

The American Risk in Japan

By **JEFFREY E. GARTEN** (NYT) 958 words

Published: March 18, 2001

We have often seen how the fate of the American economy cannot be divorced from global markets, and how even a spark abroad can create a fire at home. In 1987, for example, the stock market crash was precipitated in part by a dispute between Washington and Bonn over interest rates and trade. In 1998, a financial crisis that began in Thailand ultimately spread until it forced a dramatic bailout of one of America's largest hedge funds -- a rescue that prevented an implosion of many American banks. Now Japan is the trouble spot that ought to keep us up at night.

When Tokyo's economic bubble burst in the early 1990's, we held our breath because it seemed the world's second-largest economy couldn't go into a tailspin without taking the global marketplace with it. In the end the fallout was contained, but that was the result of unusual circumstances. America was entering a powerful business expansion, Europe was boosted by a new common currency and a burst of internal deregulation, and Mexico, India, China and other nations were reaping the rewards of having recently opened their economies to foreign trade and investment. In that heady environment, Japanese stagnation didn't have as much global impact as we feared it would.

The current global economic scene, in which America and Japan together still account for over a third of global production, is starkly different. America is headed for recession, European growth is slowing and most emerging markets are fragile. With other engines of the world economy spluttering, further deterioration of the Japanese economy could finally have a serious effect on us.

Today, Japan's economic growth is stagnant, property values are declining, government and corporate debts are at an all-time high. Despite the fact that Tokyo has poured trillions of yen into public works and lowered interest rates to negligible levels, not only has the economy failed to respond, but serious deflation is in the air. Adding to the woes, the country's political leadership is in meltdown, with Prime Minister Yoshiro Mori having agreed to resign next month, leaving behind a fractured one-party system of exhausted politicians bereft of new ideas for how to reverse Japan's descent.

One looming problem is that as the Japanese economy contracts, so could American exports. This would hurt the earnings of many of our most important companies, further impairing their stock prices. But the Japanese banking system, already choking on bad debts, is the major point of vulnerability. The reason is that Japanese banks carry much of their reserves in the form of Japanese equities, and the major stock market index has now declined to its lowest levels in more than a decade. If some Japanese banks become insolvent, that could impair the health of foreign banks that have extended loans to them or that have other complex financial relationships. A crippled banking system would be unable to extend credit and would therefore drag down Japanese companies, too. In

recent days, the Japanese government has acknowledged these acute problems, but given its miserable track record, whether it will address them effectively is another question.

If Japan's problems mount, companies there could begin liquidating their investments abroad. In the late 1980's American officials and business leaders worried that Japan would sell some of its American holdings as leverage to get the United States to ease its pressure to open the Japanese economy to trade. Most experts concluded that would never happen because the value of the Treasury securities held by Japanese was so vast that selling some would weaken the price of the billions they still held. However, if Japanese investors become sufficiently desperate now, selling may be the only option.

Japanese entities still own some \$350 billion of Treasuries, about 25 percent of all such holdings outside of the United States, not to mention hundreds of billions of other marketable bonds and stocks. Japanese firms own some \$150 billion in direct investments in America, more than those held by any other foreign country except for the United Kingdom. And Japanese companies employ over 550,000 Americans.

A Japanese sell-off of American assets could mean more downward pressure on our softening economy -- more surplus property, more layoffs. It could mean that the Japanese would exchange dollars for yen, weakening the dollar, which in turn would lead to increases in the price of imports that are now crucial to our economy. Rising prices in a no-growth economy -- stagflation -- may be more possible than we think.

Everyone wants and expects the Federal Reserve to bail out the economy, not only by lowering interest rates on Tuesday when the Open Market Committee meets, but also by lowering rates over the next several months. But if Japanese investors sell off their American assets and cause the dollar to sink, the Fed could face an agonizing dilemma. On the one hand, cutting interest rates could help revitalize the economy and the stock market. But it could also further weaken the dollar by making dollar-based returns less attractive, thereby discouraging European and Latin American investors from continuing to invest in American securities.

We have seen how herd-like markets can run wild, and were there to be a precipitous decline of the dollar, the Fed would have to consider holding rates steady or even temporarily raising them. This is not a position that Alan Greenspan would want to be in. As consumers, investors, employers and employees, neither would we.

Drawing (Pascal Le Maitre)