Ending the "Age of GAIATSU"

– Japan Confronts Need for Straight Answer to "U.S. Policy on Japan" –

By Tanaka Nobuo

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The recent U.S. presidential election was an extremely rare, extraordinarily close race. Undoubtedly the most urgent issues facing the new President include reconciling a divided public and unifying public opinion. Because the campaign promises made by both candidates in the election were not terribly different, the results are likely to strengthen the trend toward middle-of-the-road politics. The same surely goes for foreign policy, including U.S. policy toward Japan.

Fortunately, policy toward Japan played no role whatsoever in this campaign. In fact, China policy was the only focal point in the foreign relations arena. With the ongoing stagnation of the Japanese economy, the Japan-bashing of the past has dissipated. While working in the United States for two years prior to June 2000, I never had any first-hand Japan bashing experiences. Quite the contrary, I was treated by some former bashers I once knew with a great deal of sympathy.

Premise of "Disequilibrium" between Japan and the United States

Nonetheless, one could hardly say that all traces of friction in the Japan-U.S. relationship have been eliminated since the presidential election. In states, like Michigan and Pennsylvania, that have a lot of voters and a conventional industrial structure, the steel and automobile labor unions are strong, and the Democratic Party, which relies heavily on their support, takes a harder line on trade with Japan than the Republican Party. To help the Gore campaign, the Clinton administration insisted on holding Japan-U.S. automotive trade talks before the election, and Gore's campaign promises included an emphasis on labor unions with regard to auto and steel trade. Bush's experience as the governor of Texas may have held the key to his success in figuring out how to cooperate with southern Democrats. With an evenly divided Congress, it became clear that the influence of the labor unions would remain strong regardless of the election outcome.

In the past, Japan-U.S. friction has tended to be triggered by downturns in the American economy. Whenever a U.S. economic slowdown was accompanied by a surge of exports from Japan, protectionist trade rhetoric would reappear. Japan's current trade surplus with the United States is taking a backseat to the fray with China, which is the "worst one" for the United States. But if the surplus continues, there is a good chance that Japan-U.S. frictions could once again rise to the surface, depending on the direction the U.S. economy takes.

An even graver problem still is that this disequilibrium between Japan and the United States is not a result of overall economic conditions, exchange rate problems or issues of trade competition, but of the many asymmetries found in the economic structures of the two countries. Japan maintains a current-account surplus as a result of its under-consumption, over-saving, government budget deficit and an export-oriented economy that directs investment into export industries. The U.S. structure, meanwhile, is the mirror image – a huge current-account deficit as a result of its over-consumption, low savings, budget surplus and a domestic demand-oriented economy that directs foreign investment into domestic industries, especially those in the service sector. The imbalance is sustainable between the two. And surplus capital from Japan is circulated back into the United States. Japan's money flows into the United States are due to Japan's inability to find domestic consumption and investment opportunities on which to spend its wealth accumulated by exports, and has created a bubble in the U.S. stock market, which, in turn, supports American over-consumption through the wealth effect.

As long as this process continues smoothly, it won't present any problems and may in fact be considered a mutually complementary relationship. Common sense dictates, however, that this is not sustainable. If Japan accumulates an enormous current-account surplus, and the United States, as the world reserve currency supplier, continues to print and circulate more dollars without reducing its cumulative deficit, a day will come when the world's investors are going to lose confidence in the dollar and the dollar will come crashing down. To avoid this scenario, the U.S. government has to suppress spending and encourage savings. Japan, on the other hand, needs to implement economic structural reform that achieves domestic and private demand-led growth.

These are tall orders for both countries, however. At my speaking engagements in the United States, I repeatedly said, "Making the Japanese spend is as difficult as getting all of you (Americans) to save," and many people agreed. I continued, "The Japan-U.S. disequilibrium is not a 'Japanese problem' but a 'mutual problem' that has arisen from the symmetrically opposite economic structures of the two countries." The audience understood. But, understanding something and putting it into political practice are two very different things.

Policy Proposals for Japan

Any discussion of the future Japan-U.S. relationship must start with an acknowledgement of three points: that beneath the surface calm lie seeds of friction between the two countries; that the tendency toward disequilibrium is rooted in that foundation of potential friction; and that the solutions will be politically difficult.

That given, let's turn to the new administration's likely policy toward Japan. Propositions issued before the election – and today – by various think tanks will serve as reference tools. I can think of five reports that specifically focus on the Japan-U.S. relationship: a Council on Foreign Relations paper by Bruce Stokes, another Council on Foreign Relations paper by former National Economic Council chair Laura Tyson, a report by C. Fred Bergsten at the Institute for International Economics, a report on security issues by Richard Armitage, a senior foreign policy and defense adviser to the Bush administration of 1989-1993, and a proposal by David Asher, a senior researcher at the American Enterprise Institute.

The first of these to come out was the U.S.-Japan "open marketplace" concept by Stokes. He argued the importance of rejuvenating the Japanese economy and described the U.S.-Japan "open marketplace" as an environment in which economic structural reform measures – such as the recreation of the financial infrastructure, deregulation to encourage new businesses, competition policies, corporate governance reform, and expanded direct investment in Japan – are encouraged. Meanwhile, tariffs are eliminated and regulations are loosened to create a business-friendly environment. He argued that this should be implemented by 2010. In order to avoid detailed legal discussions and political opposition from American and Japanese farm lobbies, he used some rather obscure terms to make his argument, but essentially it boiled down to a common market or free trade agreement (FTA). If he has to be labeled, Stokes would be more of a Democrat than a Republican, but the content of his argument is similar to the idea of revising the U.S.-Japan Friendship Commerce and Navigation Treaty proposed by Asher, a Republican.

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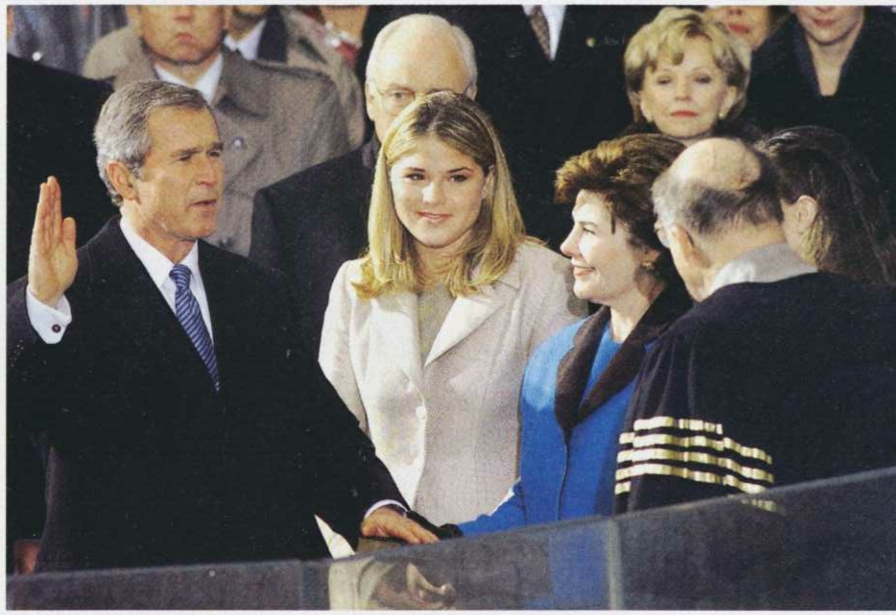

George W. Bush (left) is sworn in as the 43rd President of the United States on Jan. 20, 2001 by U.S. Supreme Court Chief Justice William Rehnquist (right/foreground)

The other Council on Foreign Relations paper by Tyson, by contrast, is generally similar to Stokes except that she opposes the "open marketplace" idea. The report by Tyson, a hard-liner toward Japan during Clinton's first term, is surprisingly non-confrontational. Richard Katz, a member of the Tyson group, says this is because Japan is not the threat it once was, and it reflects the fact that Japan is currently outside the range of the Washington radar screen. Bergsten likewise says that the United States and Japan have a "normal relationship" and that therefore it would seem strange to take any special steps. The Democratic Party – excluding Stokes's argument – is leaning toward not making any changes to the former administration's foreign policy, while the Republican Party starts by rejecting it.

In any case, the common element in all of these proposals is the appreciation of Japan's efforts to undertake economic structural reform, which is extremely significant in discussing the future Japan-U.S. relationship. If one assumes that this kind of recognition is spreading in the United States, and the Japanese government continues to exhibit a strong commitment to structural reform, the risk of a worsening Japan-U.S. relationship will be greatly reduced even if the shadow of the economic downturn stretches on to the American economy.

It is important to understand that the Stokes or Asher proposals are addressed in conjunction with domestic structural reform. The significance of those issues will be addressed in more detail later, but first let me raise one concern about what the Stokes proposal calls a "proactive trade policy." He says that to achieve a U.S.-Japan open marketplace, the United States must use pressure from Congress and other administrative measures to urge Japan to participate. The words sound fine, but in essence it is nothing more than Japan bashing.

The Age of Foreign Pressure is Over

After the arrival of Commodore Matthew C. Perry at Uraga in

Kanagawa Prefecture, *gaiatsu* (though translated as "foreign pressure," the term "gaiatsu" has come to be used in English as well) was necessary for opening Japanese ports or markets to foreign trade. Today, however, foreign pressure is not what is needed for economic structural reform. The goal of Stokes's "open marketplace" is a gaiatsu friction-free economic partnership between Japan and the United States. Achieving this through the use of pressure represents a contradiction between the ends and the means. Actually, among the various policy recommendations made to Japan, there is a great deal of awareness of the need to achieve goals by encouraging reform efforts within Japan. For example, even Stokes himself states, "Gaiatsu can be smarter – in choosing allies within Japan"

It may be necessary to employ the help of outsiders to change the system. Successful insiders have been captured by the system and thus cannot reform it. In the corporate governance mechanism of the United States enabling companies to expel their presidents, companies are largely controlled by the existence of outside board members who make up a majority of most executive boards and also by pension funds that oblige them to live with fiduciary duties under the ERISA rules for investment.

An important change in this regard is that direct investment into Japan is increasing rapidly, and has reached about 1/3 the level of foreign direct investment from Japan. Considering it was only about 1/10 of that level up until several years ago, and the number alone was proof of Japan's closeness, there have clearly been major changes. The 1995 report by the Industrial Structure Council stated, "This is an era in which companies get to choose their countries," and the Ministry of International Trade and Industry's (MITI; now the Ministry of Economy, Trade and Industry [METI]) industrial policies have focused on "how to be the country that companies choose." The age in which industrial policy meant cultivating Japanese-made computers to compete with IBM has come to an end, and the aim today is to welcome foreign capital as a new player in the market that creates employment and fosters competition. Bergsten, who recently came to our brown-bag lunch seminar, said, "Direct investment in Japan is a kind of privatization of gaiatsu." This is a casual, but interesting expression. Undertaking reform is Japan's own problem, and the Japanese fully recognize that they have to do it on their own. Lectures and bashing from the outside are useless and counter-productive. What would be useful, however, would be to have foreign capital come into Japan and stimulate reform by creating competition. Indeed, this is what is already happening between the United States and Europe.

Photo : REUTERS•SUN

The State of the Union Address delivered by President Clinton on Jan. 19, 1999 pointed the finger at the steel industry in its criticism of Japan

The Trap of "Multilateral vs. Bilateral" Thinking

So what is the significance of an "open marketplace"? This is a theme that must be considered in relation to developing a global trade regime. First let's examine the conceptual changes of multilateralism and bilateralism.

By concluding voluntary export restraint agreements, which began with textile negotiations between Japan and the United States in the 1960s and extended to color TV sets, steel, automobiles and machine tools, Japan was able to avoid trade friction with the United States. Under the liberalism of President Reagan in the 1980s, however, the United States shifted from eliminating disequilibrium by demanding not that Japan restrict its exports, but that it open its markets. This started the long-running friction in the semiconductor industry. Due to the 20% market share target established in the semiconductor agreement and the sanctions imposed on Japan when that target was not met, MITI rejected the idea of setting numerical targets and distanced itself as much as possible from bilateral deals. Since then, this has become a real source of trauma for MITI. As a result, Japanese trade policy became grounded in rule-based multilateralism focused on the Organization for Economic Cooperation and Development and the World Trade Organization (WTO), and in loose regional ties through the Asia-Pacific Economic Cooperation (APEC) Forum.

It is unfortunate, however, that the phrase "bilateralism is over" became the Japanese slogan for this period of antagonism between Japan and the United States or between MITI and U.S. Trade Representative. Outside of Japan, there was a great deal of emphasis on regional trade agreements aimed at creating some kind of common markets, such as the European Union (EU) in Europe, North American Free Trade Agreement in North America, MERCOSUR in South America and the Association of South East Asian Nations (ASEAN) in Southeast Asia. The only countries in the world that do not belong to some kind of regional bloc are Japan, China and South Korea.

There haven't been any such major trade friction incidents between Japan and the United States since the 1995 Automotive and Parts Arrangement. But at the 1997 APEC Ministerial meeting conflicting strategies were taken by the United States and Japan vis-à-vis the next round of negotiations. While Japan tried to support the WTO regime through loose cooperation with APEC members, the United States tried to make APEC members voluntarily commit themselves to the early liberalization of trade in certain sectors, including agricultural products. The United States aimed at isolating the EU in agricultural liberalization negotiations. Ironically, this strategy eventually pushed Japan to ally with the EU in the comprehensive agreement approach in the next WTO round.

In 1998 an incident, the likes of which hadn't been seen since the earlier era of friction, occurred when steel exports flooded U.S. markets due to very weak domestic demand in Japan and caused a resurgence of classic trade friction. The State of the Union message of President Clinton put the blame on the steel industry in its criticism of Japan. This steel problem wasn't resolved as a bilateral issue until exports to the United States returned to their previous levels. Japan, wanting to bring the issue of anti-dumping procedures to the negotiation table during a new round of trade talks, began rubbing noses with developing countries, leaving the United States isolated at the WTO Ministerial Meeting in Seattle. The U.S. President, however, needed the political support of the steel labor unions and consequently hardened his attitude toward labor issues. The report said that the United States "will impose sanctions on exports from countries that do not meet certain labor standards." This served to completely alienate the developing nations, and the Seattle talks failed to launch a new round.

Although free trade is a life-and-death issue for both Japan and the United States, U.S.-Japan cooperation on launching a new round in Seattle completely disintegrated. Certainly this happened primarily because the United States was not willing to compromise, but it also bore the lesson that multilateralism cannot be realized without the bilateral cooperation of these two major countries. In other words, multilateralism and bilateralism should not be seen as being mutually exclusive, but need to be used together in effective coordination. It is unfortunate that a framework for liberalizing industries that would support the new economy, such as service industries and e-commerce, could not be constructed at the WTO talks due to the lobbying activities of waning industries like steel and agriculture. But an inevitable reality is that economic rationality alone is often powerless against politics.

Singapore's Challenge

Of useful reference here will be the bilateral FTAs being promoted by Singapore, known as the New Age Economic Partnership Agreements. Singapore is considering agreements with such countries as New Zealand, Australia, Chile, Japan, and most recently the United States. These agreements allow Singapore to keep one foot in the ring with ASEAN while creating a hub of economic partnerships for the new era.

Seven years after the end of the Uruguay Round, trade negotiators steeped in negotiations in Geneva have been criticized for not being able to keep up with trends in information technology (IT) and globalization. Singapore's pragmatic approach is based on the idea that it is easier to create several bilateral agreements with several willing partners, and then work to expand those agreements multilaterally. These bilateral agreements are subsystems to the global system and complement the WTO. Economics teaches that if one country unilaterally opens its markets, the surplus that will be created by increasing incomes in its partner country and by falling domestic prices caused by imports into its own markets will be returned to it in other consumption, thereby accelerating economic growth. Japan has begun to make bilateral efforts not only with Singapore, but with South Korea and Mexico as well. The Japan-South Korea FTA idea initiated by President Kim Dae Jung has the potential to effect major changes in the historical relationship between the two countries.

The use of the wording "new age" in Singapore's agreements indicates that they differ from conventional regional FTAs on several points. First, in addition to liberalizing trade in products and services, the new agreements also facilitate cross-border flows of people, capital, and information. Second, based on the understanding that market competition and technological innovations lead to higher economic growth, the agreements include plans to ensure technological innovation and competition in their integrated markets. Third, it indicates that the agreements will start by focusing on what can be done instead of what cannot, and will foster an ongoing process of review and reform that incorporates creative experimentation.

The agreements emphasize the fact that the new economy will be borne on the shoulders of IT, service industries, education, and personnel transfers. Singapore is not one of Japan's neighbors. It is as far from Japan as Alaska and differs in terms of culture and size. Still, given the importance of the new economy, Japan and Singapore are trying to conclude a bilateral agreement within 2001. Both also hope to raise the level of creativity and flexibility in their economics through mutual stimulation.

Possibility of a New Age Economic Partnership between Japan and the United States

What can the Japan-U.S. relationship learn from efforts to create a partnership with Singapore? The differences in size of the American and Singaporean economies and the degree of their dependence on Japan do not lend themselves to comparison. Given the large weight of trade between Japan and the United States in traditional sectors such as agricultural products, steel, and automobiles, an approach focused on conventional trade sectors makes an FTA between the two counties politically impossible at this point in time.

In the future, however, IT, telecommunications and financial services will be the keys to economic growth. The

Photo : REUTERS•SUN

Singapore's Prime Minister Goh Chok Tong (left) shakes hands with his Japanese counterpart Mori Yoshiro at the start of negotiations for a free trade agreement between both countries on Oct. 22, 2000

WTO has agreed for now to exempt e-commerce from taxation. In an era in which companies choose their countries, a country's international infrastructure will be as much of a factor as its domestic infrastructure in a company's decision-making process. The fact that IT has nullified the geographical distance between countries makes the Singaporean approach all the more appealing.

If globalization is to produce integrated markets regardless of distance, then liberalizing the flow of information, people and capital between the two economic powerhouses of Japan and the United States would be the first step in that direction and would be of incalculable economic value. Nevertheless, promoting that kind of market integration will require mutual economic structural reform efforts by both countries as mentioned earlier. As was necessary for market integration in Europe, this would require the harmonization of competition, structural, and macroeconomic policies.

Returning to the Japan policy proposals discussed earlier, Armitage supporters agree with the creation of a new age FTA between Japan and Singapore, arguing it could be a test case for creating similar agreements with other interested countries such as South Korea, Canada, and the United States. The Stokes proposal is none other than a plan for concluding this kind of new era economic partnership between Japan and the United States.

Stokes warns, "If two economic superpowers do not have a long-term goal defining their economic relationship, that relationship gets defined by a laundry list of short-term problems." He argues, "This is the trap Washington and Tokyo now find themselves in. An open marketplace initiative is the way out."

Even so, it is dangerous and wrong to believe that these frictions have ended. As mentioned earlier, trade friction sometimes occurs as a result of economic conditions in both countries at a particular time and how those conditions are handled. Dispute settlement mechanisms are needed both within the WTO and on a bilateral basis.

Yet, if progress can be made on harmonizing market rules while both countries proceed with economic structural reform, it may be possible to find solutions for resolving individual issues amidst larger systemic reforms. For example, the reason that dumping is not considered a problem domestically is not that it is illegal to cut prices, but because of concerns that such behavior will be considered "predatory practices" under the anti-trust laws. Consequently, if both countries were to enforce domestic competition laws in exactly the same way, anti-dumping problems would never occur legally. The enforcement of common anti-monopoly laws in the EU has meant the prohibition against imposing anti-dumping taxes within the region. Even the Tyson report, which does not make the open marketplace a goal, indicates that if the economies of Japan and the United States were to be integrated, "sectoral trade disputes are likely to become the exception rather than the rule in U.S.-Japan economic relations as they were during much of the last twenty years."

Indivisibility of Security and Economics

How can Japan respond to these challenges from the United States? Responding to this question raises another unavoidable issue: security. For example, the Armitage group report titled "The United States and Japan: Advancing toward Mature Partnership" pointed out "it is time for burden-sharing to evolve into power-sharing." Unfortunately there is no room here to discuss the problems they raised regarding the way Japan exercises its right to collective self-defense. Nevertheless, a country's security is closely related to its economic strength. The Armitage report says, "An economically healthy Japan is essential to a thriving bilateral partnership." Each country had its share of security experts who, during the Cold War, were proud to say, "The U.S.-Japan security relationship will not falter even if trade frictions exist." Conversely, one could say that the U.S.-Japan relationship was treated with special care, and thus kept the relationship from worsening as a result of trade friction.

How can Bergsten's "normal" relationship, Armitage's "mature" relationship, and Stokes' and Asher's market integration all coexist? Recent reports argue that the 21st century Japan-U.S. relationship needs to be reevaluated from both the perspectives of economic integration and security issues.

The new U.S. administration will first have to focus on reunifying the country, but at some point the new president will begin talking about foreign policy. Before then, there's little time left for Japan to respond to the proposals made by Japan-U.S. specialists. JJTI

Tanaka Nobuo is the vice-president of the Research Institute of Economy, Trade and Industry (RIETI), METI.