# REASSESSING U.S.-JAPAN RELATIONS

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## INTRODUCTION

Despite noisy trade disputes, close, friendly relations and a firm strategic alliance between the United States and Japan have been an unchallenged assumption throughout the postwar era. Recent economic developments, however, are undermining that assumption and could lead to a fundamental realignment of the bilateral relationship over the next decade. The future is uncertain and will be much more complex and difficult as both nations adjust (or resist adjusting) to new realities.

Since the end of the Second World War, Japan has been a strong ally of the United States. Accepting its defeat, with its institutions remodeled in the American image during the Occupation, and representing a bastion of capitalist democracy in Asia, Japan was an important and useful element in American global strategy. The constitutional restraints which have kept Japan a non-nuclear nation with a low level of defense spending reinforced the alliance because of Japan's resulting dependence on American military power for its ultimate defense. The United States has also been able to maintain important military bases (which proved useful in the Korean War and which impede Soviet naval access to the Pacific Ocean) that have a strategic value beyond the purely bilateral. That Japan was successful economically further enhanced its value to American strategy by decreasing the possiblity of domestic upheaval (considered a very real threat in the late 1940s) that could be exploited by the Soviets and by providing an example for the rest of Asia.

Professional economists tended to ignore the strategic dimensions, but drew similar conclusions about the positive and beneficial nature of the relationship. With only a few exceptions, most economists subscribe to the view that a reduction in trade barriers is good for the world (and the United States), and that more trade is better than less trade. Japan has been removing trade barriers for the past 20 years (albeit starting from a very protectionist position) with relatively little backsliding. A large, industrially advanced, wealthy Japan is also better for the United States because it buys more from abroad (including from the United States) and because it increases the probability that it can and will produce goods that Americans want to buy and, conversely, that it will consume the kinds of products that the United States produces. The fact that bilateral trade has produced a surplus in Japan's favor ever since 1966 that has escalated to very large amounts ($59 billion in 1986, according to U.S. data) has not bothered the economists because bilateral trade balances

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are an irrelevant focus of attention; economists neither expect nor desire bilateral trade to balance. Some economists even conclude that Japan's trade barriers are not unusually high and do not unduly distort trade patterns, so that pressure on Japan to change is not particularly important.[1]

Given these strong assumptions about the strength and desirability of a close relationship, those who complained about Japan in the past have been clearly outside the intellectual mainstream and their arguments dismissed as flawed. This remains true despite the fact that the United States has fairly frequently resorted to protectionist policies on an ad hoc basis for particular industries; we do it, but we feel guilty about it because the concept still has very negative connotations. Those complaining about the lack of market access to Japan have been written off as too ignorant about Japan to devise effective marketing strategies, or pushing individual industrial concerns too hard in the context of the strategic alliance.

These assumptions have governed the past 40 years of U.S.-Japan relations, but they cannot govern the next 40 years. Why? Profound economic changes have been taking place that will alter fundamentally the nature of the overall relationship. The significance of these developments has been systematically ignored until now. There are two problems, both of which emerge from the very success of the relationship: Japan's position as a wealthy nation, and Japan's rise as a leading creditor. Neither of these developments sounds ominous; indeed, Japan's ability to transform itself into an advanced industrial nation is a development deserving great praise and respect, and a capital hungry world welcomes creditors to fuel its appetite and thereby promote growth. But this response represents a narrow economic interpretation that is less sustainable when set into the broader context of political and diplomatic issues.

## THE MACROECONOMIC ENVIRONMENT

### *Japan's Advanced Status*

The first development reshaping the bilateral context has been coming about for many years. From the end of the war to 1973, real GNP growth in Japan averaged 10 percent annually, while the United States averaged about four percent. Even in the less vibrant 1970s and 1980s, Japan grew on average a little less than four percent while the United States managed a bit more than two percent. Thus, Japan has been slowly catching up with the United States, the product of a highly successful industrial development strategy buttressed by a strong educational system, political stability, a hard-working and docile labor force, and government policies skewed toward industrial development. Japan's achievement has been remarkable and it remains the only non-Western

1. See C. Fred Bergsten and William R. Cline, *The United States-Japan Economic Problem* (Washington: Institute for International Economics, 1985), pp. 53-116; or Gary Saxonhouse, "What's Wrong With Japanese Trade Structure," Seminar Discussion Paper No. 166, Department of Economics, University of Michigan, December 1985.

late-comer to reach an advanced industrial status. At current exchange rates, per capita income in Japan is now higher than in the United States.

Having caught up, the question remains as to whether Japan will continue to grow more rapidly than the United States. Creating a system that efficiently imported and adapted foreign technology to Japanese needs does not necessarily imply an ability to redesign an economic system that will outperform others at the technological frontier. Japan will certainly do relatively well, but it if outperforms American economic growth, the margin is unlikely to be very large. Most Japanese forecasts of the future, however, assume a continuation of past trends in which per capita income would rise far beyond U.S. levels.[2] Perhaps it is less important that these forecasts are unrealistic, and more important that they represent the dominant strand of Japanese thinking — they assume that Japan will pull far ahead of the United States.

Even if it does not outperform the United States on economic growth, Japan is an important leader in a number of industries. It dominates the world in certain types of semiconductor devices, it is at the forefront of research on superconductors, it is the acknowledged world leader in the technology of automobile manufacturing, and is the leader in consumer electronics. It fully intends to occupy a major role in these and other high technology industries worldwide and the government will continue to devise policies to encourage that outcome. In the past, technology flowed primarily from the United States (and Europe), but now Japan has much to offer in return.

### *Macroeconomic Balances*

Since the early 1980s a more complex set of developments has been affecting Japan and the United States. For Japan, the key changes date from the slowdown in economic growth in the 1970s. High growth had been supported by equally high levels of savings (enabling the nation to invest heavily without borrowing from abroad). Slower growth in the 1970s entailed lower levels of investment, but the desire to save showed little abatement. Therefore, a serious surplus of savings over investment resulted in the private sector. This surplus had to find an outlet somewhere, or else stagnation and recession would have driven it back down. The two possible outlets are government deficits and external surpluses. For the rest of the 1970s the dominant response was an expansion of the government deficit, soaking up the excess of private-sector savings by issuing government bonds. But by 1979 a counterreaction set in, based on fear of the long-term consequences of large government deficits (fears that were considerably exaggerated). The story of the 1980s, therefore, has been one of sustained and substantial reduction of government deficits.[3]

2. The Japan Economic Research Center, *The Industrial Structure in the Year 2000: Are the Propositions Made in the "Maekawa Report" Feasible?* (Tokyo: The Japan Economic Research Center, April 1987), p.37, for example, concludes that by the year 2000, per capita GDP in Japan will be 70 percent higher than in the United States.

3. For a more detailed discussion of these developments and their implications for Japan's external position, see Edward J. Lincoln, *Japan: Facing Economic Maturity* (Washington: The Brookings Institution, 1987).

Since the surplus of private-sector savings has continued, and the government absorbed less of it, the outcome has been the enormous expansion of Japan's trade and current-account surpluses. From an actual deficit of $10.8 billion in 1980, Japan's current-account balance ballooned to a surplus of $85.5 billion in 1986. This represented an extraordinarily high level of 4.6 percent of GNP.

One of the often misunderstood features of current-account surpluses is that they represent capital outflows of equal size. Therefore, this string of surpluses has propelled Japan into the position of being the world's largest net creditor with $180 billion in net assets ($727 billion in assets owned abroad, minus $547 billion in liabilities owed to foreigners). As recently as 1981 Japan's net asset position was only $10 billion. Thus, for the first time since it had extensive investments in colonial positions before the war, Japan has become a manager of large foreign assets.

The United States has also played an important part in the macroeconomic developments of the 1980s. The Reagan administration chose to carry out large income tax cuts and simultaneously expand military spending. The resulting jump in the U.S. federal budget was the exact reverse of what was happening in Japan. Rising deficits more than absorbed excess U.S. savings, so that the United States borrowed heavily from abroad. The combination of current-account deficits and capital inflow has made the United States the world's largest debtor and a significant share of the capital inflow from abroad has come from Japan.

Uneasy over these developments, the finance ministers of the five largest members of the International Monetary Fund (dubbed G-5) met in September 1985 and called for a decline in the foreign exchange value of the dollar. Since that time, the yen has risen more than 50 percent against the dollar; from ¥237 to the dollar, the yen has risen to ¥140, a level that only a few years ago most people scoffed at as totally unrealistic. Economic theory indicates that this change should reduce Japan's current-account surpluses (and the general decline of the dollar should reduce the U.S. deficit). These developments have been slow to materialize, but economists still confidently anticipate them.

However, even though the size of Japan's surpluses will decline, no one expects them to disappear completely in the near future. For years to come, Japan will be expanding its ownership of foreign assets. In addition, the rise in the value of the yen is bringing a shift in the nature of that investment as manufacturing firms move production abroad. Unable to generate profits by exporting from Japan because the exchange rate has moved against them, some industries are embarked on a wave of foreign investment, in both low-wage developing countries and in the major markets for their products (especially in the United States). While the Japanese had always engaged in modest levels of foreign direct investment, most of it had been in sales infrastructure (rather than manufacturing) and in raw material development. Much of the manufacturing investment had been undertaken reluctantly in response to threats (or actual implementation of) trade barriers abroad. Now a new and very large wave of investment is taking place motivated by the exchange rate.

The interest of the Japanese in investing abroad, and especially in the United States, has been further heightened by the fact that the exchange rate movement has lowered the cost of foreign assets. U.S. real estate, corporations, and art works all appear much more inexpensive than they did several years ago, or in comparison to comparable assets in Japan. Therefore, Japanese investors are rapidly diversifying from their predominant interest in the U.S. bond market.

## THE PROBLEM

Why do all of these developments matter? A number of European countries have per capita income levels higher than the United States, and foreign ownership of American assets has never been regarded as much of a problem in the past. The capital inflow from Japan has also been frequently labeled a boon for the United States, helping to keep interest rates down and to sustain U.S. economic growth, in what has now become one of the longer economic expansions of the postwar period. Others have pointed to this growing interdependence as implying that neither nation can afford to damage the relationship. Nevertheless, there are troubling and serious problems inherent in these events.

The United States remains the leader of both the strategic alliance against the Soviet Union and the international economic alliance that can be labeled the liberal-trade regime. The United States has maintained the primary military counterbalance to the Soviet Union and has marshalled other nations, with varying degrees of success, into an effort to contain Soviet expansion while avoiding nuclear conflict. Even though the rhetoric of the Reagan administration has been rather extreme, the overall orientation of this effort has been a liberal one: it is not based on any desire for territorial aggrandizement; it is not grounded in a desire ultimately to defeat the Soviet Union militarily; but it is premised on a moral belief that Soviet-style communism unacceptably limits the aspirations of individuals in society so that its expansion to other parts of the world should be actively discouraged. The same can be said of the philosophical underpinnings of the liberal-trade regime: the United States has led this movement out of a strong ideological conviction that free trade is good for the world (and not just the United States), and that economic growth and industrial development around the world is a desirable goal.

Important to both the strategic and economic roles of the United States is the strong belief that policies are intended for global benefit. All nations place a heavy emphasis on their own national self-interest, and many of the specific decisions made by the United States are so motivated. But the general principles guiding U.S. actions are much broader.

U.S. leadership, both strategic and economic, requires that the United States maintain a strong position. The predominance of U.S. military and economic might at the end of the war was unusual and short-lived. Since the 1960s the situation has been more of a first among equals; still far ahead in terms of sheer economic and military size, but not necessarily ahead in terms of income levels, technology, or other indicators of success. Some have made much of the decline of the United States, but in economic terms it has largely held its own over the past decade, despite the overvalued dollar in the first half of the 1980s.[4] What holds for the general comparison of the United States and the world does not hold when the comparison is made to Japan. From relative insignificance, Japan has risen to become an equal, as detailed above. Japan's increasing economic importance now presents serious complications for American leadership in the world.

Until now Japan had avoided much involvement with the major political issues of the world. It chose a deliberate strategy of concentrating on economic development and of leaving international issues to the United States. This was a logical and welcome development when Japanese militarism was fresh on everyone's mind in the early postwar period. This decision also simplified the pursuit of American strategic goals; Japan could be relied upon to support American positions in principle if not in action. As Japan has risen in economic strength, however, many have questioned the fairness of this behavior. Involvement in international problems is an expensive proposition — both materially and spiritually. Put in simple terms, Japan is seen as benefiting from the international system without paying any costs.[5] As with most simple ideas, this one is not entirely true; Japan does spend one percent of GNP on defense, does provide some of the financial support for American bases in Japan, has rapidly increased its foreign aid spending, and has occasionally tried to play a constructive diplomatic role in promoting peace in the Mideast. But these costs have been rather trivial and few of these activities have involved Japan in the affairs of the world very heavily.

This lack of involvement will be questioned increasingly by the United States and in Japan itself. The United States is already pushing Japan to become more involved because of the perceived contradiction between its strong economic position and its puny international role, and the perception that this represents an unfair and intolerable "free ride." Uninvolvement will be questioned in Japan because ownership of assets around the world involves the nation much more intimately in world affairs than does exporting from home. These pressures have not built very far yet, but they will continue to grow over the next several years.

At the moment, Japan does not exhibit much enthusiasm over undertaking a larger role. Over the summer of 1987, Prime Minister Nakasone raised the issue of sending mine sweepers (purely defensive naval vessels on a humanitarian mission) to the Persian Gulf to join those of the United States and

4. In 1976 the U.S. share of world exports was 12.6 percent; in 1986, after five years of a very overvalued dollar, that share was 10.9 percent.

5. This sense of unfairness is manifest in the recent full page advertisement in *The New York Times* (among other major newspapers) by Donald Trump calling on Japan and others to shoulder a greater burden. 2 September 1987, p. A28.

Great Britain. This initiative did not meet with any success domestically, although Japan has agreed to provide some financial support indirectly by covering more of the costs of maintaining American troops in Japan and by providing increased financial aid to several Mideast countries affected by the Iran-Iraq conflict. Five or 10 years from now, Japan is more likely to send minesweepers, and the United States will be much more likely to press hard on Japan to do so.

Domestic interest in playing a greater role and U.S. pressure on Japan are a natural outcome of Japan's rising relative economic status and its emergence as a major creditor. If it is so natural, why should it be a matter of concern? The key problem with Japan is its failure to represent the liberal tradition that has marked U.S. behavior in leading the postwar system. Japan remains an illiberal nation with a mercantilist view of the world. Starting from the premise that other nations are primarily concerned with their own national interest, Japan justifies the projection of its narrow self-interest. Import liberalization, for example, has been accepted primarily as a necessary action to prevent possible protectionist reactions abroad that would harm exporting industries, rather than embraced as a generally beneficial move that would be good for Japan *per se* (by promoting a more efficient allocation of domestic resources and by lowering costs to consumers). Japan has consistently preferred voluntary restrictions on its exports rather than opening its own markets when it felt that this would sufficiently appease foreign criticsm. Japan would be quite willing to live in a world of heavily managed trade in the absence of U.S. liberal trade leadership.

A similarly illiberal view applies to Japan's foreign aid. Even though much of Japan's foreign aid is now officially untied (meaning that the money is not tied to purchases of goods from Japan) it manages its untied aid in such a manner that it remains tied in practice. Japanese officials at the Asian Development Bank, the multilateral bank for regional soft loans, regularly notify Japanese companies of upcoming loans so they can get the jump on the resulting contracts. Companies in developing countries find that if they try to substitute some non-Japanese equipment on factory investment projects financed by Japanese commercial banks, they are threatened with cancellation of the loans. The Japanese government encouraged Japanese firms to invest in the Mideast after 1973 on the theory that the goodwill represented by these investments would protect Japan in future oil disruptions (a theory that failed). In all these cases, the benefit to Japan and Japanese firms has been more important than any sense of global needs or support for developing country aspirations.

Not only has Japan's pattern of behavior to date been characterized by a rather narrow self-interest, it is being pushed into a more active world role at a time when nationalism, arrogance and contempt appear to be on the rise. Japan is a nation with a hierarchical society and it projects that sense of hierarchy upon the rest of the world. For the past hundred years, Japan has been willing to look up to industrial nations as superior in this international system, but now firmly believes that the order is reversed and Japan is on top. In this hierarchy, there is little room for equality (just as there are relatively few relationships of true equality in Japanese society). Therefore, if Japan is on top, the United States and Europe have been demoted to inferior positions. Put bluntly, the United States has been relegated to the trash heap of industrial anachronism along with Great Britain; we are assumed to be a deindustrialized failure rapidly becoming an industrial museum of historical interest but unworthy of much respect. While there is always a modicum of truth to Japanese beliefs about the United States, they exaggerate tremendously and accept the exaggerations as gospel. This pattern is highly reminiscent of Japanese beliefs about the United States in the 1930s. When pressed by the United States to lower trade barriers, a common Japanese response has been that there is no point to changes because the United States produces few goods of sufficient quality to interest Japanese consumers. Such attitudes are no longer the province of right-wing nationalists in Japan; they represent mainstream thinking among government officials and businessmen. These are unhealthy attitudes for a nation moving into a more significant world role, and they are intensifying.

That Japan behaves differently than the United States is no surprise; all nations are different, have unique cultural features that work well in their domestic context, are motivated by nationalism, and often see themselves as better than other nations. However, accepting the validity of Japanese culture is far different from agreeing that Japanese cultural patterns represent a useful and acceptable behavior pattern on which to base a paradigm for international interaction. If Japanese attitudes and cultural norms do not change, then a world with Japan as a dominant international force would be quite uncomfortable for Americans and others.

Herein, then, lies the essential dilemma. If Japan fails to play a more visible role in the world, the United States will become increasingly frustrated over Japan's free ride. If Japan does play a larger role, the United States will find Japan's actions difficult to accept.

The above pessimism may be overdrawn. But even a world in which the United States maintains a role of considerable leadership will become more difficult to manage as Japan exercises its economic clout. Japan is already the largest donor of bilateral foreign aid to other Asian countries and could begin making suggestions to the United States about appropriate roles and programs for developing countries. As a major creditor to the United States, Japan could easily apply conditionality to its lending, refusing to lend unless the United States promises to alter its economic policies. More ominously, it could threaten to withdraw capital in retaliation against American trade policies that it dislikes. These are real possiblities and some in Japan have begun to speak openly about them.

The dependence of Japan on the U.S. market could be a cause for optimism. Japan cannot afford to seriously offend the nation that absorbs fully 38 percent of its exports and a third of its overseas investment. Where would Japan trade or invest if it antagonized the United States so much that its access to the market were severely limited? This realization has had a powerful moderating influence on Japanese actions in the past. However, the large flows of capital may undermine the situation; the Japanese see capital as a source of countervailing power as explained just above. Rather than moderating behavior on both sides, it may simply escalate the frustrations and potential for damage. Pessimists see Japan turning to Asia as an alternative to the United States. This is not a viable alternative at the moment, but it would be entirely conceivable for Japan to cultivate an Asian market over the next one or two decades with an eye to reducing reliance on the United States (and the high allocation of Japan's foregn aid money to Asia could be interpreted as part of such a policy).

There are other hopeful signs. With the rise in overseas assets, an increasing number of Japanese and their families have been living abroad to manage them. These people tend to develop a broader view of the world, and their children are probably affected the most. They are becoming so numerous that the Japanese educational system has finally begun to accept the idea that children with foreign living experience are an asset rather than a liability. One could also argue that in the early part of the twentieth century the United States had views about the rest of the world that were about as narrow as those held by Japan today. If the United States was able to progress beyond that level, Japan should be able to do so as well.

## CONCLUSION

What, if anything, can be done to avoid these problems? Perhaps the most important problem is to correct American macroeconomic policy. The United States must continue to reduce federal budget deficits, thereby taking the pressure off interest rates and slowing the inflow of foreign capital. Increased Japanese ownership of American assets is a reality, but it is in our interest to reduce the pace of future additions to that ownership. Reducing the federal deficit would also help to keep the value of the dollar from climbing again. In order to shrink the U.S. trade deficit, it is essential that the dollar remain at its current levels or even fall again. Furthermore, correction of U.S. macroeconomic policy would be the most effective way to get Japan to stimulate domestic demand rather than relying on external surpluses and capital outflow. These changes would be to the long-term benefit of both the United States and Japan, moderating the strong swing of the past several years to debtor and creditor status.

Combined with these policies, the United States must continue to reexamine other domestic policies. Now that Japan is at the frontier, there is no inherent reason why it should outperform the United States, but it will if some basic changes are not made. The failures of the American educational system, the overemphasis on shuffling corporate assets rather than concentrating on making those assets more efficient, and an overemphasis on military technologies are but a few of the areas that need to be examined. There is a modicum of truth to Japanese contempt for the United States, and if the relative position of the United States continues to slip, it will be because of failure to come to grips with the domestic problems that impede our performance.

Even if economic performance is respectable, however, Japan will remain an important force in the world and it is in the U.S. national interest to design carefully policies that encourage Japan to reach out in a constructive way to the rest of the world. More Japanese should work in international organizations such as the World Bank and the International Monetary Fund. Japan should be pressured to move away from the heavy commercial orientation in its foreign aid. A greater lobbying effort should be mounted by American business and government in Japan to encourage belief in the advantages of free trade, just as the Japanese lobby heavily in Washington in pursuit of their commercial interests. Educational programs on Japan should be expanded, increasing the pool of people in the United States with professional training who can deal more effectively with Japan.

All of these measures will help, but even in the most optimistic scenarios, Japan will be a force that cannot be ignored in the future. At the very least, management of the relationship will become more complex. If we fail to understand and deal with these problems, it is now conceivable that 10 to 20 years in the future Japan will be an independent, nuclear-armed competitor of uncertain loyalties.