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10 Domestic Politics and Regional Cooperation: The United States, Japan, and Pacific Money and Finance

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10.1 Introduction

International monetary and financial issues are central to Pacific economic relations. Financial flows in the Pacific region are of great size and economic importance. Movements in exchange rates and related macroeconomic variables affect almost all economic activities in the region.

The future of Pacific monetary and financial policies is, however, uncertain. Japan's role in regional financial policymaking is not commensurate with its financial importance. Regional policies toward currency values and macroeconomic trends are nonexistent or embryonic. Interstate relations on these two dimensions might go in any number of directions, and the direction taken will have broad and deep implications for economic and noneconomic developments in the Pacific.

This paper examines prospects for monetary and financial relations in the Pacific by focusing on Japanese and American policy in these arenas. It looks primarily at the domestic politics of international money and finance, particularly how the distributional impact of different policies within the United States and Japan affect policy choice. Its tentative conclusion is that groups favorable to international monetary and financial cooperation are gaining ground in Japan, where they have typically been relatively unimportant. Conversely, "internationalist" groups are slipping in influence in the United States, although they remain very influential.

Section 10.2 explores the contours of regional monetary and financial issues, the variety of conceivable outcomes, and analytical tools to understand policy

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trends, especially the economic interest groups expected to affect the domestic politics of different international monetary and financial policies. In section 10.3, these tools are applied to an important previous case in which similar issues were raised, that of the United States in the interwar years. Section 10.4 looks at the economic interests at play in the formulation of Japanese policy toward international money and finance, and where they appear to be leading; section 10.5 does the same for the United States. In section 10.6, the essay's implications and conclusions are summarized.

10.2 The Problem: Cooperation or Conflict in Regional Money and Finance

The principal concern for monetary and financial relations in the Pacific is that they might become unstable, which in turn might dampen regional flows of goods and capital. Most scenarios for such a breakdown involve one of two expectations of Japanese and American international monetary and financial policies.

A first pessimistic scenario is that of "Japan as free rider" on increasingly reticent American leadership. In this picture, the United States continues to act more or less alone in attempting to manage Pacific monetary and financial relations, and incurs substantial costs to do so. Japan, however, is content to enjoy the benefits of American policies without paying for any of their costs. This would, in other words, be something of a continuation of the postwar pattern, in an era in which Japan is far better able to contribute to regional monetary and financial management than it once was—and perhaps better able than the United States now is. Japanese refusal to play a bigger part in regional monetary and financial issues would probably precipitate an American refusal to continue its leadership, and an era of hostility and conflict between the two nations.

A second pessimistic scenario is that of "Japan as bloc leader." In this picture, Japan responds to its newfound financial strength by carving out a zone of more or less exclusive monetary and financial influence in Asia. It seeks a formal or informal "yen zone," with preferential treatment of the Japanese currency and Japanese financial flows and discrimination against the dollar and American finance. Such Japanese policies would also precipitate a rupture with the United States.

In both instances, Japanese-American conflict in monetary and financial realms would almost certainly reduce the level of financial flows in the region, increase the unpredictability of exchange rates, and hamper trade. This would presumably bode ill for the economic and political stability of the region.

The two pessimistic scenarios outlined above contrast implicitly with two optimistic scenarios in which Japan and the United States cooperate. The first is not regional at all and simply looks toward global cooperation among the world's leading nations, including Japan and the United States, on whatever issues may be important at the global level. A second optimistic view involves Japanese-American cooperation within the Pacific region, to ensure a favorable environment for regional financial flows, and to provide generally predictable regional exchange rates. Both scenarios seem to require that the Japanese government play a more important role in global or regional financial policy; and that the Japanese government collaborate with other governments in the region or the world to stabilize macroeconomic conditions. In other words, the two governments would either participate in joint management of global money and finance, or would themselves jointly manage the region's monetary and financial affairs. Either way, the outcome would be cooperative: the jointness of the management would guard against conflict among governments; the management itself would provide economic and policy predictability.

Both the optimistic and pessimistic scenarios imply a general model of the politics of international money and finance, specifically of the role of conscious government supervision in these arenas and of intergovernmental cooperation in such supervision. The implicit model is one in which the smooth functioning of international or regional monetary and financial systems requires certain enabling government policies, the enactment of which is difficult without explicit interstate cooperation.

The most common assertion along these lines is that there are certain international public goods in money and finance, which improve the welfare of all but which no one government has an incentive to provide. Analogies are typically made to domestic money and finance, where price stability and a lender-of-last-resort function are the most commonly discussed public goods and a central bank often supplies them (a seminal discussion is in Kindleberger 1973, extended in Kindleberger 1985; see also Fratianni and Pattison 1982).

It is unlikely that the cooperative ventures under discussion in this realm involve true public goods. Most of them aim at stabilizing international monetary and financial flows, in the interest of increasing levels of international payments and trade. However, stability is not necessarily the best possible outcome for all concerned, especially as it typically involves maintenance of the status quo. Stabilizing exchange rates might involve setting relative prices that harm many producers or consumers, or that involve social welfare costs. Coordinating macroeconomic strategies might simply allow policymakers to reinforce each others' socially undesirable policies. Protecting cross-border financial contracts might involve soaking poor debtors for the benefit of rich creditors. It may be morally comforting for supporters of such measures to consider them public goods, but analytically they are probably club goods whose benefits accrue to some relatively limited group of actors. In this case, the concerns in question are of primary interest to those most heavily involved in international trade and payments, rather than public goods that benefit all without exception. This point will resurface in my discussion of the domestic politics of interstate cooperation on these dimensions. To avoid definitional controversy, I call the ventures in question club goods; those who believe they are truly public goods can simply regard the club in question to be society (or international society) as a whole.

Whether or not the sorts of goods in question are primarily of public or club interest, their provision still creates problems of collective action. Even if only national monetary authorities have an interest in macroeconomic coordination (against the interests of their citizens, let us assume), they still need to work out a way to cooperate among themselves. The cooperation problems raised can be divided into monetary and financial components.

The club goods associated with *international financial relations* have to do with monitoring and enforcing cross-border loan contracts, maintaining open markets for debtor exports, supervising international financial institutions, and providing international liquidity in times of crisis. International lending depends on the credibility of borrower commitments to make debt service payments; this credibility is a function both of the information available to lenders and of the ability of lenders to sanction errant borrowers. The provision of this information and the carrying out of these sanctions create significant collective action problems for real or potential lenders: once the information is available and the sanctions are in place, there is an incentive for individual lenders to free ride by not helping gather information and by evading sanctions. By the same token, international finance cannot long endure a major closure of goods markets—debtors need to earn foreign exchange to service their debts. Creditor countries have an interest in open markets for debtor exports, but they might prefer that other countries' markets be more open than theirs.

The supervision of financial institutions involved in the international arena has become especially important, as electronic funds transfers can magnify the impact of an international bank failure. All international financial actors gain from the stability cooperative supervision can provide. However, all banks have an incentive to evade supervision, and all countries have an incentive to skimp on supervisory expenses and supervisory requirements in order to give their banks an advantage in international competition. Similar conditions apply to the role of national monetary authorities in providing liquidity in times of international financial difficulty.

In a sense, these considerations reflect the disjuncture between a regionally or globally integrated financial system and the absence of regional or global financial authorities. National authorities and judicial systems safeguard contracts, supervise financial markets, and provide lender-of-last-resort facilities within nations. As no international agency does similar duty, these functions must be carried out by national governments acting together. However, there are real incentives for free riding on the part of national governments.

The club goods associated with *international monetary relations* raise similar problems. Again by a somewhat shaky analogy to the domestic order, just as national monetary authorities act to provide price stability, so does the international monetary system function best when international relative prices are most stable. This involves both policies toward predictable exchange rates, and the coordination of national macroeconomic measures. In this sense, the crux of the regional problem on the monetary front is cooperative exchange rate and macroeconomic policies among national monetary authorities.

For large countries, another major international monetary issue is the degree to which the national currency functions as a key currency for global or regional trade and payments. Just as a national money substantially lowers transactions costs and facilitates exchange domestically, so do reliable key currencies allow for higher levels of global exchange. For a national currency to function well as a key currency, however, generally requires certain commitments from the currency's home authorities. Especially important is stability in the real value of the currency—low rates of inflation and nominal exchange rate volatility—and generally deep and unencumbered national financial markets in which economic agents can trade freely in assets denominated in the currency (Krugman 1984; Tavlas 1991). These commitments, too, imply scope for national free riding (although there are direct advantages to key currency status for the issuing country).

In any case, most visions of Pacific monetary and financial futures, whether pessimistic or optimistic, involve an implicit model of the provision (or underprovision) of these club or public goods. Some pessimistic views expect that Japan, the United States, or both will try to avoid paying the costs involved in helping provide these goods. Others anticipate that the two regional leaders will attempt to provide these services within smaller, more exclusive zones of influence—the United States as monetary and financial dominator of the Western Hemisphere, Japan of East Asia. Optimistic sentiments are motivated by the expectation that the region's nations will recognize the gains associated with the cooperative provision of these collective goods and will act accordingly. They might do it as a joint U.S.-Japanese consortium, for the Pacific region; or globally, for the world as a whole.

The general analytical approach appropriate to an evaluation of the likelihood of international cooperation has two component parts: the domestic politics of national foreign policies, and strategic interaction among potentially cooperating nations (Putnam 1988). The first component part involves investigating different domestic socioeconomic and political realities. "National interests," in this context, vary widely along with the interests of those in national societies. A state dominated by foreign debtors in financial distress is more likely to downplay the importance of respecting cross-border loan contracts than a state dominated by major international creditors. This step looks at national priorities, as determined by domestic interests and institutions, to see what they might imply for the success of international or regional cooperation.

Along these lines and for heuristic purposes, we can think of national political economics as divided into two camps: cooperative and competitive (for similar domestic approaches to foreign policy, see Gourevitch 1986; Ferguson 1984; Nolt 1992). This flows from the observation that most of the regional monetary and financial collective goods discussed above involve subordinating domestic economic conditions to the demands of regional cooperation. For example, regional macroeconomic policy coordination by definition means that policymakers' goals involve more than purely domestic economic conditions. Allowing foreign debtors access to creditor markets may be good for regional financial flows, but bad for domestic producers of goods with which debtor producers compete.

Those in the cooperative or "internationalist" camp regard the costs associated with their home country's helping carry out global or regional monetary and financial leadership functions as minor compared to the benefits associated with smoothly running global or regional monetary and financial systems. Not surprisingly, those in this camp tend to be heavily committed to global or regional trade and payments; anything that hampers international money and finance impinges directly on their well-being. The camp includes international financial investors and intermediaries, global corporations, major exporters, and consumers of imports.

Competitive or "nationalist" economic groups are loathe to forgo the primacy of domestic conditions in national economic policymaking. They may not actively desire a reduction of cross-border goods and financial movements, but their priority is the state of the domestic economy—even if this means that their government eschews international cooperative agreements. Again, it is not surprising that such groups are concentrated among those who make and sell goods and services for the home market, especially producers of nontradables and of goods in direct competition with imports. Simply put and all else equal, the stronger the "internationalist" camp in any given national society, the more likely it is to desire and pursue cooperative international policies. To the extent that the internationalists are regionally oriented, their representatives will want to pursue regional cooperation; a global business orientation should lead to support for broader and more sweeping cooperative measures at the truly international level. On the other hand, the stronger the "nationalist" camp, the more likely it is to embark on unilateral ventures.

Domestic politics is only the beginning of the story, however, for by definition international politics involves strategic interaction among nations. The second step, then, is to bring the tools of the trade to bear on analyzing the problems of international cooperation (as, for example, in Oye 1986; Eichengreen 1989a; Frankel 1988b). Even where states have similar interests in outcomes, problems associated with interstate cooperation may arise due to the perils of collective action. Where these perils are reduced—where accurate information is available, where commitment mechanisms reduce the risk of cheating, where it is possible to provide selective incentives to cooperators—regional cooperation is more likely to be forthcoming.

The general method, then, involves looking both at the domestic politics of policies associated with regional cooperation and at the problems of interstate collective action. An examination of regional collaboration toward international debt, for example, could specify the interests of different governments on the basis of the domestic political realities they face. It could then go on, within this context, to discuss how, given their interests, these different governments might be able to work out cooperative agreements.

For the purposes of this essay, I essentially ignore considerations of strategic interaction in order to focus on domestic political considerations associated with the provision of regional collective goods in the monetary and financial arenas. This is not to downplay collective action problems in general. It is driven largely by the belief that, at least in the Pacific monetary and financial realm, collective action problems are relatively unimportant. There are only two major actors, the United States and Japan, and their interactions are multidimensional and iterated. In this context, free riding would be hard to ascribe to the severe constraints of such games as a single-shot prisoner's dilemma. Failures of cooperation are more liable to be the result of underlying policy differences—of domestically entrenched interests with divergent preferences. Even if strategic interaction between the United States and Japan were indeed problematic, we could not speak intelligently of it without a clear picture of the two countries' preference functions. The point, then, is to clarify the domestically derived national preference orders of the two major nations in the region. In this sense the analysis presented in this paper is simply the first step of the two-step process described above. My purpose is to understand the nature of these preferences more fully. I leave to others a more extensive exploration of strategic interaction between the two nations.

In the Pacific context, the provision of the "infrastructure" necessary to sustain regional financial and monetary flows is first and foremost a function of American and Japanese policy. While strategic interaction between these two actors may color outcomes, I think the goals of the two countries are particularly important to explaining outcomes. The remainder of the paper uses historical and contemporary evidence to clarify the issue and its potential paths.

10.3 The American Precedent

A fascinating example of the effects of domestic political conflict on a country's participation in managing the world monetary and financial system is given by the interwar United States. The parallels to today's Japan are striking. In the space of a few years, the United States leapt to a predominant international financial position. It was faced with many of the problems of international cooperation currently facing Japan, and there was much domestic conflict over how to confront these challenges. The interwar American experience with the domestic politics of national commitments to international cooperation in money and finance was grim. During the interwar years, indeed, opposition from nationalistic forces practically stymied U.S. government participation in efforts at international monetary and financial cooperation.[1] In this context, it is worth seeing what lessons the American episode may hold for Japan.

World War I catapulted the United States to international financial leadership. The Allies were deeply in debt to the U.S. government, and the financial reconstruction of European economies was largely entrusted to American private bankers. American trade and investment had come to predominate in Latin America, and even in Europe's colonies and protectorates.

The United States was at least as important an actor in the international financial system in the 1920s as Japan is today. By 1929, the United States accounted for 31 percent of the stock of all international loans and investments outstanding (calculated from Staley 1935). In capital flows, the American position was overwhelming: while reliable figures are not available, the United States accounted for well over half of all new international loans and investments in the 1920s. By comparison, Japanese investors now account for about 30 percent of all international direct investment flows; Japanese international banks account for 33 percent of the global stock of cross-border bank assets. The total international and foreign assets of Japanese banks are, in fact, larger than the combined cross-border assets of banks from the next three most important countries (the United States, Germany, and France) combined (foreign direct investment [FDI] figures from Froot 1991; bank asset figures from Bank for International Settlements 1991, 19).

International finance and investment were also important to the U.S. economy. Foreign bonds floated on Wall Street averaged over a billion dollars a year in the 1920s, equivalent to more than one-sixth of annual corporate bond flotations. Foreign direct investment averaged over a half-billion dollars a year. In 1922, the stock of overseas loans and direct investments totaled $9.1 billion, equivalent to 12 percent of American gross national product (GNP); by 1929, it was $15.2 billion, equivalent to 15 percent of GNP.[2]

The importance of U.S. loans and investment to the interwar international economy was clear to contemporaries. American private capital financed large portions of total investment in Germany and in other central and southern European nations. American bankers arranged stabilization programs for Germany, Poland, Rumania, Italy, Belgium, and other nations. In Latin America, American loans and direct investment fed an economic euphoria known as "the dance of the millions." Princeton economics professor Edwin Kemmerer—the "money doctor"—roamed the Western Hemisphere to supervise economic policies and certify their reliability to American investors (Drake 1989).

1. What follows draws on Frieden (1987, 25–78; 1988). Only where information is not taken from these publications will exact citations be given. A parallel story involves the evolution of American domestic economic-policy institutions in response to changes in the international position of the U.S. economy; for one treatment see Broz (1992).

2. Figures are from the *Economic Report of the President,* various issues. GNP for 1922 is actually net national product plus 10 percent, the average difference for this historical period.

Important as the United States might have been to the world economy in the 1920s, there were very divergent views among Americans about what policies were appropriate to this new reality. These different views reflected the divergent interests of major economic interest groups. "Internationalism" was rooted in those associated with the country's international economic predominance, especially money-center banks and multinational corporations; it also found support among exporting farmers and a few industries with important foreign markets. Internationally oriented bankers and industrialists belonged primarily to the internationalist wing of the Republican party or were Wilsonian Democrats; export agriculture was important to the southern Democratic party. For these groups, the world economy had come to be significant indeed, and they had a clear and present belief that the U.S. government should lead in stabilizing international monetary and financial relations.

The internationalists believed that the U.S. government should reduce or forgive European war debts: "Those debts should be canceled," J. P. Morgan, Jr., said in 1922 (Forbes 1981, 125). The Allies owed the U.S. government $10 billion, and American insistence on repayment helped destabilize European financial and monetary affairs. War debts complicated economic policymaking in Allied countries; they encouraged the French and Belgian governments to press demands for higher German reparations; and they reduced the ability of indebted nations to borrow privately.

The international monetary agenda was also full and required American involvement. The dollar was the only major currency that had not suffered serious disturbances during World War I, and it was the centerpiece of attempts to reconstruct the gold standard and stabilize European currencies. This required coordination of the policies of the United States, Great Britain, and France, especially cooperation among central banks.

Internationally oriented groups also wanted reduced American trade barriers. Those with overseas loans needed the American market open to their debtors, as investment banker Otto Kahn explained: "Having become a creditor nation we have got now to fit ourselves into the role of a creditor nation. We shall have to make up our minds to be more hospitable to imports" (Maltz 1963, 204–5). American exporters feared that protection would lead foreigners to close their markets to American products.

However, the internationalists' plans for international cooperation were thwarted by the hostility of the politically powerful isolationists. Isolationism found its principal socioeconomic base in portions of the U.S. economy unconnected to the foreign sector. Despite a rapid expansion of overseas investment and trade, indeed, this activity was narrowly concentrated. Many manufacturers and farmers faced serious import competition and had no desire to see the U.S. government engage in cooperative ventures that would increase world trade and payments or otherwise open the economy further (Eichengreen 1989b).

The isolationists adamantly opposed trade liberalization, since they were under competitive pressure from abroad. By the same token, they saw no reason to spend taxpayers' money to stabilize the currencies or regularize the finances of their European competitors. Inasmuch as war debt forgiveness would make European economies more competitive with the United States, it was undesirable; inasmuch as it would reduce U.S. Treasury income and perhaps require tax increases, it would depress domestic economic activity. Reconstructing the gold standard would only make it easier for foreigners to sell to the American market, especially as most monetary plans called for a strong dollar. On all counts, then, the isolationists opposed the country's internationally integrated banks and corporations.

Isolationist opposition thwarted most of the internationalists' attempts to get an American government commitment to international monetary and financial leadership. Despite the prominence of American banks and corporations in the world economy of the 1920s, American officials were absent from most discussions of international money and finance. At the Versailles Conference, the United States under Woodrow Wilson presented elaborate designs for the postwar political and economic order, including money and finance. After Wilson was unable to obtain congressional approval for American membership in the League of Nations, however, the U.S. government was largely forced to abdicate the international scene.

Most American official involvement in international monetary and financial negotiations was foreclosed by the predominance of isolationist sentiment within the United States. Supporters of a greater role for the U.S. government were unable to prevail in domestic debates over foreign policy. This forced the internationalists to cobble together private schemes for international monetary and financial management, and these schemes typically were fragile enough that they collapsed under strong economic and political pressure.

The isolationists were anything but a fringe group. They were economically important, and the strength of localist interests in Congress reinforced their influence. For all intents and purposes, the isolationists controlled Congress and the cabinet in the 1921–33 Republican administrations. However, economic internationalists were often able to influence government agencies out of the public eye. Foremost among these was the Federal Reserve Bank of New York, which was supportive of the interests of money-center banks. The State Department, too, tended to sympathize with international businessmen. In both cases, however, participation in attempts at international cooperation had to be carried out surreptitiously, for Congress blocked whatever it discovered.

The limitations placed on the U.S. government by domestic isolationism made it extremely difficult for official American delegations to be openly involved in the most important monetary and financial negotiations of the period. For example, the stabilization of the German economy, carried out under the Dawes and Young plans, required American support, but the U.S. government could not be involved. While other parties to the agreements were represented by their central banks, the American delegation was composed of partners and friends of J. P. Morgan and Company, which provided the bulk of the original German stabilization loan. When, as part of the Young Plan, the Bank for International Settlements was established in 1930, partly to oversee German finances and partly to provide a framework for international monetary and financial cooperation, again the members were the European central banks and Morgan and Company.

The Federal Reserve did participate in a series of international monetary conferences in the 1920s and did cooperate with the Bank of England and the Bank of France on a number of dimensions. However, the Fed's room to maneuver was severely hamstrung by congressional sniping at the allegedly Europhilic central bank, and less directly by the unwillingness of Congress and the administration to make concessions in domestic economic policy that might smooth the path of international monetary cooperation (Clarke 1967).

Important as trade liberalization may have been for financial reconstruction, the protectionists within the United States prevailed at almost every turn. The trend toward liberalization begun under Wilson was reversed by the Republican protectionists, and tariffs were raised in 1921 and 1922. In 1930, the Smoot-Hawley Act raised American tariffs to extremely high levels (Eichengreen 1989b).

The inability of the U.S. government to commit to international cooperation seriously undermined these ventures (Eichengreen 1992). On the one hand, American private investors were at the center of international finance. On the other hand, the U.S. government was almost nowhere to be found. American private bankers organized financial and monetary stabilization programs with the support of European governments, but without the support of the U.S. government. U.S. overseas lending grew by leaps and bounds, along with the progressive closure of the U.S. market to foreigners. The refusal of the U.S. government to involve itself in international monetary and financial negotiations, and its unwillingness to take into account the international consequences of its policies, probably contributed to the collapse of the already-fragile international monetary, financial, and trading orders during the Depression.

The American example is one in which private overseas financial interests grew far more rapidly than the government's willingness or ability to act on behalf of these interests. This meant, specifically, that the U.S. government simply did not help provide many of the club goods we have identified as potentially important to stable global monetary and financial relations. This was so much the case that American private bankers often found themselves driven to carry out these functions themselves, although the experience of private businesses acting on these dimensions without government support was rarely positive. The disparity between economic activities and government support was large and grew larger with time. If this were to happen in Japan, we might expect difficult times both for Japan's partners and for world money and finance generally.

The principal inference that can be drawn from the interwar American experience is that entrenched domestic interests can impede the evolution of government policies to help stabilize international money and finance—even in a country that dominates the international monetary and financial systems. This makes it crucially important to understand the political balance of power among various domestic economic interest groups in countries faced with important international policy choices along these lines. The next sections survey the balance of power in contemporary Japan and the United States.

10.4 Contemporary Japan

Japan has come to dominate international money and financial markets, and international conditions have become extremely important to many Japanese firms. Japan's rise to predominance has been almost as rapid as that of the United States during and after World War I. In the late 1970s, Japanese investors accounted for 6 percent of direct investment outflows from the major industrial nations, 2 percent of equities outflows, 15 percent of bond outflows, and 12 percent of short-term bank outflows. By the late 1980s, the figures were 20 percent of FDI, 25 percent of equities, 55 percent of bonds, and 50 percent of short-term bank outflows (calculated from Turner 1991, 42–75; a general survey is Thorn 1987). Temporary difficulties can slow this process, but they are unlikely to alter the overall trend: Japan's role in Pacific financial and investment flows is extremely large and likely to grow larger.

This process has made major Japanese banks and firms far more integrated into the international financial system. Japanese financial investors and intermediaries have enormous overseas positions; as of 1991, the international assets of Japanese banks were $1.9 trillion, one-third of total international bank assets (Bank for International Settlements 1991, 19). The number of Japanese bank affiliates abroad went from 253 in 1975 to 913 in 1988, while affiliates of securities firms went from 54 to 196 in the same period (Tavlas and Ozeki 1991, 15). In 1990, foreign securities were 15 percent of total bank securities holdings, up from less than 3 percent in 1980 (Turner, 1991, 77). The Japanese offshore market grew from nearly nothing in 1985 to almost half a trillion dollars in 1991.

Similar patterns characterize major Japanese multinational corporations. The explosion of Japanese FDI in the late 1980s was concentrated in some of the country's leading sectors: finance, real estate, and sophisticated manufacturing (especially electrical machinery and transportation equipment). At this point, FDI is important to many major Japanese industries, including traditional export producers that have located production facilities in lower-cost regions (Froot 1991; Naya 1990).

Many Japanese firms have come to depend on global financial markets as a source of funds. Indeed, Japanese issuers accounted for one-third of all international bonds issued in 1990–91 (Bank for International Settlements 1991, 15). Between 1984 and 1988, approximately half of all corporate bonds issued by Japanese residents were bought abroad, while the share of foreign bonds in total corporate securities issues went from 11 percent in the late 1970s to 35 percent in the late 1980s (Osugi 1990, 15, 55).

Japanese predominance in world and Pacific money and financial markets is not reflected in the corridors of international and regional policymaking. Japan's decision-making role in such multilateral financial institutions as the International Monetary Fund (IMF) is quite small, and more generally Japanese involvement in structural adjustment in the Pacific region is minimal. The United States continues to dominate at both the global and regional levels, even though Japan is a far more important provider of external finance to the world and the Pacific. The same is true of the position of the yen in international currency affairs. The dollar remains the world's vehicle currency, with the yen typically third or fourth (depending on the use in question) after the deutsche mark, the ecu, or the pound sterling.

Nonetheless, Japan's global and regional positions in international money and finance have been changing. Perhaps the most easily measurable change is in fact in the use of the yen in international trade and payments. Yen are but a small portion of total world official foreign exchange reserves, only about 8 percent in the late 1980s, but this is up from just 3 percent in the late 1970s. The proportion in selected Asian countries is much higher, about 25 percent in the late 1980s, nearly double the figure of a decade earlier (Tavlas and Ozeki 1991, 46). The use of the yen in international finance has also increased. In mid-1991, some 17 percent of all international fixed-rate bonds outstanding were denominated in yen, compared to 33 percent in dollars, but the two years up to mid-1991 saw more net new yen issues (23 percent) than dollar issues (19 percent) (Bank for International Settlements 1991,12). And the foreign debt of the major Asian borrowers (Indonesia, the Philippines, Korea, Malaysia, and Thailand) is much more heavily denominated in yen than in dollars, 38 and 27 percent respectively (Tavlas and Ozeki 1991, 45).

Qualitatively, Japan has been participating more actively in regional and international negotiations over monetary and financial issues. This has perhaps been most prominent in discussions of currency values across the Pacific, in which the yen-dollar rate has been a constant topic. Nonetheless, there is little doubt that the Japanese government is inconclusive about its commitment to systematic regional or global leadership.

Many of the reasons for Japanese official ambivalence concerning regional and international monetary and financial relations can be traced to the domestic political economy. For purposes of simplicity, we can identify two broad groups in Japanese society, those with interests in more determined Japanese leadership in international and regional money and finance, and those whose interests lie more in safeguarding domestic conditions regardless of their external consequences.

The sorts of policies in question consist of a wide range of issues. Japanese monetary and financial leadership would require the following measures, some of which are already under way:

- The liberalization of the domestic financial system, in order to provide a broader and deeper market for yen-denominated assets. This would permit the yen to develop toward full key currency status.
- Continued commercial liberalization, especially toward the products of countries with net liabilities to Japan.
- A major Japanese role in multilateral financial institutions.
- Domestic macroeconomic policies undertaken with a strong eye toward their international effects. This implies monetary and fiscal stability, and high levels of cooperation with American and European policymakers.

These policies have differential effects within Japan and thus attract both political support and opposition. Those most inclined toward international cooperation are, not surprisingly, major Japanese banks and corporations with global interests. For them, whatever domestic price may be paid for Japan to help manage regional and world financial and monetary conditions pales in comparison to the benefits associated with stability in these arenas. Leading financial institutions may have reservations about financial deregulation, but these are outweighed by the recognition that such deregulation is a prerequisite to a greater Japanese role (Rosenbluth 1989; Pauly 1988; for background see Suzuki 1987; Friedman 1986; Semkow 1985). The same may be true about the attitude of major exporters and multinationals toward trade liberalization, and toward the strong yen that macroeconomic policy coordination tends to imply (Rosenbluth 1991; Funabashi 1988, 87–107; Frankel 1984; Green 1989; Cargill and Hutchison 1988; Suzuki 1989, 91–171). Their general sense that the trade-off of domestic for foreign goals is worthwhile is heightened by the greater ability of internationally oriented firms to make up abroad for what business they lose at home.

Other groups in Japan are unenthusiastic about sacrificing domestic economic goals on the altar of regional or international cooperation. Such groups include producers of nontradable goods and services: construction, wholesale and retail trade. They also include many small and medium-sized manufacturing companies. While these companies often produce for export or subcontract for large export-oriented firms, they often concentrate in the production of standardized goods for which price competition is crucial. Such firms are thus very hard hit by a strong yen and trade liberalization, while larger firms in markets where nonprice competition is more important (automobiles, sophisticated electrical equipment) are less adversely affected. (Rosenbluth [1991, 6–12] has a good summary of the interests and organization of these business groups.)[3]

The influence of small- and medium-scale businesses has traditionally been magnified by the character of Japan's political system. Liberal Democratic party (LDP) politicians have depended on local supporters in the small business sector, and have been quite responsive to their demands. This pattern was unproblematic so long as the policy preferences of small business were not in conflict with those of big business—especially in foreign economic policy. However, as big business has become more international, strife on these issues has increased.

Although conflict between internationalist and nationalistic groups in Japan continues, there are reasons to believe that the balance of power is swinging in favor of the internationalists. The first reason is that internationalization of the Japanese economy continues apace. Unlike in interwar America, the process affects broad segments of Japanese business. Second, the increasing importance of unattached urban voters in Japan has reduced the relative influence of such localist groups as farmers and small businesses, which have tended to be nationalistic on economic policy. Third, the central LDP leadership is generally able to enforce its policy preferences on LDP backbenchers, and the party leadership's ties to big business tend to make it favorable to internationalist policies (Rosenbluth 1991). All these factors tend to push Japan toward more cooperative policies at the regional and international level, regardless of foreign pressure—albeit not without difficulties and opposition.

The possibilities for a regionalist Japanese, or even Japanese-American, sphere of monetary and financial influence in Pacific Asia are often discussed. Most of the evidence, regarded from the political economy standpoint taken here, does not seem favorable to such an outcome. Indeed, the traditional concentration of Japanese foreign loans and investments in Asia has eroded in the past ten years; Japanese FDI has grown more slowly in Asia than in any other region. The United States and the European Community (EC) combined accounted for four-fifths of all long-term capital outflows from Japan in the late 1980s: the most rapid relative growth in Japanese foreign investment was in the EC (Tavlas and Ozeki 1991, 31–33; Froot 1991, 8–9). This implies that policies that might cut Japan off from the European or North American markets in favor of an exclusive Asian zone are unlikely to be supported by major externally oriented sectors.

While the jury is most definitely still out, then, there are indications that Japan's domestic political economy has become more hospitable to the country's playing an important role in regional and international monetary and fi-

3. There is no doubt that this typology is far too crude for nuanced analysis. Japan exports some construction services; there are many dynamic and internationally oriented small firms; and exceptions could be found to many of the patterns discussed here. I do not claim to have devised a detailed map of Japanese economic interests, only to have summarized some of the broad patterns.

nancial policymaking. Those who stand to benefit directly from Japanese provision of collective or club goods in these arenas have become more numerous, economically important, and politically influential. There are plenty of political obstacles to thoroughgoing Japanese commitment to these policies. If current trends continue, however, Japan is likely to avoid a repetition of the interwar American experience, and to move into a position of leadership in regional—and eventually international—money and finance. Of course, regional trends depend also on the policies of the United States, to which we now turn.

10.5 Contemporary United States

Concern about Japanese policy focuses on incomplete progress toward a greater international role, but the problem in the United States is the opposite: the possibility of a retreat into traditional economic nationalism. Although internationally oriented economic groups remain politically very important, they appear to be in danger of losing ground to those less interested in American cooperation with Japan over regional and international monetary and financial, or other economic, issues.

To be sure, the United States remains heavily involved in the world economy, as do many major banks and corporations. Indeed, explicit pressure for trade protection seems to be on the wane, as the result of three factors: the increased globalism of American industry, the development of greater export interests, and the generally weak dollar (Destler and Odell 1987; Milner 1988). Nonetheless, there are residual demands for trade barriers from remaining import-competers, and these demands could rise if the domestic economy grows slowly.

Probably the major source of future nationalistic pressures on economic policy will be the accumulated liabilities of the United States, and of the U.S. government, to the rest of the world. It is indeed ironic that, while in the 1920s the principal axis of debate over the role of the United States in the international economy had to do with foreign debts to the U.S. government, in the 1990s the principal axis of debate will likely have to do with U.S. government debts to foreigners.

Foreign holdings of over a trillion dollars in U.S. government securities, and of hundreds of billions more in corporate stocks and bonds, represent claims on future government and private revenues. As these claims come due, they will be met by pressures to give them less priority than domestic economic needs. Perhaps the simplest way to reduce the external debt burden would be to inflate it away, as almost all of the liabilities are denominated in dollars. Support for such measures will come from those whose economic activity is wholly or primarily domestic—nontradables producers, import-competers—for whom external debt service is an unmitigated drain. Support for more internationally cooperative policies will be centered in those tied to such internationally oriented activities as international banks and multinational corporations, for whom the costs of debt service are outweighed by the benefits of untrammelled access to the global economy. Of course, temptations to shift some of the adjustment burden onto the shoulders of holders of government securities will face opposition both from foreigners and from wealth holders within the United States. This set of issues will be crucial to resolution of America's regional and international positions, but the contours of the debate and its outcome are still too murky to forecast—and they depend too importantly on the underlying state of the U.S. economy (Frankel 1988a).

A related issue has to do with the conflict between domestic and international macroeconomic policies. The dollar remains the centerpiece of international trade and payments, and its stability is clearly of interest to most of those involved in the Pacific and world economies. However, confidence in the dollar can often be obtained only at the expense of policies to spur domestic economic activity—and vice versa. As above, interests on the relative importance of stability in the international value of the dollar as against efforts to stimulate domestic economic activity vary according to how involved the actors in question are in external as opposed to domestic business. And while the influence of more internationally oriented businesses—those more interested in international macroeconomic policy cooperation—has grown, the portions of the U.S. economy still relatively unaffected by external conditions remain very large (Destler and Henning 1989; Gowa 1983; Odell 1982; on specific episodes see Funabashi 1988, especially 65–86; Cohen and Meltzer 1982, 15–64; Destler and Mitsuyu 1982).

A specific problem that has long been contentious in American politics is that of support for multilateral institutions, including the IMF–World Bank system. Indeed, congressional support for the 1983 general increase in IMF quotas, which amounted to an $8.4 billion increase in the U.S. quota, was extremely weak. The quota bill passed only because it was tied to a public housing bill that the administration supported in return for the vote of key congressional Democrats on the IMF. The IMF bill's problems were compounded by domestic economic weakness at the time and by a very strong dollar—all of which inflamed the opposition of import-competers, nontradables producers, and many others (Frieden 1987, 179–190). Such conflict will undoubtedly recur and will undoubtedly be exacerbated if the U.S. economy is not growing rapidly at the time.

Other difficulties arise on the financial front, where the snail's pace of financial deregulation in the United States risks impeding American contribution to more integrated global financial markets. As is well known, the slow speed of deregulation is largely due to jockeying for position among financial institutions of different size and functional specialization. Although the cost to the taxpayers of the savings and loan crisis and the potential cost of similar problems in the commercial bank sector give an impetus to reform of the financial system, the economic and political barriers to rapid regulatory change are quite high. It is unlikely that the desire of the most competitive and international of financial institutions to move the American regulatory environment into lockstep with that of Europe and Japan will prevail rapidly, costlessly, or without compromise.

The political institutions through which economic interests are mediated in the United States are not especially favorable to those who desire more internationalist policies. The interwar pattern of political institutions, with a highly decentralized government that was especially responsive to localist (and typically nationalistic) groups, is still largely intact. Unlike in Japan, central party leaderships cannot impose the preferences of big business on local politicians more concerned with local conditions and pressure groups. The closest American analogue is the executive branch, and the relative power of the president is constrained by congressional and bureaucratic institutions quite responsive to local political influences. The Treasury and the Federal Reserve System are closer to international business and somewhat autonomous from day-to-day political pressures, but even this is tightly circumscribed by legislative oversight capabilities—as has been demonstrated, most recently, by battles over financial deregulation. American political institutions thus tend to reinforce the position of those least sympathetic to the sacrifice of domestic for foreign economic goals.

Unlike in Japan, the intermediate position of a U.S. zone of economic influence does not seem quite so far-fetched as Japanese resurrection of the Greater East Asia Co-prosperity Sphere. Although the relative share of Canada and Latin America in U.S. trade, lending, and investment has declined since the 1950s, it is still quite high—on the order of one-third to one-half depending on the arena. Negotiations on free trade agreements with Canada, Mexico, Chile, and other Latin-American nations are progressing; preliminary discussions are taking place about macroeconomic (especially exchange rate) policy in the region. However, considerations similar to those mentioned in the case of Japan tend to apply for the United States as well: most internationally oriented American businesses are not specifically concentrated in the Western Hemisphere and would not welcome Pan-American initiatives if they would threaten markets or investments in Asia and Europe.

The future of American international monetary and financial policy is unusually difficult to predict because the domestic politics of American foreign economic policy are particularly sensitive to the state of the domestic economy. This is especially the case with the debt overhang and its impact on macroeconomic policy. If U.S. economic growth is weak, there is likely to be much more significant opposition to measures that might threaten macroeconomic performance in the interest of regional or international cooperation. If growth is strong, such opposition will be mitigated.

Nonetheless, there are some reasons to anticipate that nationalistic economic-policy pressures in the United States, although powerful, will not prevail. The level of overseas commitments of major American firms is now higher than ever before. The rapid growth of inward direct investment has also increased the size of another support group for international economic-policy cooperation: managerial and production employees of foreign firms. Should the U.S. economy collapse, these more internationalist groups will be hard-pressed to prevail politically, but in the absence of serious macroeconomic disturbances, they are likely to remain politically predominant, albeit not without a struggle.

10.6 Implications and Conclusions

The analysis presented here can be used to evaluate the probabilities of the various scenarios discussed at the outset of this paper. The two pessimistic scenarios—one in which Japan free rides on American Pacific leadership, the other in which Japan creates an exclusive monetary and financial zone in the Pacific—both presuppose that inward-looking or exclusivist, regionally oriented groups will prevail over internationalist interests in Japanese domestic politics. Most of the evidence weighed here runs in the opposite direction, to indicate that internationalist groups have gained in influence and are likely to prevail in policy debates. Similarly, there is little evidence for bases of support for a primarily regional, as opposed to global, approach that would involve cooperation between the United States and Japan solely within the Pacific region. However, this does not necessarily mean that optimism should prevail. Indeed, most of my analysis of the American political economy indicates how conditional policy outcomes are on unpredictable events, especially the state of the domestic economy.

Indeed, one inference that can be drawn from this analysis of the domestic politics of Pacific money and finance is that the dangers of conflict come more from the American side than from Japan. Given the reversal in the net asset position of the United States, it is not unreasonable to expect growing dissatisfaction with the tradeoffs involved in continued American commitment to regional and international cooperation. Whether this dissatisfaction will translate into an all-out assault on current American policy, and whether it will predominate against the persistent strength of internationalist interests, depends in large part on the state of the domestic economy.

In this context, an aspect omitted from this analysis can be reintroduced. Strategic interaction among national governments can affect the domestic politics of regional and international negotiations (Putnam 1988). Specifically, the Japanese response to American demands, and to American political realities, can help reinforce the domestic political position of those in the United States who would like to maintain cooperative regional ties. This would require recognition of the need to mitigate the cost of such regional cooperation to domestically oriented economic groups, and of the desirability of reinforcing the benefits of cooperation to already-supportive internationalist groups. Although there may be little justice in asking Japan to bear greater sacrifices than

America for the good of regional cooperation, realization of domestic political realities in the two countries probably leads to the conclusion that this injustice may be the price paid for the maintenance of an open and stable regional monetary and financial order.

This analysis is unquestionably tentative, partial, and schematic. However, the very contours of the issues it addresses are still not entirely clear, and the information available to assess them is very sparse. As the issues and the data become more definite, more robust analyses and predictions may be possible. For now, I am content to insist on the importance of the domestic political lineup—both the economic interests involved and the mediation of these interests by political institutions—for the future of Pacific money and finance. The specifics of this future will be resolved by both domestic politics and interstate negotiations, but we cannot understand one without understanding the other.

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Comment Takeo Hoshi

Jeffry Frieden's paper examines the possibility of international cooperation in money and finance between Japan and the United States. As the paper correctly points out, such an analysis must be carried out in two stages: analysis of domestic politics and analysis of the international game. This paper focuses on the domestic politics and classifies the major political actors into two camps: internationalists and nationalists. Comparing the relative power in each camp in each country, the paper concludes that Japan and the United States are likely to achieve cooperation. Internationalists are likely to be more influential than nationalists in both countries, although there is some possibility that the U.S. nationalists could gain enough power to impede the process toward cooperation.

Focusing on the domestic politics, the paper gives us a good starting point for an examination of the likelihood of international cooperation. This is just

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a starting point, however, and the analysis has to be refined and expanded to get firm conclusions. The analysis is preliminary not only because of its exclusive focus on the first stage of the two-stage game but also because of the lack of depth in its discussion of domestic politics.

The paper identifies two camps that have opposing views about internationalization, but it is too quick to conclude on the relative power of these groups. For example, the paper mentions three reasons the internationalists are likely to dominate in Japanese politics. The supporting evidence is, however, weak and not very convincing.

The first reason internationalists are likely to dominate in Japan is because the Japanese economy will continue to become more international. It may be true that internationalization will increase the number of people who will gain from international cooperation, but this does not necessarily mean that the power of internationalists will be enhanced. In fact, a larger population of internationalists may make the internationalist camp weaker relative to the nationalist camp because of a classic collective action problem. The larger number of internationalists aggravates the collective action problem within the camp and makes the group politically less effective.

The second advantage for internationalists mentioned in this paper is increasing importance of urban voters relative to localist groups such as farmers. If this means that the number of urban voters is increasing, then again the argument ignores the collective action problem, which becomes more serious as the size of a group increases. If this refers to some radical changes in the Japanese political system that make urban voters more important, the paper should show exactly what these are. As long as the current election system continues, in which most Diet members are elected in local districts, it will always be important for politicians to maintain local support in order to be reelected. Thus the influence of localist groups is not likely to decline in the near future.

It is also interesting to point out that farmers are not necessarily nationalists and urban voters are not necessarily internationalists. A good example is the recent discussion on liberalization of rice imports in Japan, in which large farmers often expressed a favorable view toward liberalization. They hoped that import liberalization would pressure the government to abandon its food control system, which is government planning of production and distribution of rice. Consumer groups generally opposed the import liberalization. They claimed that rice imports should continue to be prohibited so that they can enjoy safe Japanese rice.

The third advantage of internationalists in Japan is the significant power exercised by the central LDP leadership over its members. This statement, however, is an exaggeration. One can find several examples that show the LDP leadership often fails to force its policy preferences on individual members. One example is Prime Minister Nakasone's attempt to introduce the sales tax in 1987 (see Nakamura 1988). As soon as Nakasone suggested the introduction of sales tax in January 1987, the local chapters of LDP started to voice their opposition. They were afraid of the voters' response in the unified local elections scheduled in April. The central leadership made several attempts to convince the members that they would be able to persuade the voters. First, they advertised that the tax reform package, which includes the sales tax, actually reduces the total burden of taxpayers, and the key issue is not the introduction of sales tax but the implementation of a tax cut. Then, the LDP National Convention for Advancement of Tax Reform was held on February 10, and Nakasone made a forty-minute speech asking the members' support for the tax reform. All these efforts failed, and many individual members continued to voice opposition to the tax reform. In March, a candidate from the LDP lost in a supplementary election for the House of Councilors in Iwate prefecture, where the LDP had traditionally been very strong. And in April, the LDP lost several important seats in the unified local elections, just as the local offices had anticipated. At this point, Nakasone had no choice but to drop the sales tax bill.

In each case discussed above, the analysis would be significantly improved by paying serious attention to some important factors that are not appreciated in the paper. Here I suggest three such factors. The first one is the collective action problem among the members of each camp: internationalist and nationalist. The second suggestion is an explicit consideration of institutional constraints, such as the election system. It is important to know if the existing election system favors one camp or the other, or one group or another. The third factor is the resource constraint for each camp, or what each party can do to influence the government. For example, the paper argues that, if the U.S. economy grows slowly, there will be more opposition to international cooperation from import-competers. The slow growth, and hence lower profits for the nationalists, however, affects their capability of influencing the government at the same time. Because lobbying is costly, although the nationalists' incentive to oppose the international cooperation may increase following the slow growth, their ability to influence the government will be reduced.

Another possible improvement of the paper is a general theory of what determines the line between the internationalists and the nationalist camps. There seem to be two factors that determine to which camp a political agent belongs. The first one is industry affiliation. If a firm belongs to an industry that benefits from international cooperation, then the firm becomes internationalist; if the industry gains little or is actually hurt by internationalization, then the firm becomes nationalist. The second factor is the position of the firm within the industry; whether it is large or small. The American experience after World War I discussed in the paper is useful to clarify the first factor, but it is not very helpful in identifying the second factor, the size of the firm. Looking at the experience in the same period in Japan may help establish that the size of the firm matters. During the late 1920s, the biggest policy debate in Japan was whether Japan should go back to the gold standard. Since the government planned to restore the gold standard at the prewar parity and the yen had depreciated in the postwar period, going back to the gold standard also meant revaluation. Some of the supporters of the gold standard were large *zaibatsus* (family-owned business conglomerates), like Mitsubishi and Mitsui (Nakamura 1978). They knew that the Japanese industries would be hurt by the revaluation, but they argued for the revaluation, because the troubles at weak firms would help increase their monopoly power. This episode shows that the size of the firm often affects its preference for internationalist and nationalist camps. Another example is the Japanese farmers' attitude toward rice liberalization in contemporary Japan, mentioned above. Large farmers are for the liberalization, and small farmers are against it.

The strategic interaction at the international level, which is omitted from the analysis in this paper, can potentially be important even for the analysis of the domestic level game, as Frieden correctly argues in his conclusion. The paper argues that the favorable Japanese response to American demands may strengthen the internationalists in the United States. The argument, however, could go in the opposite direction. Seemingly opportunistic demands from the United States may strengthen the nationalists in Japan. Or if the internationalists in the United States see that cooperation is more likely because of Japan's efforts, they may reduce their lobbying effort, which gives nationalists a better chance. Again, more substantial analysis is necessary.

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