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## **THE FINANCIAL CRISIS AND FOREIGN POLICY**

*What to Expect from the New US Administration #3*

*Naoki Tanaka*

Under the new presidency, the US federal government will have to tackle an unprecedentedly massive financial deficit problem. This will make the US' international involvement highly selective. The Japanese government will be faced for the first time since the end of World War II with the US government taking a negative interventionist policy. What does this mean for Japanese foreign policy?

*The views expressed in this piece are the author's own and should not be attributed to The Association of Japanese Institutes of Strategic Studies.*

The problem of toxic securities issued by US financial institutions, which first emerged in 2007, has finally developed into a global credit system crisis. In its attempt to defuse the crisis, the US federal government was forced to open three “umbrellas”: the first to save government-sponsored enterprises (GSEs) that have purchased and securitized mortgage-backed securities; the second to break up American International Group (AIG), a major insurer in the credit default swap (CDS) market; and the third to set up a special fund designed to buy up toxic assets and recapitalize financial institutions.

The federal government must have wanted to avoid providing all these umbrellas. However, given the seriousness of the crisis, it had to acknowledge its role as the last buyer as well as the last lender of capital; the debts accumulated by GSEs exceeded the outstanding obligations of the federal government and the collapse of AIG could trigger a global credit crunch by causing massive losses to world financial institutions.


The process by which US taxpayers will bear the costs of these umbrellas will begin in 2009. How much exactly they will cost will depend on the economic situations of the US and the rest of the world in and after 2009. The cost of the first umbrella will depend on how far US housing prices will fall and how long it will take them to bottom out. The cost of the second umbrella will depend on the level of damage suffered by financial institutions and businesses. The cost of the third umbrella will depend on how severe the damage to the value of securities was.

Given that the amortization rate of bonds issued by the now-bankrupt Lehman Brothers will become less than 15 percent, we cannot be optimistic about the costs necessary for the three umbrellas. Even at a moderate estimate, the federal government’s outstanding obligations will swell by the end of the new administration’s first term in 2012 to 1.5 times those at its inauguration; I would not be surprised if they double. Such a financial state will inevitably make US commitments to the international community drastically selective.

Firstly, the new administration will be forced to reconsider NATO’s expansion and seek to rebuild a relationship with Russia. It may refrain from deploying missile defense systems in Poland and the Czech Republic and

pushing NATO membership for Georgia and Ukraine. Secondly, the new administration will try to develop a more comprehensive Middle East policy while continuing its effort to fix Iraq. It will try to achieve a diplomatic success by addressing broader issues in the region while committed to resolving the Israeli-Palestinian conflict. Thirdly, the new administration will take initiative in countering the threats of nuclear proliferation posed notably by North Korea and Iran. To this end, it will seek to allocate diplomatic resources in a more multilateral way. Fourthly, the new administration's policy toward East Asia will basically be maintenance of status quo. China's expanding military is surely a concern for the US, but the new administration will continue to avoid confrontation with China.

Keeping the alliance with the US in good shape is one of the most important missions in Japanese diplomacy. In developing its own foreign policies, the Japanese government must consider what approach it should take to each of the US' new foreign policies. In that way, it will be able to take advantage of the US' selective international involvement.

Moreover, the Japanese government must present the whole picture of how Japan should be engaged with the rest of the world, even if its involvement is limited to nonmilitary means. The Japan-US alliance will be redefined by the shift in their approaches to the world. 

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