CHAPTER 5

Japan and the Latin American Debt Crisis

Japan was quite an important actor in the solution of the Latin American debt crisis. The Japanese government extended a significant amount of official funds to the indebted countries in need of foreign exchange income, and it also consistently supported the U.S. debt initiatives, thus facilitating collective action among creditor governments. In the late stage of the debt crisis, the Japanese government came up with its own debt initiative, the Miyazawa Plan. This plan finally gave rise to a tangible solution to the debt crisis for many countries, with the U.S. government adopting it in the form of the Brady Plan. Despite such involvement, very little of the abundant economic and political science literature analyzing the debt crisis in Latin America[1] examines Japan's role; nor does the majority of the literature explain how and why the Japanese government was willing and motivated to help Latin America and to support the United States in this crisis.[2]

This chapter argues that the Japanese government was motivated by the private returns it expected to gain from its active involvement in the debt crisis solution, frequently in support of the United States. After briefly describing Japan's actions during the debt crisis, the analysis of motivation is structured according to the hypotheses outlined in chapter 1. Both of these hypotheses, the joint product nature of international financial stability and the importance of transnational linkages, significantly influenced the behavior of the Japanese government during the debt crisis.

Japan's Involvement in the Latin American Debt Crisis (Dependent Variable)

The debt crisis of the 1980s, which began in Mexico in August 1982, was a major economic crisis that had the potential to destabilize the international financial system.[3] The crisis lasted for almost a decade, preoccupying the financial world and policymakers. On August 12, 1982, Mexican finance minister Jesús Silva Herzog informed the U.S. government and the IMF that Mexico would not be able to service interest payments on its debt. This sudden announcement shook the world of finance because of the magnitude of the creditors' loan exposure in Mexico, which stood at $80 billion, and because of the fear of repercussions on other major debtors, such as Brazil and Argentina. Smaller debtors, such as Bolivia and Ecuador, also requested debt rescheduling, in the fall of 1982.

As the crisis hit, policymakers in the creditor governments scrambled to get emergency and fresh loans and new lending to Mexico and other developing country debtors to alleviate their liquidity crises. Mexico's rescue package was immediately assembled by the United States and the IFIs; the first $2 billion from the United States was transferred on August 15, half in the form of a food credit (PL-480) and the rest as advance payments on future U.S. oil purchases from Mexico using the Treasury's Exchange Stabilization Fund (ESF). A few days after the initial package was released, negotiations between creditor countries' central bankers took place at the BIS headquarters in Basel, Switzerland, to assemble an international rescue package. Due to the potentially destabilizing effects of the Mexican crisis, central bankers from most creditor countries were sympathetic to the idea of a multilateral rescue package. They agreed to provide $1.85 billion (including the portion from the United States) in bridge loans until the IMF agreement shaped up.[4] The agreement between the Mexican government and the IMF was finally reached in November 1982. The Mexican government agreed to cut its budget deficit drastically by lowering subsidies and raising taxes, in exchange for $3.7 billion in IMF standby credit. By the end of the year, the formal rescue package for Mexico amounted to $8.25 billion.[5] In addition, the managing director of the IMF, Jacques de Larosière, practically twisted the arms of major transnational banks, such as the Bank of America, CitiCorp, and Chase Manhattan, to commit $5 billion of the new money, the amount needed to help cover the Mexican balance-of-payments shortfalls in 1983.[6]

During this phase, the Japanese government followed the consensus of the creditor community, led by the United States and the IMF. When the $1.85 billion rescue package was assembled through the BIS, then-governor of the Bank of Japan Haruo Maekawa "promptly obtained the approval of the Japanese government to participate on a scale second only to the United States."[7] Furthermore, the Japanese government also prevented Japanese commercial banks from exiting Mexican and Latin American outstanding debt in these early months. *Nihon Keizai Shimbun* reported on December 15, 1982, that when Japanese commercial banks refused to roll over part of their short-term lending to Mexico, the U.S. Federal Reserve Board, the Bank of England, and the Mexican government pressured the Bank of Japan to make the banks respond. The Japanese MOF agreed with the strategy of the United States and Great Britain, to avoid financial panic.

Despite this Mexican rescue package and other repeated debt relief agreements between the major debtors and private and public financial institutions between 1983 and 1984, there was no definite solution in sight.[8] By mid-1984, Bolivia and Ecuador announced debt payment suspensions, and Peru stopped meeting its debt obligations. In June of that year, eleven Latin American debtors met in Cartagena, Colombia, to discuss the issue. The meeting caused some creditors to fear that the debtors might engage in collective action to strengthen their bargaining powers. Although the conference adopted a declaration that supported the creditors' debt relief strategies, debtors' frustration about prolonged economic difficulties resulting from their debt overhang was visible.[9]

At the World Bank/IMF annual meeting in Seoul, Korea, in October 1985, the Baker Plan, named after then-U.S. treasury secretary James Baker, was announced. This plan targeted fifteen of the most heavily indebted countries, ten of which were in Latin America, and announced three policy themes: (1) a continuing adjustment effort by these heavily indebted countries to produce economic growth, (2) greater collaboration between the IMF, the World Bank, and other regional banks to provide $27 billion to these countries over the following three years, and (3) increased lending from private banks, rising to $20 billion over the following three years.[10] The Baker Plan called for a greater flow of new money to heavily indebted countries, which represented the U.S. recognition of the need for more aggressive measures to provide adequate financing to Latin American countries so that they could recover from debt overhang.

Japanese and European banks responded to the Baker Plan somewhat reluctantly and suspiciously.[11] As I already noted, ten of the countries comprising the so-called Baker Fifteen were in Latin America (and twelve out of the expanded group of seventeen were in the region), where American banks had the most exposure. Moreover, the banks had already provided significant amounts of "new money" through involuntary lending to these high-risk countries. Despite these considerations, fourteen Japanese banks issued a statement to the World Bank on December 12, 1985, supporting the Baker Plan.[12]

But the plan failed to restore economic growth to the indebted countries, partly because the new money package did not restore large enough capital flows and partly because the plan did not lead to an expansion of productive capacity.[13] Some analysts then began to doubt the effectiveness of debt relief plans that presupposed illiquidity as the problem of the major debtors. They began to advocate some kind of debt forgiveness. U.S. senator Bill Bradley, for example, was skeptical about the effectiveness of the Baker Plan and of full payment of outstanding loans by the major debtors. He advocated a 3 percent interest cut on private and official loans for selected debtors that implemented successful structural adjustment led by the IFIs. At this stage, many Japanese bankers were not in favor of the debt-reducing nature of Bradley's proposal, and they emphasized market-oriented solutions to the debt problem.[14]

The payment crisis deepened once again for major Latin American debtors, such as Mexico and Brazil, between 1986 and 1987. The first major blow to the Latin American debt crisis solution occurred when, due to the decline of oil prices and increasing capital flight, the Mexican balance of payments, which had shown some signs of recovery, worsened in mid-1986. Mexico's international reserves decreased by $3 billion during 1987. It was reported that Mexico would require $9–10 billion in new loans to get the country's economy back on its feet. The IMF agreed to provide to Mexico an emergency stabilization loan package of $1.6 billion, which was part of a $12 billion multilateral rescue package. Rescheduling agreements between the Mexican government and commercial banks in September 1986 averted the worst outcome. The second major blow to the debt crisis solution was the Brazilian announcement on February 20, 1987, of a moratorium on its $67 billion commercial debt. The Brazilian balance of payments had also worsened during the latter part of 1986.

By this time, the attitude of policymakers in creditor countries had shifted. Previously, they had insisted that the developing country debt crisis should be characterized as a liquidity crisis, where more inflow of foreign capital was needed to resolve debtors' balance-of-payments problems. They had understood it as a temporary and short-term crisis. After the series of setbacks that occurred during 1986–87 despite efforts by creditor banks, creditor governments, and the IFIs, policymakers gradually became convinced that the problem was not merely a liquidity crisis: they were forced to acknowledge the insolvency of these governments as the fundamental problem.

The payment difficulties of these major debtors also triggered increased loan-loss reserves of American commercial banks that had high exposure to Latin America. The most influential response came from CitiCorp in May 1987, when it announced that it had set aside $3 billion in loan-loss reserves to stabilize its position in response to the Brazilian crisis. In December, Morgan Guarantee announced a plan to retire up to $20 billion of its Mexican debt through the exchange of outstanding loans for government bonds at a 50 percent discount. This scheme converted part of the Mexican bank debt into twenty-year bonds whose principal would be backed by U.S. government securities. In this way, Morgan Guarantee exited from large outstanding claims, and Mexico reduced its debt by persuading the banks to exchange their loans for U.S. government-guaranteed bonds at the discounted rate of two to one. The Morgan Guarantee approach was endorsed by the secretary of state, James Baker, and it constituted a model for future debt reduction schemes. The changes in perception and in the commercial banks' exposure positions were also reflected in a modification of the Baker Plan in 1987. At the World

Bank/IMF annual meeting in Washington, D.C., Secretary Baker called for a "menu approach" that enabled commercial banks to select from various options of the menu when supporting debt relief. The options ranged from trade and project loans to some debt reduction measures, such as debt swaps (with equity or for environment) and exit bonds.[15]

The Japanese government responded to the reemergence of the payment crises among major Latin American debtors by increasing its official financial commitment to the solution of the debt crisis, particularly with the objective of recycling Japan's current account surplus. Following the announcement of Mexico's economic difficulties, the Japanese finance minister announced, in October 1986, a $10 billion Capital Recycling Program over the next three years. Through this program, the Japanese government contributed $2 billion to establish the Japan Special Fund in the World Bank, $3.6 billion to the IMF, $3.9 billion to the International Development Association (IDA—a soft credit window of the World Bank) and the Asian Development Fund (a soft credit window of the Asian Development Bank [ADB]). This program was expanded from $10 billion to $30 billion in May 1987, after the Brazilian moratorium shock. Prime Minister Yasuhiro Nakasone announced that an additional $20 billion would be allocated among various IFIs committed to cofinancing, by the OECF ($8 billion), the JEXIM Bank together with the private sector and IFIs ($9 billion), and the JEXIM Bank's untied loans ($3 billion).[16] This $20 billion was announced as an *omiyage* (gift) on the occasion of a U.S.-Japanese bilateral meeting. In the United States, it was reported to be primarily targeted at Latin American countries.[17] This $30 billion Capital Recycling Program was well received at the Venice Summit in June of that year.[18]

Despite various debt reduction instruments made available to commercial banks, the banks were reluctant to participate because they doubted that even the reduced part of their claims would be fully honored by the debtor governments, due to the lack of foreign exchange income. The idea of increased creditor governments' financial involvement received a cold reception. Arguments against such action included political considerations regarding the response of creditor countries' taxpayers to bank bailout by public money; the moral hazard problem that public involvement creates for poorly behaved debtors and free-riding banks as they get bailed out with such support; and the budget implications of a large bailout plan, particularly for the U.S. government in the latter half of the 1980s.

In this context, the Japanese government took an initiative aiming to resolve the lingering debt problem. The so-called Miyazawa Plan, which included debt reduction schemes with public financial support, was informally introduced at a meeting of the IMF Interim Committee in April 1988 and then privately discussed among the G-7 finance ministers at the Toronto Summit that June.[19] Finally, the plan was formally announced during the World Bank/IMF annual meeting in Berlin in September 1988. This plan contained three major components. First, debtors would reach an agreement with the IMF on a structural adjustment program promoting economic growth. Second, the flow of bilateral and multilateral public funds for structural adjustment would be increased. Finally, banks and debtors would voluntarily convert a portion of debt to bonds and reschedule the remaining debt under suitable conditions once the structural adjustment program had been carried out. The debtor nations could securitize their debt by establishing a reserve account related to the proportion of debt converted to bonds and the proportion rescheduled. The management of this reserve would be entrusted to the IMF.[20] Analysts and policymakers then believed that the Japanese government would supply parallel lending to debtor countries, which would provide the reserves required for the collateral for exit bonds, thus creating official financial support for the bonds.[21] Japanese prime minister Noboru Takeshita lent support to this interpretation when he announced at the 1988 Toronto Summit that the Japanese government would begin a five-year (1988–92) ODA program involving over $50 billion, along with the $5.5 billion debt relief package for severely indebted countries.[22]

Although a few countries, including France and Canada, welcomed the Miyazawa Plan, and although it earned some support from scholars of the debt issue,[23] the plan received a cold reception from the other creditor governments. Some argued that the plan looked too much like "the public bailing out the banks," particularly using the IMF as a "debt purchasing facility."[24] For Washington, this debt underwriting function through the IMF was considered too ambitious and expensive. Due to the strained condition of its federal budget, the U.S. government was neither in a position to make a new infusion of money to the IFIs nor ready to relinquish its voice in these international organizations.[25] In addition, the concept of a public bailout would be resented much more in the United States than in Japan, given the U.S. political system's much stronger scrutiny over the government's use of taxpayers' money.[26] Some commercial banks joined in the criticism of the plan, arguing that it would distort the market and lead to moral hazard problems on the part of the badly behaved debtors that might benefit from the debt reduction.[27] The proposals of the Miyazawa Plan had to wait for the change in the U.S. administration in 1989 to be considered seriously.

During his visit to Washington in February 1989 right after President Bush took office, Japanese prime minister Noboru Takeshita confirmed that the United States and Japan would collaborate in their economic assistance efforts, particularly in Latin America and the Middle East. Referring to the allocation of Japan's ODA and support for debt relief, the prime minister noted that "Japan would like to expand the coverage of its ODA from the concentrated allocation to countries like China and the Philippines to a more widespread allocation toward Latin America and Africa."[28] President Bush was willing to revise the Baker Plan, and he promised that his administration would respond to the debt problem with flexibility. Washington became seriously concerned about the prolonged debt problem and the slow (or negative) growth of the heavily indebted countries.[29] This concern arose because of the negative impact on the national security of those countries arising from economic and social instability and because of the possible impact of these factors on the prospect for the democratization of some Latin American countries slated to hold elections during 1989–90.

The resulting debt strategy promoted by the Bush administration came in the form of the Brady Plan on March 10, 1989. The plan was formally called "the strengthened debt strategy" or "the new debt strategy"; it took on the name Brady Plan in reference to Treasury secretary Nicholas Brady. This debt reduction plan targeted heavily indebted middle-income countries by forgiving debt service to commercial banks and/or compressing the debt's principles. The plan conserved the principals of the Baker Plan, including the goals of (a) economic growth of the indebted countries, (b) structural adjustment of the debtors, (c) new money inflows from abroad, and (d) a case-by-case approach. However, the Brady Plan also emphasized debt reduction through various menu items and stipulated that the remaining portion of debt and new bond instruments were to be de facto guaranteed by the IMF and the World Bank. The plan also included penalties for commercial banks that did not abide by the Brady Plan; banks would have their interest and principal payments suspended for three years. The plan required the debtors to take measures to decrease their debt overhang by restructuring their economies, promoting capital inflows, and repatriating flight capital.

The Brady Plan very closely resembled the Miyazawa Plan. The Japanese government and the U.S. Treasury held consultations before its official announcement. At the end of February, a Treasury official, Charles Dallara, came to Japan and informed the Japanese government that the United States wanted to accept the Japanese proposal. The two governments then discussed the details of the plan.[30] When the Brady Plan was announced in March, Japan's finance minister Tatsuo Murayama told reporters:

> I would like to welcome the amply strengthened debt strategy just announced by Treasury Secretary Brady, and would like to support this new

> plan proposed by the United States that includes voluntary market-based debt and debt-service reduction and repatriation of flight capital. We have been in close consultation with the U.S. monetary authority on this issue, and this new American proposal incorporates fundamental ideas put forth by the Japanese government previously. Japan will collaborate closely with the United States and other governments concerned to implement this new debt strategy.[31]

The G-7 governments accepted the plan in April.[32] The heads of state at the Paris Summit in July also supported the plan. Japan was the strongest supporter of all. During the IMF meeting in April 1989, the Japanese government promised to support the Brady Plan by providing $4.5 billion through the JEXIM Bank in parallel financing with the IMF.[33] As debtor countries like Mexico, the Philippines, Costa Rica, and Venezuela entered negotiations with the IMF by the early summer of 1989, the Japanese government announced a contribution of $35 billion in addition to the $30 billion already committed to the Capital Recycling Program of 1986–87. This contribution increased the total of the Capital Recycling Program to $65 billion over fiscal years 1987–91, $10 billion of which was committed to debt relief.[34]

The first debt reduction negotiations commenced in April 1989 between various groups of creditors and the Mexican government. They reached agreement in July and concluded the details in September of that year. In the agreement, donor governments rescheduled their $2.6 billion in official loans. The IMF provided $1.6 billion through the Extended Fund Facility (EFF) and extended the World Bank $2.6 billion through the Sector Adjustment Loans (SECALs). The JEXIM Bank provided new untied loans totaling $1.9 billion—$1 billion in parallel financing with the IMF and $0.9 billion in cofinancing with the World Bank. Of medium- and long-term commercial bank debt, $48.5 billion was to go under the debt reduction scheme. Overall, 41 percent ($19.9 billion) of the total debt negotiated was reduced through discount bonds (reducing the principal by 35 percent), 49 percent ($23.8 billion) through par bonds (interest reduction to 6.25 percent per year), and only 10 percent ($4.8 billion) as a new money equivalent to a quarter of the old debts loanable in four years.[35]

During the ten years between 1987 and 1996, the JEXIM Bank alone provided $11 billion (or 23.6 percent of the JEXIM Bank's total) in untied loans to Latin America through the Capital Recycling Program (and its successor, the Development Initiative Program). Mexico (1989), the Philippines (1989 and 1994), Venezuela (1991), and Argentina (1993) benefited from the JEXIM Bank's untied loans parallel to the IMF agreement and successfully concluded their Brady deals (see table 5.1).

Crisis Management as a Joint Product

In the case of Latin America, the sense that the debt crisis threatened international financial stability was clear among the creditor governments. The list of indebted countries with the potential for debt moratorium or even default was extensive, and the exposure of many major creditor banks was alarmingly high. Because the major debtors involved in the crisis were concentrated in Latin America (beginning with Mexico), where the major banks of the United States were highly exposed, the United States was the first creditor government that sensed the crisis and acted to resolve it. The Japanese government was also drawn in, despite the fact that the center of this crisis involved geographically distant countries. In the end, the Japanese government positively contributed to collective crisis management to contain and resolve the Latin American debt crisis, committing substantial amounts of public funds in support of the U.S. government's initiatives.

The abundance of the private returns promised by this crisis management drove the Japanese government's strong interests and commitment. Although the region in crisis was far away, Japan's political and economic position in the middle and late 1980s provided ample grounds for the involvement of the Japanese government in the management of these economic problems in an unfamiliar region. The private returns to the Japanese government can be categorized into three groups: domestic economic stability in Japan; a smooth and fast recovery of the U.S. economy, in which Japan had vested economic and political interests arising from economic linkages between the two countries; and an increase in Japan's status and power in IFIs, particularly in the IMF.

Domestic Economic Stability in Japan

The first private return served the Japanese government's concern for its own domestic economic stability, particularly for the health of the Japanese financial sector, mainly the banks.[36] The private return for the Japanese government

TABLE 5.1. JEXIM Bank's Support to the Brady Plan with Signing Dates and Amounts (in millions of dollars, equivalent)

Recipient Country	Signing Date	Amount
Mexico	November 1989	1,000
Philippines	November 1989	300
Venezuela	March 1991	300
Argentina	February 1993	300

Source: Export-Import Bank of Japan, *EXIM Japan Bulletin* (November 1997).

emerged from the fact that successful management of the crisis could have led to financial security for the Japanese banks exposed to foreign debts, particularly in Latin America. Thus, such management enabled the Japanese government to maintain the stability of the country's domestic financial system. Obviously, the MOF has long been the protector of the well-being of Japanese banks.[37]

During the period of large commercial bank lending (1975–82), the MOF had regulatory concerns about commercial banks' rapid accumulation of outstanding loan claims to developing countries. MOF officials were also concerned about banks' excessive competition, which lowered the spread over these loans. By July 1979, the MOF and the Bank of Japan had prepared comprehensive rules to increase their control over Japanese banks' foreign lending.[38] Furthermore, the MOF advised banks to be more selective in their lending activities to developing countries. One way for banks to reduce their risk was to develop cofinancing arrangements with multilateral financial organizations, such as the World Bank and the Inter-American Development Bank (IDB), with the IMF working as an information provider.[39]

The concern of the MOF about the health and management of the Japanese banks was well founded. As Japanese bank profits increased 16.6 percent in the third quarter of 1979, their reliance on foreign exchange and foreign lending as sources of profit also increased significantly. The Bank of Tokyo had an exceptionally high rate of foreign lending, since it was once the only foreign exchange bank and was traditionally very internationally oriented. Its rate of profit from overseas activities in 1979 was 77.5 percent. Other major banks also expanded their proportion of overseas activities. The average rate of profit on these activities for the twelve city banks, excluding the Bank of Tokyo, increased from 9.24 percent to 10.33 percent during 1979. Several of the largest banks derived 10 to 17 percent of their profits from foreign exchange and foreign lending activities.[40]

However, the MOF's guidance occasionally increased the risk Japanese banks were taking. Although Japanese banks were at first followers of the American banks' lead in forming syndicate loans, they eventually became managers (leading banks) in such loans. The Bank of Tokyo handled $753 million as the leading bank by 1981, and other, less internationally experienced Japanese banks began to play the role of leading bank in the latter half of 1981. Sumitomo Bank increased the number of syndicated loans it led from one worth $50 million to seven worth $617 million, and the Long-Term Credit Bank of Japan led its first three such loans, worth $217 million, during this period.[41] The MOF encouraged the Japanese banks to act as leading banks in syndication, because of the greater commission fees they could earn.[42]

In 1982, when the debt crisis struck, all transnational banks feared the repercussions of a Mexican default throughout the rest of Latin America. Exposure to Mexican debt ranged anywhere between 40 percent to 67 percent of bank capital for major American banks.[43] A less-known but nevertheless striking fact about the Japanese banks' involvement in this Mexican debt was their high exposure. The U.S. banks' familiarity and expertise in Latin America (and possibly their knowledge of the U.S. government's political commitment) contributed to the concentration of debt in the region and in Mexico in particular, and that affected Japanese banks' lending practices.[44] The Bank of Tokyo's exposure level in Mexico was 83 percent of its capital, and the exposure of other major banks ranged from 28.3 percent (Mitsui Bank) to 53.6 percent (Long-Term Credit Bank of Japan).[45]

With these alarmingly high rates of exposure, the Japanese government's role as a protector became even more important. Various rescheduling agreements during 1983 and the fear of a Brazilian moratorium continued to shake the financial world. In July 1983, the MOF reported that Japanese banks' outstanding loan claims had significantly increased since the previous July, mainly due to an increase in short-term lending to maintain debtors' interest payments. The increase totaled $16 billion among the heavily indebted countries, bringing Japan's total lending to Mexico to $10 billion, to Brazil to $7.5 billion, and to Argentina to $4 billion.[46] Assisted by an appreciation of the yen, the increase in Japanese banks' exposure to Latin American loans continued until 1987 (see fig. 5.1).

Despite the high exposure, Japanese banks seldom defected from agreements set up under BACs after the Mexican debt crisis, nor did they exit from bad loans (see fig. 5.1). The reasons may be that the banks' asset base in Japan was expanding rapidly during the period (so they possessed significant hidden assets) and that the yen was getting much stronger against the dollar.[47] These factors made it somewhat easier for Japanese banks to maintain a high level of exposure in Latin America. However, from the MOF standpoint, Japanese banks were still less competitive than other major banks in the world and needed to be protected through the MOF's tight rein so that they would not incur huge losses and possibly create a domestic financial panic.[48] In return, the MOF made various gradual concessions domestically in the form of increases in the tax-deductible rate on debt losses and increased official financial commitment to the indebted region.[49]

Late in 1987, Japanese banks' outstanding loans to major Latin American countries became a bigger problem for the Japanese government, and the solution to the problem thus became a larger private return. The Cooke Committee of the BIS came to an agreement in December 1987 that member country banks operating overseas, including Japanese banks, would adopt a bank capital-asset ratio of 8 percent by 1992. Because other OECD countries had

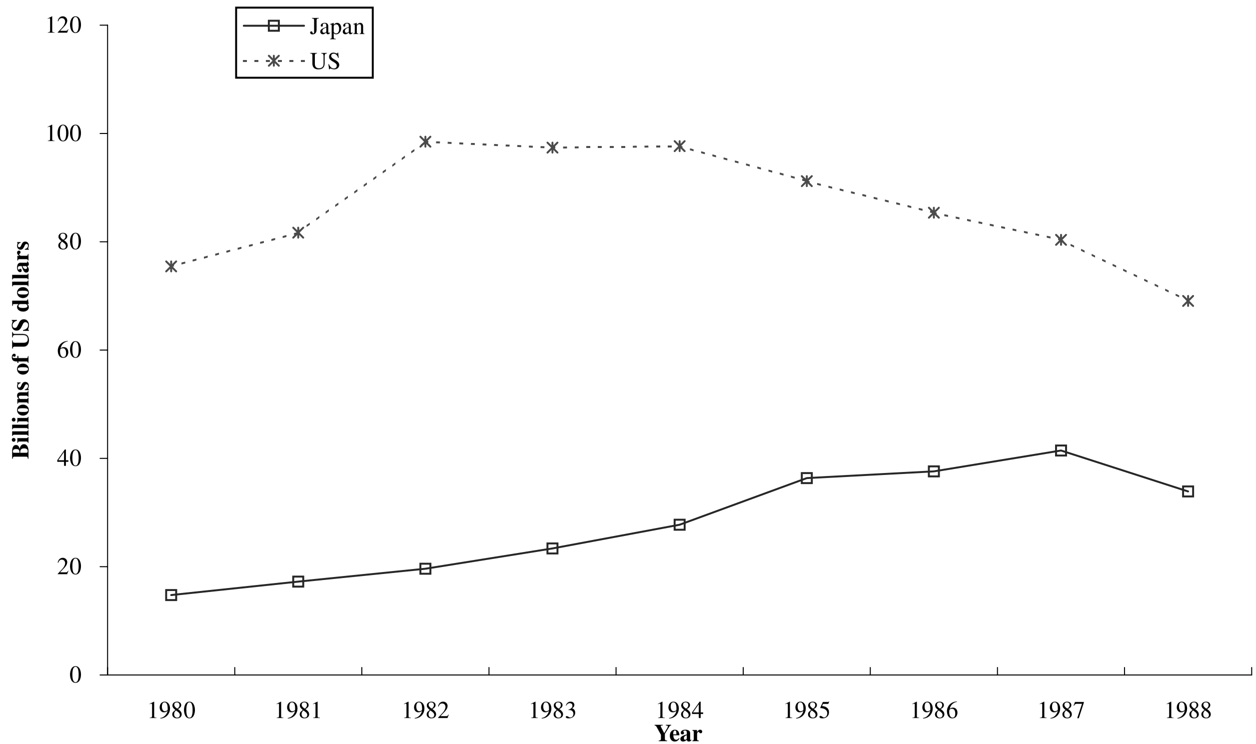

Fig. 5.1. Bank loans outstanding in Latin America, Japan, and the United States, 1980–88. (From Federal Financial Institutions Examination Council, *Country Exposure Lending Survey,* and Japan Bond Research Institute, *Country Risk Information.*)

criticized the Japanese banks for unfair competitiveness deriving from a low capital-asset ratio, the Japanese banks and the MOF feared that failure to comply with the standard would invoke retaliatory exclusion of Japanese banks from international operations.[50] At least a portion of the Japanese banks' large loans to Latin American debtors, for whom they had no prospect of swift repayments, had to be repatriated to improve the Japanese banks' compliance with the BIS standard.

The timing of the appearance of the Miyazawa Plan, a debt reduction proposal first publicly advocated at the IMF Interim Committee meeting in April 1988, reveals the MOF's concern over the course of Japanese banks' bad loans in the region. In addition to proposing the Miyazawa Plan, the Japanese government poured $30 billion into the Capital Recycling Program, a sum expanded in 1989 to $65 billion (with half of the additional money earmarked for Latin America).[51] Rosenbluth notes that through these schemes, "the Japanese government had purchased for Japanese banks a clear path for retreat" from Latin America.[52] At the same time, this policy intervention supported the resolution of the debt crisis by increasing available financial resources for the parties involved.

Japan's Concern over the U.S. Economy

The second type of private return that the Japanese government perceived as accruing through collective management of the Latin American crisis was the smooth and fast recovery of the U.S. economy in the latter half of the 1980s. The Japanese government could consequently expect a stable relationship with the United States, which was (and is) by far Japan's most important economic partner in the world. The Japanese government could also expect milder political pressure on Japan's one-sided trade surplus with the United States, as Japan supported the U.S. debt initiatives and contributed to the recovery of the U.S. economy.

The Latin American debt crisis not only gave rise to a fear of domestic financial collapse in the United States due to the heavy exposure of many major American banks in the region but also led to a deterioration in the U.S. trade balance.[53] Japan had a large trade surplus against the United States, ranging from $30 billion to $60 billion between 1984 and 1990. Therefore, those who dealt with developing country debts and the problem of liquidity expected Japan to recycle its current account surplus either to the United States or to debt-ridden Latin America. For example, Harvard economist Jeffrey Sachs calculated that if Japan recycled its surplus capital to Latin America by $2.5 billion each year for three years, there would be an improvement of the U.S. overall trade balance by $1.15 billion per year. This recycling method recommended itself as a much more effective way of improving the trade balance with the United States than would be the expansion of Japan's domestic fiscal expenditure by the same amount or the recycling of the same amount of capital to non–oil-developing countries in general.[54] In addition to the direct effect of a capital recycling program on the U.S. trade balance, such recycling, if it stimulated significant capital outflow from Japan, could be expected to have some effect on reversing or slowing the yen appreciation, which the Japanese government faced after the Plaza Accord in the fall of 1985. This perspective permeated the thinking of Japanese policymakers, and it inspired Japan's Capital Recycling Program. Although the program's target was not solely Latin America, this indebted region, with its major impact on the U.S. economy, constituted an important part of the scheme.[55]

There are some indications that the Japanese government's commitment to the Capital Recycling Program aimed mainly to please the United States (and Japan's own financial sector, as I noted earlier) rather than the debtors themselves. This perspective emerged in response to discussions during U.S. congressional hearings that outlined what American policymakers wanted and what they feared about Japan's capital recycling. In 1987, when the U.S. Senate Committee on Finance (Subcommittee on International Debt) discussed the impact of the Latin American debt crisis on the United States, some lawmakers strongly urged the U.S. government to link the issue of U.S.-Japanese trade to Japan's supportive involvement in the solution of the crisis. One report noted:

> In particular, economically powerful nations with large trade surpluses vis-à-vis the United States should be encouraged to make major commitments to a resolution of the debt crisis. Though they are certain to resist, it is ultimately in their interest to cooperate with the United States in providing debt relief, because the alternative may be a protectionist U.S. trade policy. Japan, specifically, could ease some of the current trade tensions with this country by cooperating in Third World debt restructuring.[56]

A few years later, however, in the spring of 1989, when the announcement of Japan's large financial commitment to Latin America was perceived as a threat to the United States, a U.S. congressman expressed his concerns that "[in Latin America, w]e may find that the major increased role of the Japanese in lending will cause them, by mixed credit arrangements or by the conditions they place on their foreign assistance, to capture significant commercial markets that we once had."[57] U.S. lawmakers wanted the Japanese government to become actively involved in the crisis management, but they did not want this involvement to threaten privileged U.S. economic ties to Latin America. This is not to say that the Japanese government and its private sector did not have any direct trade interests in mind when the Japanese government stepped up capital recycling to Latin America. But the modality of the capital recycling program, which totally relied on untied loans, demonstrates the Japanese government's desire to please the United States so that it could reduce political pressure.[58]

To meet such political objectives, the Japanese government resorted to an active initiative to recycle its current account surplus. The Japanese government used untied loans from the JEXIM Bank and cofinancing arrangements with IFIs to enhance private capital flows to Latin American countries that were heavily indebted. The Capital Recycling Program included activities of the OECF, the agency that deals with Japan's foreign aid loans. The OECF, however, faced some constraints in providing official capital resources to some Latin American countries, because the basic laws of the OECF did not allow it to provide concessional yen loans to countries with relatively high GNP per capita.[59] Therefore, the Japanese government needed a new funding instrument to recycle capital to such countries in Latin America. The MOF envisioned that at this stage, approximately $4 billion in capital should flow between Japan, on one hand, and Latin America and the Caribbean countries, on the other.[60] An examination of bids for these aid projects in Latin America reveals that American firms have been very successful. In 1990, two large aid projects in Mexico were contracted by American companies: railroad repair totaling approximately $44 million by General Electric Co. and General Motors Interamerica Corp., and Mexico City air pollution reduction totaling approximately $495 million by HRI Inc. and Japan Plant Kyokai. Seminars were held in Tokyo about business opportunities involving Japanese aid, and the International Trade Administration in the U.S. Department of Commerce published a booklet titled *Japanese Foreign Aid Program: Opportunity for U.S. Business* in 1991. Together with the increased implementation of PBL during this period (see chap. 2), the fungibility of governmental financial flows from Japan has helped some American firms conduct business in Latin America with Japanese funds. In this way, the Japanese government could appease and please the United States through engaging actively in the management of the debt crisis, which was considered an important gain for the Japanese government.

Furthermore, the economic returns that would have resulted when the United States regained its economic health were also in the minds of Japanese policymakers. Strengthened economic linkages between Japan and the United States increased Japan's vested interests in the U.S. economy dramatically from the early 1980s onward. A direct investment boom and an increase in mergers and acquisitions by Japanese companies in the United States increased the economic stake of both manufacturing and financial sectors invested in the country.[61] In addition, a strong yen, the progress of Japan's financial liberalization, and low interest rates in Japan (see fig. 2.14) led a large Japanese capital outflow to the United States in the latter half of the 1980s (see fig. 2.12), with Japan purchasing U.S. Treasury bonds as well as corporate bonds.

In short, the Japanese government had a high stake in the U.S. economy, with the intent of avoiding more protectionist pressure on the trade front and maintaining the economic stability of the country in which Japan had substantial investment. The U.S. economy was in a relatively weak position throughout these years. Thus, helping to reinforce the U.S. economic recovery (and being perceived as doing so) by resorting to measures that did not cause major domestic backlash in Japan (e.g., opening Japan's rice market could have caused a major protest by Japan's politically strong agricultural sector) was a private return that the Japanese government welcomed from this crisis management.

Japan and IFIs

The third type of private return to the Japanese government from collective management of the Latin American crisis was the possible enhancement of Japan's status in IFIs, especially in the IMF, where voting power is based on capital subscriptions (or quotas). Since Japan joined the IMF immediately after it regained its political independence in 1952, the rapid increase in Japan's economic power (to which the amount of IMF capital subscriptions should be closely linked) has led to some reshuffling of the major countries' voting shares in the IMF.[62] Starting out below 4 percent, Japan's IMF quota increased to 4.75 percent in 1983 and remained there for the rest of the 1980s. Japan held 4.47 percent of the voting rights in the IMF during this period, placing it in the fifth most powerful voting position, after the United States (18.9 percent), the United Kingdom (6.55 percent), Germany (5.72 percent), and France (4.75 percent).

With Japan having already acquired the position of the second largest economy and ODA donor in the world, the Japanese government saw as problematic the gap between Japan's position within the IMF and the burden of international development cooperation that Japan was bearing, especially in relation to the power Japan wielded in the IFIs.[63] The Japanese government fought for an increase in its subscription quota in the IMF between 1987–89, but it faced reluctance from the other major powers, who feared that an increase in Japanese power would relatively decrease theirs.[64] Meanwhile, the Japanese government stepped up its capital infusion to the IFIs through various parallel financing and cofinancing channels; it also channeled its official flows directly to heavily indebted countries in the name of financial crisis management. But neither of these moves counted toward an increase in Japan's capital subscription to the IMF. This intensified the Japanese government's frustration and dissatisfaction regarding its status in the organization.

The breakthrough for the Japanese government came in April 1989, when the United States finally relaxed its opposition to proposals that would increase overall IMF quotas with revisions of national quotas and voting shares. This change placed Japan (tied with Germany) in the second position of voting strength. As Rapkin and Elston observe, the timing of this reversal occurred "during the same week that Japan announced it would provide $4.5 billion to support the U.S.'s Brady Plan for developing country debt relief."[65] This redistribution, agreed on in 1990 and implemented in 1992, shifted the order of the voting shares: first was the United States (19.6 percent), followed by Japan and Germany (tied at 6.1 percent) and then Britain and France (tied at 5.48 percent). The story in the World Bank is similar. The increase of Japan's contribution (but not its subscription) to the World Bank's soft window IDA and Japan's cofinancing resources, used in part to deal with the debt problem, were explicitly and implicitly linked to Japan's increased voting share in the institution.[66]

Although the process and negotiations of such private returns to Japan were long and complicated, the Japanese government's active role in the debt crisis management, especially its support for U.S. initiatives, such as the Brady Plan, helped Japan achieve its goal in the IFIs. Because the Japanese government neither expects nor wants the number one voting position in these institutions, the country's major goal was already achieved by the early 1990s.[67]

Transnational Linkages and Domestic Dynamics

Two noteworthy aspects of bank lending in the 1970s and early 1980s influenced the way the Japanese government responded to the 1982 Mexican crisis and the Latin American debt crisis. The first aspect was the strong ties existing among those transnational banks that had high exposure to developing country debts. The second was the effective lobbying power of Japanese banks on the Japanese government. The banks demanded that the government take up the lender-of-last-resort function and protect financial stability. The pressure from the international financial community on the Japanese government was transmitted in two steps: first from overseas to Japan through private sector channels, then from the powerful domestic actors to the government.

Institutional Linkages

During the Latin American lending boom prior to 1982, and in the aftermath of its debt crisis, cross-border linkages between American and Japanese transnational banks were formally and informally institutionalized. The linkages established before the crisis included the very structure of syndicated loans, with their cross-default clauses. After 1982, BACs were set up among the creditor banks in each debtor country to deal with their debt negotiations. BACs transmitted transnational pressures in dealing with various major debtors in Latin America, and Japanese banks were obligated to follow the agreements for rescheduling or forced to provide new money despite their desire to exit. In this process, the Bank of Tokyo, the traditionally outward-looking foreign exchange bank with a large exposure to Latin American debt, with the help of the MOF, served as a major channel of pressure among the transnational bank community carrying loan exposure.[68] It also served as a key coordinator of international cooperation for debt relief.[69] In addition, the Japanese banks' tendency to follow the American banks' lead, particularly in Latin America, created higher reliance and responsiveness of the Japanese banks to the needs and strategies of the American banks.[70]

Gaiatsu (foreign pressure) successfully influences foreign governments when the one who pressures has a strong domestic supporter in the country it is pressuring.[71] Such institutional links and the dynamics between private Japanese financial institutions and the Japanese government greatly influenced Japanese decisions whether or not to become involved in financial crisis management. This linkage and the natural convergence of interests among transnational banks in dealing with the debtors transmitted demand from abroad to the Japanese government. Furthermore, the financial sector became more dominant and less dependent on the government's support, a trend that increased its bargaining power as the sector became internationalized, expanding "its ability to seek out overseas sectoral allies"; in short, "[f]inance is mobile, it can easily search out overseas complements," and this cross-border alliance "has strengthened their respective hands domestically."[72] Such transnational linkage and leverage translated into positive and more involved actions of the Japanese government in the debt crisis management, because of domestic dynamics.

Domestic Dynamics

The relationship between the banks and the government in Japan was crucial during the debt crisis. As I discussed earlier in this chapter, when the Mexican debt crisis struck in 1982, not only were the major American banks highly exposed to Latin American debt, but Japanese banks also had a similar or even higher debt exposure. Thus, during the debt crisis years, Japanese banks put pressure on the government. They needed governmental support to secure an exit from their heavy exposure to the Latin American debt and to create a better environment for absorbing such debt without excessively impairing their business performance. Japanese banks felt locked in and forced to contribute to debt relief for two reasons: (1) Japan's stringent regulations on loan-loss reserves and the tax deductibility of such reserves[73] and (2) the pressure of the agreements produced by the BACs with various major debtors in Latin America.

In the first five years of the Latin American debt crisis, commercial banks, creditor governments, and IFIs strove to contain this international financial problem and to later support the recovery and economic growth of the Latin American debtors. Although the debt crisis affected developing countries in other regions, it was obvious that the United States was most concerned about the problems of its neighbors to the south, where U.S. bank exposures were the highest and where its security concerns were also substantial. The Baker Plan and its modification to a menu approach mostly targeted Latin America, and all plans attempted to restore private capital inflow to the debtors with some help from the creditor governments and the IFIs. In 1986 and 1987, the deterioration of the balance-of-payments conditions of the two largest debtors, Mexico and Brazil, shifted the perspectives and strategies of commercial banks and led them to prepare for their exit. The Japanese government, which had quietly supported U.S. initiatives during these first five years, began to show increased commitment to the solution of the Latin American debt crisis, particularly by supporting Japanese banks and increasing official lending to the region.

Larger Japanese city banks and long-term credit banks have exerted a powerful influence over the Japanese government.[74] They are a tight-knit group with homogenous views and preferences about Japan's foreign economic policy. They have also been the critical actors shaping the Japanese economy, in collaboration with the government. This relationship has created strong ties with the government. Regarding international financial matters, the Bank of Tokyo functioned as a coordinator, which made the collaboration among the banks easier. Politicians also channeled the banks' demands to bureaucrats, with whom they have customarily close relationships. The bureaucrats are accustomed to reading the LDP Diet members' interests and positions and responding to their needs and wishes.[75]

A big agenda on which Japanese banks confronted the MOF during the 1980s debt crisis involved loan-loss reserves. Japan's low loan-loss reserve under the domestic regulatory environment was one major factor that led the

Japanese banks to hesitate from exiting the Latin American debt, and ever since 1982, Japanese banks had pressed the MOF for provisions to cover possible loan losses to developing countries. Unlike some European countries where banks could set aside almost 50 percent of their developing country loans as loan-loss reserves to hedge possible default, Japanese banks had no such provisions. This made it very difficult for them to tolerate any losses in developing countries, since these losses would not be covered by a reserve and would directly affect the value of the banks' assets.[76] Finally, beginning in March 1983, Japanese banks were allowed to accumulate a 5 percent loan-loss reserve for loans to countries the MOF considered high risk. Initially, these reserves were completely taxable. The banks pressed both for an increased loan-loss reserve and for its tax deductibility.[77] In 1984, thanks to heavy lobbying by the banks, the arrangements were modified: 20 percent of the loan loss reserve—1 percent of total loans—became tax deductible.

The Japanese government's role as lender of last resort and as the banks' protector was stretched further when the Latin American debt problems resurfaced in 1986 and 1987. The banks reacted strongly and wanted to get out of this never-ending spiral of financial problems, which included the moratorium by Brazil and various rescheduling arrangements. The banks became increasingly impatient with the MOF for not letting them quickly exit from this long debt ordeal. After four months of negotiation, the banks and the MOF struck a deal setting up a holding company, JBA Investment, Inc., in the Caribbean tax haven of the Cayman Islands. The company bought the Japanese banks' Latin American debt at a discounted rate. Under the new arrangement with the MOF, banks' losses were now tax deductible. The precise amount involved was tailored to make it the equivalent of a loan-loss reserve tax deductible by 5 percent—exactly the amount that the banks wanted.[78] These negotiations created the first opportunity for the Japanese banks to reduce their outstanding loans to heavily indebted countries in Latin America without paying tax on the loss.[79] The rate of reserve was increased in 1988 to 10 percent of the book value of high-risk loans, in 1989 to 15 percent, and later to 35 percent.[80]

Japanese banks' impatience with the burden of the prolonged debt problem made the Japanese government increase its private returns by minimizing banks' dissatisfaction and shortening the time that it took to resolve the problem. This led the government to propose alternative solutions. The first stage came in the form of a 1987 study by the World Institute for Development Economics Research (WIDER) in Finland and the United Nations University (UNU) in Japan, calling for a large Japanese capital recycling program. *Mobilizing International Surpluses for World Development: A WIDER Plan for a Japanese Initiative,* produced by a group chaired by the prominent Japanese internationalist Saburo Okita, proposed the recycling of the Japanese current account surplus—$125 billion over five years—to developing countries.[81]

Following the same line of thought, the Japanese government produced a practical alternative to the U.S. solution of the debt problem, an alternative that allowed Japanese banks to exit from the Latin American debt burden. The Miyazawa Plan, as I noted earlier, was formally announced during the World Bank/IMF annual meeting in Berlin in September 1988. Although the plan was not adopted, it marked a clear commitment by the Japanese government to alleviate the debt overhang in the severely indebted countries.

For Japanese banks that wanted to exit from Mexico, the 1989 Brady Plan came as a blessing. Twenty-nine Japanese commercial banks with outstanding loans to Mexico opted not to put up new money but to write off some of their Mexican debt. The outstanding stock of Japanese loans to Mexico was stable at the $11 billion level in 1988.[82] From the three options of the 1989 Brady Plan,[83] most Japanese banks chose the principal reduction option, and they converted $8 billion worth of principle into discount bonds and almost immediately sold them on the secondary market, even at a loss. About 83 percent of the Japanese banks' outstanding debt to Mexico was converted into discount bonds and then written off through this option, while only 41 percent of the total of Mexican debt reduction by other creditors was carried out through this channel. The Japanese government supported the principal reduction option, which "made it easy for [the banks], counting effectively 100 percent of their losses as tax write-offs and giving the banks flexibility in when to record their losses."[84] No new money came from Japan through the new money option, while about 10 percent of other creditors' debt to Mexico followed this option.[85] Transnational banks thus exited from Mexico by swapping their debts for bonds at a discounted rate or writing them off. Private creditors' outstanding amount of long-term debt to the Latin American countries declined slowly after this period. In the process, the Mexican debt swaps, along with a Mexican privatization scheme, invited new investments. Japanese banks and institutional investors, however, did not get on this bandwagon.

In short, transnational linkages were established among major banks highly exposed to the Latin American debt crisis, and their political power in Japan has proven to be very influential in the process of the Japanese government's policy-making. Despite the much discussed characterization of the Japanese polity as a developmental state or autonomous bureaucracy, the Japanese government was still very responsive to the pressures coming from its powerful financial sector. Institutional linkages among the transnational banks made such pressures particularly effective on Japan's decision making.

Conclusion

During the time of the debt crisis, Japan demonstrated an increasing presence in financial crisis management in the developing world, particularly as a source of development finance. Even Latin America, which was traditionally outside Japan's sphere of interest and did not have strong economic links with Japan, developed more ties with Japan, particularly on the financial side of economic exchange. Especially between 1988 and 1991, the Japanese government made an unprecedentedly strong initiative to help resolve the debt crisis, initiating and supporting debt reduction schemes both politically and financially. Japan's active involvement in providing official financial support to resolve the debt crisis made the Japanese government an important supporter in financial crisis management. Many heavily indebted countries in Latin America succeeded in reducing their debt through the Brady deals and other debt reduction measures. In turn, they began to attract private (mostly portfolio) investment based on their bond issuance and privatization. The so-called emerging markets of Latin America started booming in the early part of the 1990s, and the Latin American financial crisis appeared to have finally been solved.

The Japanese government became actively involved in the solution of the Latin American debt crisis because its actions in Latin America directly or indirectly would accomplish private returns. Its actions could protect the Japanese financial system and allow Japanese banks to exit gradually, without a major disturbance or criticism, from Latin American debtors. Its active participation also supported the United States, possibly improving Japan's most important bilateral economic and political relationship, and making it easier for Japan to enhance its power and influence in IFIs. Finally, the tight institutional linkages among transnational banks secured the meeting of private sector needs through the Japanese government's active provision of official financial resources to the region. The quantitative and microlevel analysis in chapter 3 provides support for this picture arising from the analysis of the Japanese actions in the Latin American debt crisis. The variables associated with Japan's private financial sector involvement and U.S. economic interests in Latin America increased Japan's official financial commitment in the region as well as in particular countries in the region.

The remaining task on hand is to compare the Japanese government's behavior and the factors that led to the government's active involvement in the Latin American debt crisis to those in the case of the more recent Mexican peso crisis (1994–95). This comparison should illuminate with increased robustness the importance of the level of private returns and transnational linkages.