

Asia Pacific

I S S U E S

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The Center promotes responsible development, long-term stability and human dignity for all people in the region and helps prepare the United States for constructive involvement in Asia and the Pacific.

SUMMARY The latest U.S.-Japan trade dispute and the shuffle in Japan's top leadership should not divert U.S. attention from the need to design a new trade policy toward Japan. A "get tough" policy driven by disputes involving specific industries is not enough; the United States also needs a "get smart" approach more focused on resolving fundamental trade imbalances and pushing for growth and deregulation in Japan. Japan must be encouraged to take strong measures to stimulate domestic demand in order to change the driving force behind its economy from exports to domestic consumption. The United States should entrench itself in Asia, working for economic integration through the Asia-Pacific Economic Cooperation (APEC) forum and forging a link between Asia and the new North American Free Trade Agreement (NAFTA)—possibly by allowing Asian countries to join NAFTA. Finally, the United States must put its own economic house in order by rekindling productivity growth and narrowing the gap between incomes, rewarding small and high-tech entrepreneurs, and removing disincentives to exports.

The important economic and political relationship between the United States and Japan has for too long been defined by trade disputes involving the impact of Japan's export-led growth on specific U.S. industries. These sectoral disputes have given America a distorted picture of the full relationship and obscured other developments in the region. U.S. political leaders, under great pressure to "get tough" with Japan, manipulated exchange rates, called for targeted market shares, and imposed import surcharges, embargoes, and retaliatory sanctions during the 1970s and 1980s. Many of these "get tough" efforts were exceedingly narrow, reactive, and shortsighted. Japan's reaction was equally limited and uninspired.

Rather than just a "get tough" policy, a new U.S.-Japan relationship must also reflect a "get smart" policy in which toughness means the tenacity to keep the focus on the major economic and political issues, where the interests of both countries are often similar—for example, on economic growth and political stability in East and South Asia. The sectoral approach, generally unpopular in Japan, helps fuel opposition to changes of more long-term importance such as fiscal stimulus and deregulation. The bilateral relationship is too important to be driven by sectoral issues alone, and must be integrated into a larger set of regional and global issues.

A "get smart" policy would do the following:

- *Focus on opening and expanding the Japanese market.* This can be done by pressing for deregulation to promote new foreign entrants and by urging fiscal stimulus to energize consumption-led growth as opposed to Japan's traditional export-led growth.
- *Reexamine Japan's role in America's total trading universe.* This universe of possibilities now encompasses the industrialized economies of the European Union, the emerging markets of Latin America, the burgeoning Asia-Pacific region, and the former Soviet bloc. The picture is much too large and diverse—as the recent NAFTA and GATT agreements underscore—to

permit trade policy and politics to be driven by an overstated Japanese challenge.

A Window of Opportunity

There are several reasons why it is clearly the right time to develop a better U.S.-Japan relationship in the context of better all-around trade and international economic policies. Most important, the fear that Japan was about to bury the United States seems to have receded. This change in perception should allow American leaders to reengineer the country's policies in a more realistic atmosphere. At the same time, there is new reform-oriented political leadership in both countries, and the arrival of new geopolitical problems with the end of the Cold War has also created a climate for change.

U.S. resurgent, Japan stumbles. The United States is more competitive and confident than it has been in decades, once again the most productive developed economy with some of the lowest manufacturing costs. In response to global competition, recession, and deregulation and structural change, the private sector has rationalized its operations, pared waste, flattened management structures, held down labor costs, and intensified its technological base. These changes were aided by the correction in the dollar's exchange rate. U.S. firms, building upon their lead in high-tech innovation and skills, have made their high-tech service centers much more productive and advanced than Japan's. U.S. industry is increasing domestic investments and output, maintaining exports, and adding workers even as imports rise.

In Japan, on the other hand, the mood is gloomy as the nation experiences the longest recession since World War II. In 1993 economic growth was virtually flat for the first time since the oil crisis two decades ago. This less confident attitude in Japan may help create a better relationship. Many Japanese believe the country has severe structural problems, in large part due to a maturing economy, that will require a wrenching change in investment strategy. And more people in Japan now believe

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Japan's economic health may require open markets

that restructuring, including opening the country's markets, may be an indispensable element in restoring economic health.

Reform-oriented leadership. These economic changes coincide with the ascension in both countries of new political leadership committed to reform. President Bill Clinton, the "New Democrat," is committed to attacking the "brain dead" ideas of both U.S. political parties and creating new coalitions. Prime Minister Morihiro Hosokawa led a political reform process that, after a transition period, should help usher in economic policy reform. These changes have broad support among Hosokawa's likely successors in the coalition that replaced the long-running rule of the Liberal Democratic Party. As a result, Clinton has less need to follow 1980s' thinking about "managing" trade problems and can instead encourage the Japanese government toward structural regeneration that is enhanced by market-opening initiatives.

The end of the Cold War paradigm. The end of the Cold War has cleared the way for new security arrangements that may paradoxically have more tangible benefits for Japan than did the previous arrangement. Japan is now feeling pressure from a potentially very troublesome North Korea and its muscular Chinese neighbors. The United States and Japan also share a common interest in developing Asian institutions similar to those developed by the United States and Europe, moving from resolving trade disputes bilaterally to building multilateral or possibly regional institutions. Both countries face competition from newly industrializing countries with well-educated but less costly labor. Another long-term challenge for both lies in extending developed-country standards on the environment, human rights, workers' rights, and other social issues.

The 'Japan Problem' Debate

Despite the window of opportunity, the relationship is still dominated by old thinking. In the U.S. debate about Japan, one side—that of the so-called

"managed traders"—sees the Japanese way as so powerful and successful that the United States will have to manage trade more or less as the Japanese do in order to compete. The other side retains a fragile confidence in the ability of Americans operating in relatively free markets to meet and turn back the Japanese challenge. Any reengineering of the U.S.–Japan relationship by the Clinton administration will require a choice between these two perspectives. If the Clinton administration decides that Japan's present economic difficulties are fundamental and not just a cyclical setback, U.S. officials will more easily shift their attention to challenges that will confront both countries in the future. If, on the other hand, the administration sees Japan's difficulties as a temporary setback after which Japan will continue its managed-trade march on its trading partners, the response is likely to be more confrontational.

Where Do We Go from Here?

The most important U.S. objective must be to open up the Japanese economy and encourage the shift from exports to domestic consumption as the engine fueling investment and growth. If, however, the framework negotiations become bogged down in deals involving specific industries, the Clinton administration will be waylaid much as its predecessors were. A smart approach must keep a balanced focus on macroeconomic issues such as growth rates and the exchange rate, structural issues such as the thousands of regulations dictating commerce in Japan, and sectoral issues in automotive and other specific industries.

Macroeconomic issues. *Japan should be encouraged to take strong measures to stimulate demand.* High public and private savings rates coupled with low inflation give Japan ample room to stimulate domestic consumption and spur import growth. Although the stimulus packages and deregulation measures of the past two years have proven inadequate, the Finance Ministry continues to resist meaningful, long-term fiscal stimulus. The

Central Bank governor has warned of dire inflationary consequences from such fiscal stimulus plans, yet inflation remains virtually nonexistent. Relying on low interest rates in the past triggered a weaker yen that increased the trade surplus and also led to the "bubble economy" in Japan. The Ministry of Finance should learn from past miscalculations and rely on fiscal measures, especially significant tax reform, rather than on monetary policy to stimulate demand.

Neither U.S. trade protection nor short-term exchange rate manipulation will do as much to reduce the long-term trade imbalance as will strong growth and deregulation in Japan. Trade patterns between Japan and the United States track growth rates closely, and the yen/dollar relationship roughly tracks the trade figures over the long term. If Japan stimulates growth, it will import more; if it imports more, the impact on the yen will be downward. If unsustainable exchange rate intervention is put before growth, it will fail in the long run, and an overreliance on exchange rates to tackle some of the macroeconomic imbalances will generate volatility.

Yen appreciation may help the trade balance but has other effects that will set back efforts to open and expand the Japanese market. For example, a stronger yen hampers foreign direct investment in Japan, which generates imports and creates new entrants that break up the traditional arrangements in Japan, much as foreign investment has increased competition in some U.S. sectors in recent years.

Structural reforms to encourage imports. *Significant structural reform is needed in the context of renewed growth to make the Japanese markets more porous and accessible.* Clearly, more than macroeconomic adjustments are needed. Some discouraging projections suggest that a 1 percent increase in the growth rate in Japan would reduce its trade surplus by only \$4 to \$5 billion dollars. Reform of Japan's intellectual property rules, expansion of the Japanese retail and wholesale distribution system, strengthening of Japan's product liability law, and parallel enforcement of the two

countries' antitrust statutes are all areas for continued attention.

The assumption underlying structural negotiations is that convergence between the U.S. and Japanese economic systems must be accelerated to head off at least the most serious frictions. But should Americans be seeking convergence around their standards on some issues, around Japanese norms on others, or at some middle ground on yet others? Are there areas in which the differences are either so great, or conversely so inconsequential in their effects, that convergence is impossible or unnecessary, and should the United States and Japan then follow the lead of the European Union nations in agreeing on "mutual recognition" of their different standards?

The United States and Japan should work toward creation of an international code of investment to limit governmental interference in companies' international operations and a code on competition to harmonize antitrust policy. Additional microeconomic issues to be tackled in negotiations derive from the concerns over "unfair practices" and "collusive behavior" by Japanese companies, including such actions through their investments in the United States. Competition policy is especially important because the *keiretsu* system of associated companies poses a barrier to foreign companies. Convergence in the direction of norms in America and most other countries—not to eliminate the efficiencies of *keiretsu*, but to make them more internationally compatible—should be one goal. While agreement on competition and antitrust policy and investment rules are important bilateral objectives, it may be more realistic to reach agreement with the European Union before attempting such an arrangement with Japan.

Japan should not wait until negotiations are complete to open unilaterally through deregulation. Over the last 10 years Japan made \$325 billion in business investments abroad with 40 percent in the United States while the United States made only \$22 billion in Japan. Foreign direct investment is not only a means of structural opening but an important generator of exports from U.S. multina-

**The best cure
for the trade
imbalance is
growth and
deregulation**

tional corporations to their subsidiaries abroad. Agreement on investment rules would help deal with some of the sharpest criticisms now levied against Japan: lack of reciprocity on direct investment, tolerance of corporate oligopolies, and inadequate tax payments by the U.S. subsidiaries of Japanese firms.

Limited sectoral negotiations. Sectoral approaches are needed to deal with specific trade barriers that are causing serious problems and to maintain U.S. domestic political support for open trade. But the danger of sectoral approaches is clear: political muscle, more than markets or real opportunities for trade gains, will determine the sectors to be negotiated. Moreover, sectoral approaches lead to unrealistic expectations. According to the President's Council of Economic Advisors, if Japan were to eliminate all formal and informal barriers to trade, U.S. exports would increase between \$9 and \$18 billion per year. Removing all such barriers still leaves much of the \$60 billion U.S. trade imbalance with Japan, and much of the trade—such as automobiles and auto parts, semiconductors, machine tools and textiles—has already undergone “managed trade” treatment. The fact that large problems remain suggests the limitations of an approach focusing on sectors. Still, some negotiations should be pressed on their merits—if only because the modest successes help move both countries in the right direction until the fundamentals change.

Before targeting a single industry for bilateral trade discussions—or insisting on numerical targets for market share—the United States should review the relationship of that industry to overall U.S. trade goals. It makes no sense to expend limited resources in areas where the trade payoff is likely to be too small to matter, or for industries that have made insufficient efforts to increase overseas sales.

At the U.S. International Trade Commission (ITC), experts examine the competitiveness of each industry that asks for new government regulations to erect border barriers of protection. Why not do the same before asking another nation to manage

its markets by setting aside market share for a particular product? One model for such an investigatory body is the Clinton-initiated National Commission to Ensure the Competitiveness of the Airline Industry, which investigated trade along with many other competitiveness issues. Unlike the ITC, which can only seek import relief, such a body would be able to recommend such things as technology assistance or regulatory relief.

A Bilateral Relationship in a Regional Framework

To advance a trade policy that expands trade and investment with Japan, the United States should pursue more regional initiatives in Asia. This would reflect America's shift toward the faster-growing, more receptive markets in Asia, and many U.S. objectives with Japan could be advanced if the bilateral dialogue was reinforced by regional negotiations.

Most exporting nations, Asian and otherwise, can sympathize with America's efforts to open the Japanese economy to imports. Japan's fastest-growing surpluses are with other Asian nations, not the United States, their major market. Asian exporters are also aware that inroads for exports into Japan have been more successful when the products come from Japanese-owned factories shipping back to members of Japanese *keiretsu*.

A regional market is beginning to form in Asia primarily in response to market forces, not governmental arrangements. But these bottom-up developments driven by Japanese and Chinese capital investments should alert American business leaders and government policymakers that they must initiate more trade and institutional ties or become increasingly less influential.

The specter of a U.S. withdrawal into its own hemisphere is disturbing to East Asian nations. President Bush's proposal to extend NAFTA throughout the Western Hemisphere, a prospect that President Clinton has publicly contemplated, reinforces Asia's concerns. Now that Congress has approved NAFTA, the United States must im-

***The United States
should entrench
itself in Asia***

plement policies that (1) will not send the wrong signal to Asia; (2) will capitalize on the opportunities in that vast marketplace; (3) will provide a crucial balance to Japan's influence in the area; and (4) will provide the necessary political and security leadership in the region as it undergoes unavoidable, challenging political transitions. This is particularly important in 1994 as the United States hosts a Latin American summit in Miami in December during which the expansion of NAFTA will be discussed.

Thus, the administration must move rapidly to pursue three broad initiatives:

- *Transform APEC so it provides a regional framework for economic cooperation and integration.*
- *Lay the groundwork to forge a link from NAFTA to Asia*
- *Strengthen U.S. commercial ties in the region through improved export financing and promotion programs*
- *Reinforce the process of open regionalism to avoid formation of trading blocs*

APEC, although less than five years old and still fragile, is the best potential forum for seeking closer ties and building confidence among Pacific nations. So far, APEC has been a floating forum more for talk than action. If achieving consensus becomes an excuse for going as slow as the most recalcitrant member, APEC developments will not serve American interests in a timely fashion.

Even as the United States pursues modest goals through the slower, consensus-oriented approaches in APEC, it must look for other ways to demonstrate positive engagement in Asia for symbolic as well as for economic and strategic reasons. The United States must entrench itself in Asia to ensure that it will be included in future arrangements in the region. One way is to look East as well as South for future members of NAFTA. Chile has already been promised membership, and there is nothing in the NAFTA accession clause or implementing legislation that would prevent an appropriately open Asian nation from being next in line.

This would have a number of benefits for the United States. It would be an important signal of

U.S. interest in the region, and dispel fears in Asia that NAFTA will discriminate against or ignore Asia. Moreover, the inducement of NAFTA membership could encourage less open Asian countries to adopt much-needed economic liberalization as the process of constructive cooperation deepens both within APEC and between Asia and NAFTA.

There will be some resistance in some Asian APEC members to a bridge between NAFTA and Asia. The Japanese, for example, are concerned that NAFTA entry for other, more open Asian economies would be a divide-and-conquer move by the United States. In fact, such an effort would be a vivid demonstration that the United States does not hesitate to move toward more open trading arrangements with economies that offer reciprocal benefits, and this might have a strong positive effect in spurring Japanese liberalization. Eventually the NAFTA-Asia link might develop into a Pacific Area Free Trade Agreement (PAFTA).

Such an arrangement spanning the Pacific is at least a generation away, but the groundwork can be laid by sharing information between NAFTA and APEC as well as among other subregional Latin and Asian trade groupings. A monitoring organization might be set up to deal with disputes between the regions; for example, when one group believes another is adopting rules that discriminate against non-members. These measures would reinforce the ongoing process of open regionalism—regional arrangements that are nondiscriminatory and transparent, allowing ties between countries in the same region but not erecting barriers to countries outside the region.

Reinforcing the U.S. domestic economic base.

Essential to any "get smart" trade policy is for the United States to "get prepared" at home. To assure continued global leadership, the United States must enhance its domestic economic base by rekindling productivity growth and reversing widening income inequality that threatens the nation's social fabric. The key to solving these dangerous social problems is investment in human resources, which drives the competitive advantage of nations in this age of globalization.

To get smart, the United States must get prepared

There are many hopeful signs that the United States is getting its domestic house in order. Most significantly, the Clinton program aims to reduce the federal deficit by \$500 billion in five years. President Clinton in his State of the Union Address on January 25, 1994, stated that the United States managed to cut \$255 billion in spending in 1993 alone. The Congressional Budget Office lowered its estimate of the deficit for the current fiscal year ending September 31, 1994, to \$223 billion—\$68 million less than projected a year ago—and expects the budget deficit to shrink to \$166 billion in Fiscal Year 1996.

**Small entrepreneurs
are the major source
of new ideas
and jobs**

To gain in overseas markets—in Japan and elsewhere—the Clinton administration must foster a renewed entrepreneurial spirit in America by targeting export financing and promotion assistance to small companies and high-tech industries. Many have been arguing that the age of U.S. competitiveness is over. This defeatism is wrong. Thousands of small, risk-embracing, entrepreneurial firms are challenging larger conglomerates in many areas and represent America's hope for the future. These are the companies that are expanding, while larger companies are contracting.

The Clinton administration, in order to expand rather than manage trade, must encourage entrepreneurs large and small to boldly explore the global marketplace. All exporters will benefit from expanding overseas markets, and renewed entrepreneurial spirit will be rewarded both at home and abroad. An emphasis on general growth rather than individual sectors more effectively takes into account the medium and small entrepreneurial businesses—the major source of new ideas and jobs in the U.S. economy. These companies, however, tend to lack political muscle because they are spending their time at work on their shop floors or in marketing, not in Washington. As a result, their interests tend to be underrepresented when Tokyo and Washington design sectoral deals.

An expansionary trade policy must focus on export promotion and financing while easing export obstacles. The Clinton administration recognizes the export imperative and has made signifi-

cant strides in removing domestic export disincentives that were costing an estimated \$40 billion annually. Cold War-era export controls that have required some form of written permission for 30 to 40 percent of all U.S. manufactured exports are undergoing urgent revamping. Meanwhile, there is a need to reset budget priorities and streamline the 19 U.S. federal agencies operating more than 150 export promotion programs. Currently, agricultural promotion programs receive around 75 percent of outlays even though agricultural goods constitute only 10 percent of U.S. exports.

Toward Balanced Global Leadership

The United States will need to pursue tough and smart negotiations with Japan on macroeconomic, structural, and sector-specific issues. It should deploy a regional engagement strategy together with a bilateral approach. Much more importantly, the United States will have to adopt a wide-ranging series of domestic reforms to meet the challenge from Japan and other countries.

Japan and the United States are at very different points on the spectrum of international leadership. The United States has been the clear leader of the international economic and security systems throughout most of the postwar period. Japan has been the quintessential "free rider," defended by someone else and benefiting enormously from an economic order created and nurtured by someone else. The United States wanted Japan to play such a deferential role in the earlier postwar period, but that day has long passed. Japan has already begun to take a lead in areas such as foreign aid, where it is now the largest donor country in absolute terms.

Neither country, however, has had much experience in international power sharing. Japan's exercise of power overseas before World War II is something no one wants to see repeated. Americans, for their part, have vacillated between strict isolationism and broad intervention in foreign policy, rarely stopping in the middle. When compelled by circumstances to play a major leadership role internationally—as it was after World War II—the United

States has displayed a tendency to go it alone.

The emphasis in resolving future problems must be on spawning global economic growth. The good news is that some of the preconditions for this new world are already in place. The United States has seriously begun to curb its deficit, increase productivity and prepare itself for export-driven growth through reduction of remaining export disincen-

tives. On Japan's side, there is more willingness to discuss overdue structural reform of the Japanese economy, and there is a growing chorus inside and outside of Japan pushing for more consumption-led growth. What is crucial is that the new political leadership in Japan and the United States achieve the political will to translate these sentiments into economic reality.

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