, and although they had some short-term effects they did not lead to a major change in market views. The marginal utility of orthodox intervention obviously declined as the market got more and more used to it. Moreover, the United States, which had carried out a series of interest rate hikes in 1994, had entered a phase of relaxed monetary policy in the wake of the Mexican and Argentine crises. If other factors had remained unchanged, the policy would have led to a weaker dollar.

There was an obvious need to do something different. Two ideas suggested themselves. One idea was to sever the strong link between Japanese-US current account imbalances and the yen-dollar exchange rate, and the other was to give the market, which had grown accustomed to intervention, a surprise of some sort. Theoretically, there was no problem with the first step. Because more than 90 percent of exchange deals are made on the basis of capital transactions, rather than goods transactions,

if the direction of capital flow changed as a result of interest rate trends or anticipated exchange rates, it was possible—at least in theory—to promote the reversal of currency fluctuations. Yet institutional investors such as life insurance companies and trust banks, which have suffered major losses on a number of occasions in the past because of the yen's rise, were extremely reluctant to invest in dollar-denominated assets. The problem, therefore, was how to persuade Japanese institutional investors to act.

The point of the second step lay in making effective use of so-called push-up intervention, in which the authorities push up the market using huge funds on only a limited number of occasions. The market would be shocked into reacting to the surge of funds. The basic premise for conventional currency market intervention lay in the so-called smoothing operation, designed to smooth out excessive fluctuation in the currency market. On this premise, monetary authorities intervene in the market by carrying out small-scale yen-selling operations when the yen rises sharply, in a bid to prevent rapid fluctuation in the foreign exchange market. As long as the market is basically stable and deviations from exchange rate norms occur only briefly, this sort of market intervention can prove effective. Yet it seemed to me that in this “cybercapitalism” age, when huge amounts of information can travel around the world instantly and sizable amounts of money can be moved quickly, the market was not so stable.

In the cybercapitalism era, authorities, while watching market trends carefully, should intervene and send the market a message clear enough to change its perception by surprise. If the occasion demands, the authorities should also counter the market by force, at least temporarily. The authorities should push up the market to make it react, and continue to do so until the market accepts the authorities' viewpoint. This seems to me to be the principle of push-up intervention, as opposed to conventional smoothing intervention.

On the morning of 2 August 1995, Finance Minister Masayoshi Take-mura announced at the ministry a package of emergency measures to counter the yen's rise, including ways to promote capital investment abroad by Japanese institutional investors and ways for government-run financial institutions to expand their loan-extending cooperation to foreign countries. Later the same day, the ministry intervened in the market in Tokyo. The yen, which momentarily stood at about ¥87 to the dollar, fell briefly to ¥90.1 to the dollar on 2 August. After confirming the reversal in currency movements in the Tokyo market, Japan and the United States jointly intervened in the New York market to push up the exchange rate reversal. We injected an unprecedented amount of funds into the market to push the rate above ¥90 per dollar. On 15 August, the yen fell briefly to ¥99.5 per dollar on overseas markets with coordinated intervention by Japan, the United States, and Germany.

With the continuation of joint efforts to achieve “an orderly reversal” of misaligned currency levels—including foreign exchange interventions in September 1995 and February 1996 by Japanese authorities—the yen gradually dropped against the dollar and closed at ¥116.21 in Tokyo on 30 December 1996. The Japanese economy also began to recover beginning in the fourth quarter of 1995 thanks to an easing of monetary policy, introduction of the ¥14 trillion pump-priming package, and efforts to redress the yen’s hyperappreciation. Real GDP growth was at 6.8 percent in the first quarter of calendar 1996, in comparison with the same period of the previous year. Relatively high growth rates of 4.4, 4.4, and 4.8 percent (at annual rates) were recorded during the second, third, and fourth quarters, respectively. The shift of US policy and the resultant joint, cooperative efforts by the two countries—along with Japanese policy to stimulate domestic demand—paid off, although belatedly, in the brief recovery of fiscal 1995 and 1996.

Crisis Coordination and Japanese Financial Reform: January 1997-October 1998

The Japanese recovery in fiscal 1995 and 1996 was short-lived. Although the contraction during April-June 1997 had been anticipated because of substantial withdrawal of fiscal stimulus, amounting to close to 2 percent of GDP, the government and most analysts thought the turnaround would occur, at the latest, between October and December 1997. The advent of the international financial crisis in Asia during the summer of 1997 and the bankruptcy of three major financial institutions in November 1997 plunged Japan into an unprecedented financial crisis. GDP growth in fiscal 1997 became -0.7 percent, sending the economy back to a severer recession than had occurred in the 1992-94 period. In October, net selling of Japanese stocks by foreigners amounted to ¥591.4 billion and ballooned to ¥754.5 billion in November.

In late November, the Japanese premium on interbank lending reached 1 percent, and Japanese banks faced difficulties in procuring funds in international markets. US and European banks also gradually reduced their credit lines to Japanese banks. On the other hand, interest rates for procurement of yen funds by foreigners dropped to near zero and were negative in some cases. From this period on, hedge funds and others borrowed yen funds that carried almost no costs and operated the so-called global carry trade, in which they bought the dollar or currencies pegged to the dollar and gained profit margins from investing using yen funds.

It was clear that Japan had entered a financial crisis and had become the target of speculation by hedge funds and other institutions. Thanks to the desperate efforts of the government and political parties following

the financial crisis in November, the revised Deposit Insurance Law and a law on emergency measures to stabilize financial functions were passed on 16 February 1998. In addition, ¥30 trillion in funds, including ¥13 trillion for dealing with the collapse of financial institutions, was made available. However, distrust in Japan's financial systems and in Japan itself deepened rather than eased.

Foreign trading of Japanese stocks recovered temporarily due to the two new laws, but selling outweighed buying again in March 1998. "Japan selling" weakened the yen and caused anxiety, because the yen's further depreciation could have resulted in a currency free fall and the breakdown of the Japanese economy. Large-scale market interventions were conducted on 9 and 10 April, coinciding with the announcement of a ¥4 trillion tax cut that temporarily boosted the yen's value to above the ¥130 level against the dollar. However, its effects were not felt for long. When net selling of foreigners' holdings of Japanese stocks reached ¥507.8 billion in June, the yen's value fell to over ¥140 per dollar.

The government's effort to intervene could not strengthen the yen, and the last remaining option concerned a combination of drastic measures to rescue the financial system and concerted intervention with foreign authorities to reverse the trend and prevent the yen from falling further. However, due to the government's schedule at the time (which included the closing of the Diet session and the House of Councillors elections in July), it had been impossible to immediately implement new, unconventional policies. The only option available was to combine policy commitments after the upper house election with intervention. However, I was uncertain whether we could assemble a package before the election that would be approved both by then-Prime Minister Ryutaro Hashimoto and leaders of the Liberal Democratic Party and Western countries, especially the United States. Although I lacked confidence, I had no choice but to try. Washington demanded clear plans to dispose of banks' bad loans and additional stimulus measures. However, Tokyo could not immediately present practical measures in line with the request.

As a result of the negotiations, we agreed by the evening of 16 June that Hashimoto would release a statement in which he would indicate his intention to implement new policy measures but refrain from citing specific steps. Meanwhile, we arranged telephone discussions between Hashimoto and Bill Clinton, and Summers and then-Assistant Secretary of the Treasury Timothy Geithner eventually agreed to concerted intervention. However, Rubin and Greenspan at the time opposed such intervention.

Later, Rubin recalled that his decision concerning intervention was one of the most difficult judgments he had made as US Treasury secretary. Late in the evening of 16 June, Rubin clearly told Clinton during a meeting at the White House that intervention alone would be ineffective, and returned to Summers' office to continue negotiations.

The negotiations continued into the next day. We agreed to a visit by Summers to Japan and to hold an emergency currency meeting between deputy G-7 finance ministers and the Manila Framework Group—deputy finance ministers and central bank governors from the Asia-Pacific region—on 20 June. After that, Rubin finally agreed to concerted intervention on 17 June at 10:30 a.m. After the negotiations, telephone talks between Hashimoto and Clinton took place at noon on 17 June, and that day Japan and the United States began joint interventions in New York. The yen soared by nearly ¥6 to ¥137.60 against the dollar that day in foreign markets.

As suspected by Rubin and others, the effects of joint intervention did not last long. In August, the yen started to weaken, again, toward the high of ¥140 per dollar. Ironically, what saved Japan and, perhaps, the rest of Asia, including Hong Kong and Australia, was the Russian crisis of 17 August. Indeed, the crisis spread to Brazil and other Latin American countries and finally to Wall Street in late August and September. However, it was also true that this new round of the crisis seriously crippled hedge funds and others, forcing them to unwind their speculative positions in Asia. The yen-dollar rate, for example, came down from ¥146 per dollar on 17 August to ¥134 on 17 September. Crises in Hong Kong, Australia, and Malaysia had subsided somewhat.

In September 1998, the US position on Japanese banking issues shifted dramatically as well. Up to this point, the US Treasury was emphasizing the liquidation of insolvent banks and expeditious downsizing and restructuring of viable banks. Their position was that the infusion of public money had to be strongly conditional on liquidation and restructuring. However, in September, in the midst of suffering from the Long-Term Capital Management problem themselves, the US authorities dramatically changed their stance and demanded that the Japanese government increase to more than ¥13 trillion the public funds it had already committed to be injected into troubled but viable banks, and that the funds be infused as quickly as possible.

It was evident that Washington was worried about the danger that a collapse of the Japanese financial system would spread to New York and accelerate the meltdown of Wall Street and the global economy. This shift of US policy was a boon to the Japanese government, because US ambivalence about the infusion of public money had been a big factor in making Japanese public opinion largely antagonistic toward such infusion. The Japanese government, at least partially because of this shift in US policy on Japan, was able to pass the controversial bill to create ¥60 trillion credit lines of public funds on 16 October 1998. This shift in US policy toward Japan to quickly quell the Japanese financial crisis was a part of efforts by the G-7 countries to overcome the crisis of global capitalism that hit the world, including the United States, in the fall of 1998.

In retrospect, the three phases of US policy toward Japan were at least partially responsible for major developments in the Japanese economy during the corresponding years. The contentious trade policy of 1993-94 seemed to be an important factor in delaying Japanese recovery by as much as a year or a year and a half. Macroeconomic and foreign exchange cooperation starting in early 1995 helped the economy to recover in early 1996. The shift of US policy during the fall of 1998 finally helped to resolve the difficult political issue of infusion of public money into the financial system. Of course, Japanese domestic policies during the period were more important than US policy toward Japan. However, it still remains a solid fact that US policy plays an important and crucial role not only in the Japanese economy but also in the economies of the rest of the world.