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JAPAN AND THE LIBERAL ECONOMIC
ORDER: HEGEMONY AND SYSTEM SUPPORT

by

Syed Javed Maswood

A thesis submitted to
the Faculty of Graduate Studies and Research
in partial fulfilment of
the requirements for the degree of
Doctor of Philosophy

Department of Political Science

Carleton University
Ottawa Ontario

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HEGEMONY AND SYSTEM SUPPORT"

submitted by

Syed Javed Maswood, B.S., M.A.

in partial fulfilment of the requirements
for the degree of Doctor of Philosophy

.....
Chairman, Department of
Political Science

.....
Thesis Supervisor

.....
External Examiner

Carleton University

May 19, 1987

ABSTRACT

This thesis attempts to explain Japanese foreign economic policies using the concept of 'system supporter', as developed by David Lake and Inoguchi Takahashi. The concept of 'system supporter' modifies Charles Kindleberger's thesis of hegemonic-stability which argues that a liberal international economic order can only be sustained when a hegemon exists to provide leadership. The present crisis of the liberal trading regime and the growing threat of protectionism, it is argued, can be explained by industrial dislocation and relative economic decline of the United States. This created conditions that strained the ability of the United States to continue to perform the leadership function as it did after the Second World War. The emergence of Japan as an economic superpower and the fact that it was the principal beneficiary of the postwar trading regime combined with the present threat to that regime has, we argue, led to a greater awareness on the part of Japanese leaders on the need to play a more active and supportive role in the international system. Using this new found sense of responsibility, we try to assess the major new foreign economic policy initiatives of the Japanese government.

We focus on the period from 1979 to the present and examine the nature of the U.S.-Japan automobile dispute, the U.S.-Japan trade imbalance and the various initiatives undertaken by the Japanese government to liberalize its economy and restructure the industrial structure with a view to both contain the threat to

the liberal trading regime and to promote imports. In each case, we find some support for our working hypothesis although the lack of a clearcut domestic consensus made the task of overcoming the opposition from specific groups particularly difficult. We also look at one potential threat to the future stability of the system and attempt to understand what Japan could do to defuse this potentially destabilizing factor.

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Chapter One

INTRODUCTION AND OUTLINE

This dissertation is a study of the changing nature of Japan's foreign economic policies, with particular regard to the maintenance and stability of the liberal economic system that was set up under American aegis in the aftermath of the Second World War. It is argued that recent Japanese market opening measures and other measures, to achieve industrial restructuring can be understood and explained in terms of a recognized need to play a more positive role in the international system. The underlying motivation is the hope that such actions will strengthen the shaky foundations of the international trading system. It is acknowledged by all analysts of Japan's postwar economic growth that the existence of the liberal economic system was an important determinant in the materialization of the Japanese economic miracle. The liberal order allowed Japan easy access to international markets and the success in penetrating foreign markets helps to explain Japan's double-digit growth rate of the 1960s and the relatively superior performance in the 1970s. The fact that Japan exploited the opportunity to export while at the same time protecting its own domestic economy from the influx of foreign products, did not take long to be translated into the charge that Japan was taking a 'free ride' on the system, benefiting from its existence while contributing little to its stability. The charge of the 'free ride' was made to apply both to foreign economic and defence related issues, the latter because Japan's defence expenditure since the early 1960s has remained below 1 per cent of GNP on an annual basis, considered

too little in terms of its own defence requirements and in terms of the defence of the Western alliance. Later, as Japan, faced with mounting foreign criticism, started to liberalize her economy and expand her defence potential, while still keeping annual defence spending to below 1% of GNP, the charge of 'free ride' could no longer be sustained and was replaced with the new accusation of 'cheap ride'. We will not, in this dissertation, try to assess the validity of these charges although it must be pointed out that such broad generalizations hardly do justice to Japan's complex international relations, particularly in the field of security policies. In so far as economic relations are concerned, there is a clear recognition that Japan can and should do more to stabilize the international system. Moreover, it is important to note that this realization is based not on international pressure, but on its own self interest.

In light of the above, it will be seen that frictions between Japan and other countries of the West have centered on the trade aspect, on one hand, and on defence, on the other. Our focus in this dissertation will be on the international economic system and the role of Japan within it. This will be centered around the theme of the present crisis of leadership in the free trade system. In thus defining the theme of this dissertation, I am assuming that a liberal trading regime can only be sustained by a powerful country—economically as well as politically—acting as the leader, as has been argued by Charles Kindleberger and Richard Gilpin, among others. For much of the postwar

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period, the United States performed this leadership function and while it continues to act as the leader, fissures have developed in its capabilities to act alone as the guarantor of system stability. Given this change in global realities, the preservation of the liberal system requires, in addition to American leadership, support from the other advanced industrialized countries. It is in this regard that I propose to study Japan's foreign economic policies, that is, to what extent Japan has or is likely to become a system supporter rather than a 'free rider' or 'cheap rider'. Certainly, this conception of the role of the supporter does not fit Japan exclusively and we could consider several other advanced countries as potential supporters. However, Japan makes for a particularly interesting case study. This is so not only because it is today one of the most dynamic and robust economies but its emergence as a supporter would signify a sharp departure from the erstwhile Japanese policies of protectionism. It acquires meaning also because many Japanese scholars, politicians, and leading government officials have, in recent years, emphasized this new turning point for the Japanese economy and the imperative for a more active, constructive, and supportive role vis-a-vis maintenance of the liberal economic system.

An alternative approach to the study of system stability would be to focus on the institutional features of the system, notably the General Agreement on Tariffs and Trade (GATT), and on the attempts by the U.S., Japan, and some of the other

industrialized countries to strengthen the GATT framework by expanding its sphere of competence to include trade in services. This is manifested in the New Round of trade talks begun in 1986. Regardless of whether the talks arrive at a meaningful agreement, some find the very act of negotiations a meaningful contribution to system stability and system maintenance. The Tokyo Round of trade talks lasted nearly a decade but according to one body of opinion, even if the talks had dragged on for over 100 years, they would still be useful, since states would obviously not legislate protectionist policies while negotiating for a more liberal trading system. History, however, is not too kind to this point of view. Instead, in this dissertation, we will consider the institutions to be the derivatives rather than the mechanisms of system stability. We will take, as our point of departure, the Realist position of identifying system stability to be the function of strong leadership, and modify it to incorporate the role of 'system supporter'.

In order to understand the role of system supporter, it is essential to relate it to the costs of system maintenance. The role of the supporter, as conceptualized here, is to relieve some of the burdens imposed upon the leader and to undertake the responsibility of sharing the costs. In this dissertation, I have identified the most important costs as those which appear to have been particularly crucial in eroding the basis of American leadership. Besides the general decline in American economic performance and competitiveness, the major burden has been the

highly skewed trading patterns, resulting from an unequal commitment to the principles of liberal trade. The U.S. has been the most open economy in the system with the result also of being the single most important export market for foreign producers. To an extent this is part of the leadership function but an inordinately high degree of dependence on one market can also render the system more vulnerable to protectionist pressures, particularly in times of general economic decline. For the future stability of the international system, it will be necessary, therefore, to achieve a greater degree of balance within the system and we will explore how Japan might contribute to the realization of this. Chapters 2, 3, and 4 contain a discussion of Japan's global responsibilities in terms of sharing the costs of system stability. Chapter 5 takes up the issue of sharing the costs and making a positive contribution from a regional perspective. A brief summary of the structure of the thesis is given below.

CHAPTER 2: This chapter provides the theoretical framework in terms of the hegemonic stability thesis that assumes that a liberal trading system can only be sustained when the system contains a hegemon to provide leadership. Whether the hegemon will, in fact, play this role will of course depend on the political will and domestic constraints. After analyzing the relative decline of the U.S., I consider some of the alternatives of organizing a liberal economic system that have been proposed and express and support my own preference for the utility of

retaining the hegemonic stability thesis relatively intact but modifying it sufficiently to allow for the role of a system supporter.

CHAPTER 3: This chapter looks at the U.S.-Japan automobile dispute and explains the resolution of the dispute in terms of the broader context of preserving the Liberal International Economic Order (LIEO). It is suggested that in the resolution of the dispute, the position taken by MITI in favour of voluntary export restraints by Japan not only deviated from MITI's traditional conservatism but that this shift took place under the premise that the trading system could only be sustained by the U.S. and that the U.S. 'will' to exercise leadership would be dependent on the overall health of its economy. Thus, MITI favoured voluntary export restraints with the express belief that a 'breathing space' was necessary for Detroit to rebuild and restore its vitality, and that because the automobile industry was so crucial to the economy as a whole that if the revitalization program was successfully implemented, it would also revitalize the American 'will' to lead.

CHAPTER 4: This chapter continues on the theme of the American 'will' to lead which, it is argued, will depend on Japan playing a positive role to contribute to cost sharing within the system. It is argued that Japan's export push and protectionist policies have undermined American support for liberal trade on the ground that it is alleged to have taken a heavy toll of the American economy. The manifestation of the problem is Japan's

huge and growing trade surplus against the industrialized countries and a solution is seen as dependent on the degree Japan succeeds in bringing its international trade into rough balance. This chapter focuses on the import side of Japanese trade and looks at the measures taken in the past few years by the Japanese government to liberalize its domestic economy.

CHAPTER 5: This chapter looks at the export side of Japan's trade and tries to assess the potential of industrial restructuring in Japan to make the economy less dependent on exports, which is seen as a major cause of the trade imbalance. The purpose of this chapter is to explain the policies adopted by the Japanese government to reorient its economy away from export dependence to dependence on domestic demand as the engine of growth.

CHAPTER 6: This chapter looks at Japan's role in the Pacific region in the context of the potential problem associated with the unusually high dependence of the Association of South East Asian Nations (ASEAN) and the Asian Newly Industrializing Countries (ANICs) on the U.S. as their export market. It then looks at the possibility of diverting the export trade of these countries more towards Japan which, it is argued, could help to lower the strain on the American economy. This dependence on the U.S. is a direct outcome of the exclusionary policies pursued by Japan and the EEC in the past and which could emerge as a significant destabilizing element in the system.

CHAPTER 7: This chapter provides a summary of the main

findings as well as a brief discussion of the on going debate on industrial policy and its relevance to the task of rebuilding the American economy.

To state briefly the major findings, it is clear that Japan is seriously conscious of its new role and responsibilities. This is most obvious in the study of the automobile dispute and the market opening measures of 1985. The 1985 Action Program for improving market access is different, in many important ways, from earlier measures designed to liberalize the Japanese economy, although there remains ample scope for further improvements. One such area of improvement could be in the promotion of a greater horizontal division of labour with the regional countries. To the extent Japan undertakes this and other measures, it will have served to fortify the international economic system from the periodic surges in protectionism.

It is quite possible that the transitional period leading to the postulated new order will be fairly long, but if the short term narrow protectionist demands can be overcome, the final outcome is likely to be beneficial to all. It will be argued that the agreement to adjust the exchange rates in 1985 (G-5) was a measure specifically designed to overcome the centrifugal forces operating within the system and to ease the transitional pains. The necessity of allowing for a moderately long transitional period arises from the fact that, for each state, foreign policy, economic included, must be formulated with full consideration of both the systemic as well as the domestic

factors and constraints. A foreign policy that defies the domestic constraints will ultimately prove untenable and a foreign policy that fails to respond to external stimuli or adopt to external conditions will be unsuccessful in the long run. From the systemic point of view, Japan realizes what it must do, but it must also give due consideration to the parameters established by the domestic social and political considerations. It is obvious from the case study that the government is trying to achieve a domestic consensus around the new role of Japan but the pace cannot be rushed. Thus, even though the auto VER, for example, is an indication of Japan as a supporter of the system, the final conclusion is somewhat modestly worded. A beginning has obviously been made but the task has not yet been completed. Much will depend upon the ability to achieve domestic consensus and maintain the momentum of change.

Finally, since the subject matter under study is in a process of on going evolution, it became necessary to establish a cut-off date, if only to avoid having to continuously add materials on new developments. Rather arbitrarily, I set the cut-off date as April 1986, which still allows us to incorporate all of the major issues that form the core of the subject matter, including the question of economic restructuring in Japan, as proposed in the Maekawa Commission report of April 1986. However, as necessary, I have gone beyond the cut-off date to complete the analysis.

Chapter Two

The Theoretical Framework

SECTION I

INTRODUCTION.

The trade problems between Japan and the rest of the world have attracted considerable attention from scholars seeking to analyze the source of the frictions and to suggest solutions. These studies have been important in furthering our understanding of the decision-making process within particular Japanese bureaucracies, for example the powerful Ministry of International Trade and Industry (MITI), the many vested interests impeding trade liberalization, the work ethics of the Japanese worker, and the frugality of the Japanese consumer etc. Most also highlight the important fact that this island country of 120 million is crucially dependent on international trade for its continued well being and prosperity. This dissertation, too, is a study of Japanese trade policies but with the added dimension of the present threat and the future viability of the world trading system as it has existed in the period following the Second World War.

Japan was the principal beneficiary of the postwar liberal economic order and the future vitality of its economy will depend on whether the principle of easy access to foreign markets is preserved. The importance of this becomes obvious when we consider the structure of Japanese trade. The near-total lack of raw materials internally has forced a reliance on foreign sources of supply which could only be financed through foreign exchange

earned from export trade. Commenting on this vertical nature of Japanese trade, Krause and Sekiguchi wrote that, "Even though Japanese growth in the main has not been export led in the analytical sense, it does not mean that exports were unimportant to growth. Export expansion has been of strategic importance principally because it has financed the growing import of raw materials and capital goods that embody new technology" [1]. Problems arose not only because Japanese exports were concentrated in a few manufactured products but also because suppliers and buyers, for imports and exports respectively, constituted two distinct set of countries. Naturally, therefore, trade accounts tended not to balance on a country by country basis. Generally speaking, Japan has run trade deficits against the raw material, producing countries and this has been counterbalanced with surpluses in trade against the developed industrialized countries. Trade frictions have mainly involved the latter group of countries, U.S. and West European, and increased in intensity with the deterioration of the state of the world economy. In all fairness, however, no senior official in any American administration has been so naive as to suggest that bilateral U.S.-Japan trade must and should always balance. At the same time, there was mounting pressure to do something about the ever increasing Japanese surpluses, US\$50 billion in 1985. The chronic persistence of Japanese trade surpluses has been a major irritant in U.S.-Japan relations because it was largely perceived to arise from imperfections in the Japanese economic

system and the legacy of past policies allowing foreign manufacturers only a limited access to the Japanese market.

While there are many arguments and counter-arguments on both sides to explain their bilateral trade imbalance, both also agree that at least a part of the problem was due to the difficulty of penetrating the Japanese market. This does not mean that the Japanese government admits to a conspiratorial role (the same standards apply both to foreign and domestic businesses), but rather that it understands the need to facilitate foreign access to the domestic market. We will attempt to explain this in terms of an awareness of the Japanese government of its responsibility to contribute to system stability.

Since protection, perceived or otherwise, begets retaliatory protectionism and since Japan is highly dependent on liberal trade, it could be shown, on the basis of the rational analytical model, that Japan now had a much greater stake in acting to alleviate the trade imbalance, assuming that this will lessen the protectionist fervour. This protectionism was the main threat confronting the LIEO in the first half of the 1980s. Furthermore, this protectionist mood appeared to be particularly strong in the U.S. The danger was that if the U.S. administration fell victim to it, it would be the start of the unravelling process for the world trading system. The U.S. administration was firm in its support for liberal trade but it is open to debate whether this commitment could be sustained without support from the 'able' and 'willing' regime members.

This crisis within the system presented Japan with some crucial choices to make about its future economic policies. At one extreme, the decision could be to continue with the present policies without any significant change in the market liberalization program, regardless of whether or not this worsened the strains within the system. Alternatively, it could consciously seek to reorient its role in the international system as a supporter. From the evidence available, it would appear that Japan is ready to bear a larger portion of the burden of maintaining the liberal system. Behind this is the assumption that the system costs had contributed to the decline in American popular support for liberal trade and that Japan, by partially relieving the U.S., can help to strengthen the foundation of the liberal economic order. In depicting Japan as the system supporter, we need to identify the functions of the supporter and this will be done in terms of the costs of the system, further below.

Although the focus of this dissertation is on the concept of regime stability, we do not wish to raise it to the level of the ultimate good, nor to deny the importance of issues of equality and justice. The concerns of the Third World and of those who would seek to introduce changes in the system are real, but perhaps not realistic. Essentially, the question of justice has been approached from two different perspectives, one that assumes that justice can be achieved through modifications in the system and the other that raises fundamental doubts as to the

possibility of achieving justice within the system. In the former stream of thought, we have the growing literature on the New International Economic Order (NIEO), which aspired to work within the system to bring about changes that would take into consideration the developmental interests of the Third World. In the latter, we have the dependencia theorists who regard the system itself as abhorrent and repressive, with little possibility that the dominant interests would acquiesce to anything more than token concessions.

For the purposes of this thesis, I have deliberately decided to keep issues of value separate partly because of my skepticism about the success of the protest within the system, as efforts to shape a NIEO over the past decade have shown. The entire question of economic justice and equality not only relates to the member states of the system but also to the internal conditions of many of the Third World countries where experience has shown a clearly discernible trend towards greater inequality in income distribution. Whatever benefits the Third World derives from participation in the system is inequitably distributed within their societies. Thus, even the realization of the NIEO may not bring about the desired egalitarian effect. A perfectly egalitarian society may not be possible but the gap should at least narrow, not widen as it has in the past.

A related problem is whether the demand for justice had the potential of undermining the stability of the LIEO, by either withholding support for the system or through the pursuit of

autarkic policies, as is often advocated by the dependency theorists. Given their small share in the total trade within the system, their withdrawal from the system would probably not have the effect of undermining the system although it would certainly narrow the domain of the system. The system may not continue as the 'global' system but it would continue to function within the restricted boundaries. It is also highly unlikely that there would be any mass exodus from the system.

Looking narrowly at the question of regime stability in the context of the present crisis of protectionism, the Realist school of thought in International Relations has latched onto a modified version of Kindleberger's hegemonic stability thesis. Kindleberger, on the basis of his study of the depression years of the 1930s, had concluded that regimes required the support of a hegemon for that stability. The economic nationalism of the 1930s and the depression that it led to seemed clearly to be the result of the refusal/inability of the hegemon, the U.S., to provide effective leadership. He argued that, contrary to the teachings of classical economics that free trade could be made to work simply on common interests and comparative advantage, a 'free' trade system really was brittle and therefore required a strong country to ensure stability, with force, if necessary, as happened during the 19th century when India and China were forced to accept free trade, with disastrous consequences for their socio-economic conditions. On the basis of the hegemonic stability thesis, it could be argued that a fragmentation of

power would result in a fragmentation of economic regimes and instability, and that only a hegemonic actor had the capabilities to maintain an international economic order that it favoured [2]. In other words, the potential for order was a direct derivative of the concentration of power within the system [3]. It is easy to see, therefore, why the Realists attribute the relative stability of the LIEO for about 20 years in the post-war period to the presence of control and domination by the U.S. The doctrine of hegemonic stability has an instant appeal for the Realists, so used to explaining outcomes and behaviour in terms of power configurations within the system. In contrast to the Realist position, the Interdependence school, in attempting to present an alternative approach, denies that the success of the LIEO can be attributed solely or simply to hegemonic control. They point to the declining utility of force, which stands out in marked contradiction to the realities of the 19th century, and suggest instead a pattern of interest-based agenda setting.

Recent attempts to bridge the divide between the two contending schools of thought have been made by the neo-Realists. For instance, Robert Keohane argued that while creation of economic regimes may require hegemonic control, once established, such regimes could be sustained by the 'shared interests' of the members of the regime [4]. This was essentially a return to the Smithian notion of the 'hidden hand' working to ensure smooth operation of the system. Thus, while the Realists despaired of American hegemonic decline, leading to possible exacerbation of

international conflict and a return to the conditions prevailing before the Second World War, Keohane and the neo-Realists solved this problem not by denying a role for the hegemon, but by making it redundant under the present circumstances.

The neo-Realist approach is less logical in argumentation and more ideological in its commitment to a preferred outcome. They posit a distinction between the originating and sustaining conditions without showing why such a distinction can be made except that a system of rules once created to support a regime becomes, with the passage of time, norms not requiring enforcement.

The theoretical arguments will be fleshed out further below, but first we must define some of the terms and concepts that we shall be using. Like most concepts in the discipline, regimes have been used to mean several different things, from informal rules of international interactions to formalized institutions. Most, however, appear to accept a definition that includes a degree of order and regularity, not necessarily institutionalized but which served to constrain state behaviour in an anarchic setting. This is clear from the writings of authors like Ruggie, Stein, Keohane, and Kratochwil. For Ruggie, a regime was composed of principles, norms, rules and procedures; and Stein, concurring with this, wrote that a regime manifested itself when the interaction between the parties was not based on independent decision making [5]. The difference between rules and norms, according to Kratochwil is that while rules may become norms over

time, not all norms exhibit a rule like characteristic [6]. In addition to the above autonomy restricting nature of regimes, we must also include a time dimension. For a regime to be justified as such, it must display an element of permanence, i.e., it must be recognized as having long term viability. This, as will become clear later, is why regimes are appealing not only for the larger countries but also for the remaining members. It is no doubt true that for smaller countries, protectionism can bring about certain benefits in the short term but the long term consequences may be the exact opposite should its trading partners retaliate with counter-vailing measures. Thus, in a system with no agreed norms of behaviour, all states face the possibility of being worse off in the long run. It is this fear that provides an incentive for regime creation and which works to constrain 'beggar-thy-neighbour' policies.

The literature on regimes identifies two primary functions that they serve:

1. Simplify situations of choice, i.e., make environmental complexity more manageable, and
2. Reduce bargaining costs by providing templates for wholesale advance coordination [7].

The term hegemon may seem to require little elaboration, but it is here that one finds substantive differences. In the Interdependence approach, a hegemon can be defined largely in terms of its economic potential. Given the assumed ascendance of 'low politics' over 'high politics' in the Realist tradition the

military aspect of hegemonic power remains intact. As Gilpin wrote, there are "... two dimensions to a hegemon's power: economic efficiency and political military strength" [8]. Firstly, with regard to the economic element, it should be pointed out that the absolute size of the economy, while important, is not the only critical factor, for as Kamiyo Toshiaki notes, it is quite possible that in the 19th century both France and China may have had a larger absolute GNP than Britain [9]. For Keohane, a hegemon's economic strength depends on four factors. Thus, "Hegemonic powers must have control over raw materials, control over sources of capital, control over markets, and competitive advantages in the production of highly valued goods" [10]. Control should not be used to mean physical possession necessarily but rather the ability to affect outcomes. Keohane suggested that this was true for the U.S. in the first twenty years after the Second World War, with respect to oil resources. The loss of control thereafter did diminish U.S. economic strength but it should be pointed out that OPEC, for example, had considerably less impact on the U.S. than on Japan or Western Europe. The U.S., to use the terminology of Robert Keohane and Joseph Nye, was sensitive but not vulnerable to OPEC, in the long run. Even though, the first three elements cited by Keohane do enhance the hegemon's potential strength, ~~it is~~ the fourth element which must be given a greater weight. An uncompetitive hegemon can hardly remain a hegemon in the long run and we have already defined regimes partly in terms of their

permanence. Economic efficiency is also important for maintaining a liberal trading regime because it is in having an efficient economy that the hegemon acquires an interest in relatively free trade.

Under normal conditions, regime maintenance does not require the hegemon to wield its political clout and it is the non-use of political-military force which appeals to the other members. The postwar system was not based on overt coercion and any member is free to opt out of the system at any time although there were just enough benefits spread around to ensure that this did not happen on a large scale. One such positive inducement was the Generalized System of Preferences (GSP) under which a developed country would grant duty-free status to specific exports of the developing countries. The GSP can, however, also be used by the GSP granting country to wield influence in the system. For example, in 1985, disgruntled with the hostile and negative attitude of the less developed countries (LDCs) to a new round of GATT trade talks, United States Trade Representative, Clayton Yeutter, threatened to withdraw American GSP privileges for the LDCs unless they agreed to the new round and the inclusion of services trade on the agenda [11].

According to Kratochwil, members of a given regime agree to abide by the norms and rules only because their 'impersonal' character distinguished them from the immediate and blatant exercise of power [12]. However, we should be careful not to push this point too far because the rules and norms are not

always of an 'impersonal' nature. Military power of the hegemon also serves as a useful backup tool for reward or punishment through at least an implicit linkage of issues. Keohane readily admits to this: "American military power served as a shield protecting the international political economy that it dominated, and it remained an important factor in the background on economic issues; but it did not frequently impinge on such issues" [13]. Directly, military power may have little utility when it comes to dealing with other regime members and no one would go so far as to suggest that the U.S. might use its military advantage to secure trade concessions from Japan. At the same time, a total delinking of economic and military issues is also not possible. The military factor may not be explicitly stated but does influence decision making. Even so, threatening allies with force is not and has never been an accepted practice. The U.S. could, and did, force the Japanese market open with the 'Black ships' of Commodore Perry off the Tokyo Bay in the 19th century but the 7th Fleet today can hardly be used in a like manner. This is not because the utility of force ~~per se~~ has declined but because Japan's position with respect to the U.S. has changed. Also important is the fact that the liberal trading system is only a sub-system operating in a 'hostile' environment, which in turn calls for the hegemon to possess the capability to ward off external threats and disturbances which may affect the stability of the regime. To cite Keohane, "Sufficient military power to protect an international political economy from incursions by

hostile powers is indeed a necessary condition for successful hegemony" [14].

SECTION II

HEGEMONIC STABILITY THESIS AND ITS CRITICS

In this section, we will outline the central features of the hegemonic stability thesis. In doing so, we will provide justification for the role of regime supporter. The role of the supporter is consistent with hegemonic stability and liberal trade but the fact is that not all are agreed on the validity of the hegemonic stability thesis itself. It has been argued that a liberal trade regime could be maintained in the absence of a hegemon and, indeed, that it is being so maintained today. The mechanism for stability in this alternative framework is system-wide cooperation and it should be obvious that there is no special provision for the role of a supporter, since all members are cast into a supporting role. In what follows, I will first present the key features of the hegemonic stability thesis followed by the alternative model and finally make the argument in favour of modifying the hegemonic stability thesis to incorporate a system supporter.

As mentioned earlier, the hegemonic stability thesis is associated with C.P. Kindleberger and his study of the Great Depression of the late 1920s early 1930s [15]. That study led

him to conclude that a liberal free trade regime could only be established when a hegemonic power took leadership in the system. At other times, protectionism reigned supreme with the consequent danger of the creation of economic blocs, with competition between them bordering on or resulting in conflict. This thesis has been incorporated into the Realist approach as can be seen from the following quotation from Ruggie, "If economic capabilities are so concentrated that a hegemon exists, as in the case of Great Britain in the mid- to late nineteenth century and the United States after World War II, an 'open' or 'liberal' international economic order is hypothesized" [16]. Whether intentional or not, Ruggie implies an automaticity that may be somewhat exaggerated. In Britain, free trade did not automatically follow from her economic supremacy but rather was the result of a long and hard struggle between the agricultural interests and the industrial capitalists. The process itself began well before the repeal of the Corn Laws, which was only the culmination of a lengthy process. The U.S., too, only accepted leadership after the domestic conditions had changed sufficiently to enable this and its leadership did not automatically follow from its hegemony. Somewhat paralleling this assumed automaticity in the creation of hegemonic leadership, one finds in the literature an implied automaticity of hegemonic decline. Christopher Chase-Dunn, for example, after comparing the three capitalist hegemonies of the Netherlands, England, and the U.S., suggested that it was inevitable that over time, the hegemon will

become burdened down with an antiquated industrial base, declining productivity, and other economic ills [17]. There is, however, nothing inevitable about this just as there is nothing inevitable about a country pursuing bad economic policies.

The presence of a hegemon creates the conditions for the establishment of a liberal trade regime but it does not guarantee that this will in fact take place and one needs only to look at the dismal history of the inter-war years to understand this. The U.S., by all counts, could fill the role of the hegemon but it instead chose to stay outside the system partly because of the constraints imposed by domestic political conditions. Thus, even though the U.S. was instrumental in securing the Versailles Treaty and in the creation of the League of Nations, it was forced by Congressional opposition to remain outside the system it had helped to create. By deciding to stay aloof, the U.S. in effect, forfeited the opportunity to maintain order within the system. We could blame Woodrow Wilson for 'failing' to secure Congressional approval for the Versailles Treaty, Herbert Hoover for precipitating disorder (Smoot-Hawley Tariff Act), but Kindleberger was also extremely critical of Franklin Roosevelt for failing to assume leadership at the World Economic Conference of 1933 at London, and for displaying what he called, 'world economic irresponsibility' [18].

As we have seen, Ruggie somewhat overstates the case for hegemonic stability and as an alternative we might consider the formulation provided by Buzan. He writes, "So long as the

international political system remains anarchic, it seems most unlikely that a liberal system could be created by any mechanism other than a hegemonic actor. The interesting question is whether or not an already existing liberal system can be maintained by other means when the originating hegemonic power no longer has sufficient relative strength to act as underwriter" [19]. The first part above, fits perfectly the mold of Realist thinking with the emphasis on anarchy as the essential characteristic of international politics. It is the presupposed anarchic nature of international politics that forms the basis for the theory that only a hegemon, with vastly superior capabilities, can impose order and create a regime based on its preferred norms of international conduct. The second part of the quotation from Buzan contains the crux of the present controversy -- whether or not the originating conditions must also and always be the sustaining conditions. For the Realists, the answer is derived very simply on the conviction that until and unless the nature of international politics changes (not too likely) the originating conditions must also be the sustaining conditions and therefore a non-hegemonic free trade regime is not viable over the long run. Their critics, however, make a sharp distinction between the two and, below, we will take up the principal arguments.

David Lake challenged the Realist position with the assertion that, "...there is no axiomatic relationship between hegemony and free trade or declining hegemony and

protectionism...", and that a non-hegemonic system can have several variants in regime structure, including the liberal order [20]. With respect to the first part of his challenge, we have already pointed out that there is no strict correlation between the presence of a hegemon and free trade. Lake, however, goes on to argue that it is possible, although not necessarily guaranteed, that when a hegemon faces decline, the members of the regime will negotiate on the rules and norms so as to compensate for hegemonic decline [21]. We can well appreciate why regime members should act to preserve the regime but this general interest may not be sufficient to arrive at the desired outcome and to override individual interests. Also, it is debatable whether regimes are based on some abstract notion of general interest unless, in our case, it can be shown that the regime is composed of members that are roughly equivalent in terms of economic potential. This condition is, however, far from being fulfilled. Regimes embody the interests of the hegemon and are therefore more beneficial to the strong and less so for the weak. This is because the hegemon retains a greater say and control over the system and this is reflected partly in the various international organizations, like the IMF, GATT, and IBRD. This does not mean that the hegemon always obtains its desired objectives in which case it may simply withdraw its support for that particular organization, as did the U.S. with respect to the World Court, and the UNESCO.

The benefits of regime leadership should not be equated

with the gains from free trade. From the point of view of neo-classical economics, it would be logical to suggest that the relative trade gains for the weaker countries is greater than for the larger countries simply because of their greater dependence on trade. Larger countries, because of the size of their domestic market and better resource endowments, are usually more self-reliant and therefore less dependent on trade. They may be sensitive to loss of trading opportunities in the short run but the smaller countries are more vulnerable. Sensitivity weakness is a short run condition and therefore less debilitating than long term vulnerabilities, from which it may be more difficult to recover. Although a smaller weaker country may be more dependent on trade and therefore display a definite interest in the liberal order, particularly on assured markets overseas, by entering into a liberal trade arrangement with a stronger country it places itself at an economic disadvantage because it locks them into the existing comparative advantage situation. The infant industry argument which the Third World uses today is an attempt, however weak, to break out of this. At the same time, the protectionist concessions allowed the Third World do not fundamentally alter the cost-benefit balance sheet for the hegemon since it is unlikely that the LDCs will move much beyond basic import substitution and would continue to be dependent on imports for high value added products. Moving beyond the realm of economic benefits, Bruce Russett wrote, "The gains from an open global economy surely exceeded the costs to the United States. Despite

what ultimately proved to be heavy burdens that the United States shouldered to maintain an open economy, the balance sheet for Americans looks favorable when compared with the costs that other powers accepted in decolonization...The major goods provided by American postwar hegemony - 'stable peace' within much of the industrialized world, a ~~cord-on-satellite~~ around the major perceived security threat, a relatively open, expanding, and largely predictable world economy - were obtained in degrees that were not markedly sub-optimal from the American point of view" [22].

Returning to the notion of the common interest, Realists like E.H. Carr dismiss all arguments for the general interest as attempts to disguise the interest of the strong [23]. From the Realist perspective, to suggest that a regime can be sustained on the basis of the general interest through some cooperative agreement is tantamount to asserting that regime members will somehow agree to make themselves subservient to the hegemon's interest in the absence of hegemonic control. On top of this, Lake himself undermined his own arguments when he admitted that a non-hegemonic LIEO would be both more prone to protectionism and more fragile; the latter because of the incentive to cheat arising from the increased uncertainty levels in the operating environment, making empty promises of agreed rules. Every member may agree to the rules but few may adhere to them. In the 1920s, the European countries consistently and solemnly promised to lower tariffs and all the while raised them to still higher

levels [24].

Lake, nevertheless, continued to maintain that there was no *prima facie* evidence for firm linkage of LIEO to a hegemon, particularly if the following two conditions were met:

1. moderate certainty and predictability of others' behaviour, particularly on compliance with established rules and norms, and
2. successful rule making to compensate for and to replace the hegemon [25].

With respect to these two conditions, it must be pointed out that it was, in fact, the hegemon that facilitated rule making and rule enforcement. Also, it was the hegemon which provided for relative certainty in the system, which might otherwise break down for lack of positive inducements or negative sanctions. Given the anarchic nature of international politics, cooperation and collusion among the regime members can hardly be taken for granted even where it can be demonstrated to be in their own interest, and one need only to recall the analogy of the 'deer hunt' to grasp this principle. The former West German Chancellor, Helmut Schmidt was only being realistic when he observed that, "Neither trilateral co-operation nor worldwide co-operation is imaginable at present without American leadership" [26].

In his book titled After Hegemony, Robert Keohane using case studies of several international regimes attempted to demonstrate the relationship between regime stability and hegemonic control. Even following the observation that, "As American power eroded, so 'did international regimes'" [27], he boldly argued for the

opposite condition of how an international regime could be saved when a hegemon was no longer able to lead. This was of crucial importance because, as he stated, "Hegemonic leadership is unlikely to be revived in this century for the United States or any other country" [28].

If, therefore, the liberal trade regime was worth retaining intact, other mechanisms, besides hegemonic control, had to be found to ensure regime stability. Unlike in his earlier work on Complex Interdependence which attempted to break away from the past because increased cross-national penetration had allegedly made past patterns irrelevant to the conditions of the present, his latest book tried to find firm footing on what he called, the 'legacy' of the past. Yet, even if the past was important, the old route of regime creation was no longer available because hegemons, in the past, had arisen from the ashes of 'world wars'. Since a 'world war' in the nuclear age would bring about catastrophic results, it was unlikely that a new hegemon could take the old route. Thus, while emphasizing the legacy of the past, he was forced to reject it. Therefore, cooperation became the key word in his analysis and he wrote, "If we are to have cooperation...it will be cooperation without hegemony" [29]. Alluding to the difficulty of this process, he was nevertheless quite confident that the institutions left behind by the U.S. would continue to function as states would find it more convenient to interact within regimes, than outside, since uncertainty reduction was a major foreign policy objective. Not

only did this redefine regimes in terms of the institutional structures, but missing from the analysis, also, was any discussion of what values such a non-hegemonic LIEO would pursue. This gives the impression that regime members would continue to abide by values cherished by the former hegemon, for example, on trade with the Eastern bloc countries, and the role of the Third World within the regime. Values are important because we have to realize that the LIEO is not a regime based on the concept of perfect free trade which is inconceivable at the present, because of the diverse interests of the members. Besides being utopian in his conclusions, Keohane's position is at least sub-consciously ideological: "...it is easier to maintain them [regimes] than it would be to create new ones" [30]. Therefore, an American hegemony could be maintained, even when the basis for that hegemony no longer existed.

So far we have assumed that the period of American hegemony has ended but this is not an issue to be so easily resolved and we will return to it further below.

If the difficulty of maintaining non-hegemonic regimes was that the absence of the hegemon reduced long term certainty and predictability of the actions of others, Keohane made the counter argument that the presence of institutions set up during the period of American hegemony and which generate and disseminate 'high quality information' served to enhance the levels of certainty and that these institutions could function even without U.S. hegemony. Thus, he asserted that Realism needed "....to be

reformulated to reflect the impact of information providing institutions on state behaviour, even when rational egoism persists" [31]. Functional institutions aside, Keohane assumed that all international institutions would continue to function efficaciously even under the changed circumstances. This, however, needs to be demonstrated rather than assumed. Realists do not deny the usefulness of these institutions but rather question their ability to modify state behaviour. The ITO and the WHO, for example, would probably continue to function but could we confidently say the same for the GATT or the IMF. GATT is already confronted with a challenge of sorts from France and the so-called 'gang of four' - India, Brazil, Egypt, Venezuela. Also, it seems unreasonable to impute to information a rationalizing role. Robert Jervis showed that misperception was not an uncommon phenomenon and John Steinbrunner, too, has persuasively argued that decision makers tend only to accept information that conformed to preconceived views and that the cognitive belief system acts as a mental block against in-coming information that was incompatible [32]. The point is not that misperceptions in a non-hegemonic system are more prolific but simply that they may be more difficult to manage.

Keohane's excessive faith in rational state behaviour is also manifested in his discussion of regimes under the the assumptions of bounded rationality. Bounded rationality is a concept which relaxes the assumptions of strict rationality to suggest the possibility that given time constraints

decision-makers may exhibit only utility satisficing behaviour rather than utility maximization. He wrote that, even under bounded rationality, states would inevitably realize that the "...alternatives to regimes are less attractive than they would be if the assumptions of classical rationality were valid" [33]. This, he argued, was because regimes freed decision-makers from the costs of continuous certainty calculations, but this is essentially an argument for why states prefer to work within rather than outside regimes, when such a regime displays long-term potential, and does not really enlighten us as to how a non-hegemonic regime may be maintained over time. The Realist position has been that, benefits notwithstanding, regimes require a hegemon whereas Keohane simply sidesteps this assumption without demonstrating it to be false.

In criticizing Keohane and others, the intention has not been to suggest that the Realist formulation of hegemonic stability is without fault. A well founded criticism is that of Duncan Snidal who wrote that the theory of hegemonic stability contained a "...virtually hidden assumption: 'collective action is impossible.'" This is hardly a hidden assumption but rather fairly obvious which he himself finds to be "...well demonstrated in Kindleberger's negative assessment of the likelihood of Japan and West Germany overcoming their private interests to collaborate with a (less than dominant) United States in providing collective economic leadership" [34]. The notion of collective leadership, it should be pointed out, is different

from that of cooperative management because while the former retains the concept of leadership, the latter finds leadership to be an obsolete function and therefore not necessary for regime stability. Collective leadership, or a system in which Japan and West Germany play a supportive role is possible because these countries, with highly competitive economies, have similar interests to that of the U.S.

It is true, as Snidal pointed out, we have tended to see the hegemon as a unitary actor whereas present conditions may demand that we assess the possibility of collective leadership. This argument has acquired increasing support from both American and Japanese scholars. In Japan, several authors, Okita Saburo and Sakamoto Masahiro, have argued for both its desirability and inevitability. Okita Saburo, a former foreign minister and distinguished economist, argued that the current system of American leadership should be replaced with collective leadership because the fate of the LIEO could not be entrusted solely to the guidance of the U.S. and particularly as factors internal to the U.S. were the principal threats to the system. Similarly, Stoga argued that the future stability of the LIEO required a careful consideration of the system of collective leadership, if U.S. leadership could not be restored. He writes that, "Reinvigoration of the free trade and payments economic system with U.S. or shared U.S.-Japanese-West, German leadership holds the greatest promise for the world economy and indeed, probably for the U.S. economy" [35].

It is not clear what the notion of collective leadership involves or how such a decision-making apparatus can be made to work, whether on the basis of majority agreement or achieved consensus. If it has been neglected in its theoretical articulation, in practice, the idea of collective leadership has been with us ever since the oil crisis of 1973. At that time, it was agreed that the leaders of the major economic powers would hold annual meetings - summits - to coordinate policy response to global disturbances. Summit meetings were designed not to replace single handed American leadership in the system and their overall effectiveness, as events have shown, leave a lot to be desired. Rhetorical protestations of unity and amity can be found in plenty but actual agreements have been difficult to arrive at. The paucity of meaningful achievements has made the exercise of summitry a hollow affair of pomp and pageantry. The Bonn summit of 1985 was the first one in six years to specify, in the most general and non-binding terms, the role expected of each of the seven participating countries in the field of growth and employment for the overall stability of the world economy [36].

If collective leadership of the above type has not been very successful, there are other variants worth considering. According to Sakamoto Masahiro, a more realistic form of collective leadership would have to retain the U.S. as the powerful core. Such a system would, in effect, give the core country a veto power. It could be successful because the small group, presumably at relatively similar levels of economic

development can also be assumed to have roughly similar interests. Also, evidence from group theory suggests that decision-making in small groups is more effective than in larger groups which are often paralyzed by inaction, because in a large group there was no individual incentive for action, since the outcome would be a collective good. Mancur Olson wrote that it was difficult for large groups to "....organize for action to achieve its collective goals, even with perfect consensus...." [37]. The reason for the U.S. veto is for the simple practical reason that the United States, despite its relative decline, is still the most powerful country as well as the provider of military security within the system [38].

One concrete formulation of the system of collective leadership can be adopted from the typology provided by David Lake in a recent issue of World Politics, and which was taken up by Inoguchi Takahashi in an attempt to apply it to the Japanese case. David Lake argued that there were four types of roles that one could discern within the international system: leaders; supporters; spoilers; and free riders. [39] Using this typology we will apply the concept of the supporter to Japan and see to what extent it does apply and how might this role be further strengthened. "Supporters", as Inoguchi wrote, "are somewhat smaller than leaders in terms of relative size but they are almost the same as leaders in relative productivity" [40].

The supporter will not necessarily be a blind follower of the hegemon and this leaves open the possibility of conflict but

what makes a regime member a supporter, besides the above qualification, is the fact of demonstrable interest and the apparent lack of political power to become the leader.

In making use of the concept of 'supporter', we wish to differentiate it from the meaning given to it by David Lake. Lake suggested that when a regime had an existing leader, the supporter would tend to free ride and that when a leader was no longer present, their interests would force them to change their past free rider policies. Supporters, he said, would sacrifice protectionism only because of their interest in securing their export markets. This would assume that a regime either had a robust leader or had autonomy. This, in turn, assumes a distinction between the regime creation and regime maintenance functions but as we have seen above, this assumption cannot be given too much credibility. Stephen Krasner did take this position arguing that the constraint on American protectionism today was the existence of the liberal economic regime. The linkage, however, is both difficult to substantiate and, therefore, to disprove, but it should be noted that protectionist demands have always been a feature of American domestic politics although they have been considerably exacerbated in recent years. But if American central decision makers have indeed been constrained by the regime then it becomes important to show that they would otherwise prefer to take the protectionist road. There is no evidence of this and on the contrary, Judith Goldstein argued that "....American central decision makers

continue to be as committed to liberal trade today as they have been in any previous period in American history" [41].

That may be an exaggeration for it cannot be denied that the U.S. has had a chequered history in foreign economic policies but at least there seems to be little evidence to disprove a basic continuity over the postwar period. This is not to suggest that there was no threat to the future of the LIEO but if we accepted the autonomy thesis, it becomes difficult to justify the need for a supporter, since it would be the natural outcome in the absence of a hegemon. Instead, we argue that a supporter's main role emerges when the hegemon faces a relative decline in the system and is unable to provide effective leadership as before, because of internal domestic factors. The role of the supporter, then, is to adopt measures that mitigate the domestic pressures upon the hegemon to renounce its leadership position. Yet, just as the hegemon has to contend with domestic constraints on its leadership position, the supporter, too, cannot ignore the domestic factors that may impinge on its ability to perform a supportive role within the system. As such, while we argue that Japanese interests in preserving the LIEO provide the basis for a supportive role, we do not wish to imply a causal relationship between interest and system support. Interest constitutes a necessary condition that obtains as a precondition for support but it becomes a sufficient condition only when domestic conditions allow and the economic conditions enable such a role. In the case of Japan, interest and economic capabilities are

sufficiently present to make a reasonably sound argument for Japan as system supporter. However, the enabling conditions must be considered and a major portion of this thesis will try to address the problem of internal constraints.

To emphasize, however, the supporter is a 'regime supporter', not a leadership supporter. There may indeed, at times, be disagreement between the leader and the supporter on policy issues, but more likely, such disagreements will cluster around the non-crucial (for system stability) areas than in the crucial areas. In other words, it is assumed that neither the supporter nor the leader will implement policies that directly undermine the system.

Also, it is important to keep 'system supportive' and 'leader supportive' acts analytically separate. This may be important if the supporter is to avoid becoming a mere pawn to the leader. At the same time, it cannot be ruled out that the leader may fail to recognize the need for system support in any particular instance or may, for domestic political reasons, refuse to acknowledge the need for it. This will become clear from our case study of the automobile dispute between Japan and the U.S. and the willingness of the former and the hesitancy of the latter to accept/impose voluntary export controls on Japanese car shipments to the U.S.

To provide a justification as to the usefulness for the concept of system supporter, it is necessary to look at the nature of structural changes within the system. According to

Kenneth Waltz, a system is composed of the structure and the interacting units of the system. The relationship between the system, the structure and the units (agencies) is explained in the following terms: "Agents and agencies act; systems as wholes do not. But the action of agents and agencies are affected by the system's structure" [42]. The structure of a system is largely defined by the ordering principle or the hierarchical positioning of the units in terms of power and capabilities. The concept of system supporter is developed on the basis of relative changes in the positioning of the units --the structure. This change is attributed, here, to the relative decline of the U.S. as compared to West European countries and Japan. Since structure affects the behaviour pattern of the units, a change in the structural feature must either change existing behaviour patterns, defined as norms and rules of the system, or if the norms and rules are to be sustained, then some counter-balancing and compensatory structural modification must be induced. We argue that the concept of system supporter can be useful as this compensatory mechanism. The structural changes and the relative decline of the U.S. have, as is to be expected, altered the role of the U.S. within each regime area. Thus, with respect to the oil regime, although the U.S. no longer had the capabilities to maintain a regime favourable to its interests, it still had sufficient capabilities to deny the creation of an alternative regime. The present role of the U.S. within the international oil regime can be analysed using the concept of 'system spoiler',

which David Lake identified as one of the possible systemic roles. As a spoiler, the U.S. denied Mexico the option of joining OPEC and, according to the Iraqi oil minister, the U.S. effectively determined OPEC policies through its influence over Saudi Arabia [43]. Within the trading regime, the American relative decline undermined the domestic consensus on liberal trade and strained its ability to provide leadership as in the past. This has not only created opportunities for other countries for a more active role but also made the system's continuation dependent on a more broadly shared responsibility. Nevertheless, the American role remains critical since its relative hegemonic position gives it an effective veto power within the system. Even if the principle of American leadership remains intact, it cannot be denied that protectionism within the U.S. has made it less certain that its leadership will continue unchanged. Other countries, that have the capability, must share in the cost of regime maintenance. Also, since much of American protectionism can be traced to its trading relationship with Japan, it makes it all the more interesting to look at this particular aspect of intra-systemic relationship. By looking at U.S.-Japan relationship we can not only assess the likelihood of Japan emerging as the system supporter but also the extent to which Japanese system supportive policies help to defuse the protectionist sentiment in the U.S.

For Japan to become a system supporter, it would have to play a more positive role in the system than it has in the past.

Japan's acceptance of joint partnership does not necessarily mean only cost sharing, even though this would be an important aspect. Since we have emphasized that regimes cannot be based on appeals to altruism but rather must be based on recognition of self interest, in the leadership principle, collective leadership can be successful only to the extent that benefits are clearly identifiable. In the case of Japan, the potential gains can be easily demonstrated. Japan has been the primary beneficiary of the LIEO in the past and the continued stability of the LIEO will no doubt be equally important in the future. There will be other gains as well, if the Japanese Yen becomes an international currency based on its joint leadership of the system. Thus, as Stoga observes, Japan stands to gain from the "...loosening of constraints on economic policy that results from the reserve-currency status" [44].

The agreement reached in September 1985, at the meeting of the finance ministers of the five Western industrialized countries (G-5) to lower the value of the U.S. Dollar was an excellent example of policy coordination in the spirit of collective leadership. Of the five members of the G-5, the most important and critical to the decision were Japan, West Germany, and the United States. The two key elements of the G-5 agreement were (1) lowering the value of the Dollar, and (2) restoring fiscal balance in the U.S. and demand expansion in Japan. As a result of this agreement and by late December 1985, the Dollar had declined about 20 percent against the Japanese Yen and about

14 percent against the German Mark and other European currencies [45]. Not only the implementation, but the very process of achieving the G-5 agreement reveals the principle of collective leadership at work along with the exercise of American veto. For several years prior to the agreement, Japan for one, had consistently been arguing that it was largely an over-valued Dollar that was responsible for the Japanese trade surpluses and the U.S. deficits. The U.S., during that time, persistently refused to consider a lower Dollar value because such a step would inevitably require a lowering of domestic interest rates which, it was feared, would adversely affect the capacity to fund the huge federal fiscal deficits and cut into the anti-inflationary policies of the administration. Thus, despite repeated calls from Japan and others, the U.S. adamantly stuck to its position. In the February 1984 Economic Report of the President to the Congress of the United States, Reagan, admitting to the fact that the high Dollar value had worsened the U.S. export position, went on to state that, "I amfirmly opposed to any attempt to depress the dollar's exchange value by intervention in international currency markets" [46].

One could cite a number of reasons why the U.S. government later changed its position but it is not unlikely that it was partly the result of the persuasive abilities of the Japanese government, which wanted to readjust the exchange rate hoping thereby to deflect some of the criticisms being made against Japanese trade surpluses.

SECTION III

COST-BENEFIT ANALYSIS OF REGIME MAINTENANCE

In this section, we will analyze the nature of systemic costs associated with the liberal trading system which will provide a basis for understanding the redistributive measures necessary to ensure the stability of the system. The literature on hegemonic stability has correctly emphasized that a free trade regime imposes costs as well as benefits upon the hegemon. Drawing upon the historical decline of Pax-Britannica as well as the more recent alleged decline of Pax-Americana, analysts have assumed and argued that the long term costs associated with leadership outweigh any benefit that the leader may derive. Indicative of this viewpoint, Andrew Mack argued that, "neo-Marxist claims to the contrary, America's globalist policies were never self-financing - let alone profitable" [47]. The Nixon Doctrine of 1971, therefore, he stated, was a response to the now unbearable costs of hegemonic control, an attempt to achieve 'hegemony on the cheap' that was, however, laden with contradictions because, "It was illusory to believe that America's allies would be prepared to bear an increasingly larger share of the costs of Pax-Americana while allowing the US to continue to play its traditional leadership role unchallenged" [48].

The entire issue of costs exceeding benefits is difficult to reconcile with the Realist position which identifies states as

engaged in a single minded pursuit of the national interest and altruism only a disguised form of national interest. From the Realist standpoint, it would be impossible to explain why self-serving states should follow policies which lead to their ultimate decline. It may be possible to suggest that states are perhaps not as rational in the calculation of the longterm consequences as they are of the short term benefits. This is what Stein identified as the Hegemon's Dilemma. He saw a contradiction in the attempts by states to maximize gain and preserve relative position in the system and wrote that, "To maximize one's own return requires a commitment to openness regardless of what others do. To maximize one's relative position, on the other hand calls for a policy of continued closure irrespective of other's policies." Thus, he continued, hegemons "do not impose openness, they bear its costs" [49].

This still does not resolve the issue of whether hegemonic control must always end in hegemonic decline. The fact that hegemons have declined can probably be attributed to poor economic policies or other factors like, for example, the costs involved with the Vietnam war for the U.S. and may not necessarily be the result of the costs of regime maintenance. Andrew Mack may have one possible answer to the relative decline of the U.S. but to what could he attribute the British economic decline? The decline of the *Pax Britannica* was inevitable with the growth of pluralism within the system and the refusal of the U.S. and European countries to participate within the system on

the old terms.

In contrast to this, under Pax Americana, pluralism did not simply develop independently but was consciously recreated. Pluralism in the 19th Century became a threat because liberal trade was based on the primitive inter-sectoral complementarity of agriculture and industry whereas in the postwar system, it was based also on intra-sectoral complementarity, possible because of industrial specialization and broadening of the domain of industrial activity.

Hegemonic power is usually defined as preponderance over other members of the regime but without any reference to the magnitude of the preponderance. This is because discussions about magnitude or threshold levels can hardly be presented with sound objective arguments. It cannot simply be asserted that a hegemon be, at least, three or four times larger than its nearest rival and then proceed with the argument that since the magnitude of preponderance had declined to, say a factor of two, the hegemon therefore had lost the ability to provide leadership in the system. We could of course accept such logic as a matter of faith or convenience but we could neither justify nor defend them. Both Britain and the United States may have been in a similar position at the close of the Napoleonic wars and the Second World war, respectively, but according to Ernst Bevin, Britain in the earlier period held only 30 percent of the world's wealth compared to about 50 percent for the U.S. in the late 1940s [50].

Relative decline of the hegemon implies simply a narrowing of the gulf separating it from the second largest economy within the system. In itself, this is not sufficient to deny the hegemon control within the regime unless it is also accompanied by a secular economic decline. When that happens, the system must either generate supporters or the system must be recreated under a new hegemon. Even when the hegemonic principle is supplemented with supporter, it need not imply the replacement of unitary leadership with collective leadership because, even under the changed situation, the leader continues to exercise the veto. However, a supporter will only play the required role if its interests are taken into consideration and this implies a greater level of bargaining in the system. Elements of these can be easily discerned in the G-5 agreement to revalue currencies, in 1985. When the idea for currency revaluation was originally floated by Japan and the others, the U.S. exercised its veto to rule out any currency adjustments. When it finally did agree to devalue the dollar, it had to accept the condition imposed by the others to exercise more fiscal prudence.

Returning to the issue of burdens of regime maintenance, the costs to the U.S. of its leadership have been assessed by Sakamoto Masahiro, a senior researcher with the Japan Trade Association [51]. For comparative purposes, Sakamoto estimated the cost burdens for five developed countries, the U.S., West Germany, Japan, France, and the U.K. The indicators used include defence expenditures, foreign aid, contribution to the United

Nations, reserve currency role, R&D expenditures, and international trade, which were weighted for the GNP of each country. No surprisingly, he arrived at the conclusion that the American costs of regime maintenance had been proportionately greater than that of the other countries. However, while Germany, France, and the U.K. were not too far behind, except on some indicators, Japan was found lagging behind in all except in terms of contribution to the U.N.)

Based on his findings, Sakamoto argued that the American decline was due to the fact that the U.S. had to shoulder a disproportionately larger share of the costs. He went on to advocate a greater burden sharing by Japan since that would be in Japan's own long term interests, if by doing so the liberal economic order could be preserved. While no one can fault his findings, there are a couple of things wrong with his logic. First, in so far as the argument that the costs, as he identifies them, were responsible for the American decline, it should be pointed out that all he demonstrated was that American costs were greater than the costs to other countries, and not that the costs exceeded the benefits. Second, of the six indicators chosen by Sakamoto, only three could be classified as true costs of regime maintenance; the reserve currency role, international trade, and to an extent, defence expenditures.

With respect to foreign aid, it is by no means certain that it is a cost for the aid giver, since it also brings important benefits, perhaps more than off-setting the Dollar costs.

Foreign aid has been used typically to secure export markets for domestic producers and the origin of this motivation can be traced back to the Marshall Plan. At that time, the Under-Secretary of State for Economic Affairs, Will Clayton, argued that the U.S. would need export markets for \$14 billion worth of U.S. goods a year to stave off the possibility of over capacity in the economy [52]. The Marshall Plan was partly a response to this American fear. Aid to the Third World, particularly in the early years of tied aid, served a similar purpose.

As legitimate costs, we might include the various concessions allowed to Japan and Western Europe, especially in the early postwar period. For these much weaker economies, there was a genuine fear that under liberal trade not only would it be difficult to develop their industrial potential but that the existing industries too, might be swamped and over run by American capital. Obviously, the commitment to liberal trade was not what the U.S. may have hoped for. When faced with a similar situation, Britain in the 19th century, resorted to colonial subjugation. This, however, was not possible for the United States. The only alternative was to make concessions to the needs of these countries. Thus, after the war, the U.S. acquiesced to the pursuit of protectionist policies by Western Europe and Japan, while at the same time allowing relatively free access to its own markets. Other measures were also implemented to enhance their export potential. For example, in the case of

Japan, the General Headquarters (GHQ) of the Supreme Commander of the Allied Powers (SCAP) set the Yen-Dollar exchange rate at Y360=\$1 as opposed to the prewar rate of Y2.50=\$1. Tristan E. Beplat, who was in charge of money and banking for the occupation forces in Japan recalled that the SCAP authorities did this because, "We wanted the Japanese to be able to export..." This was playing it safe because, as he put it, 90 percent of Japanese exports could probably sell at the 300 level [53]. There was of course an implicit understanding or maybe only a hope that these privileges allowed to Europe and Japan would be gradually dismantled in keeping with their economic recovery.

Robert Keohane identified three specific benefits that other members derived from the U.S. liberal economic order.

1. A stable international monetary system with provision of sufficient liquidity.
2. An open market in the U.S.
3. Access to oil at stable prices. The U.S. and the American MNCs provided oil to Europe and Japan from the Middle East where the oil MNCs were dominant and in emergencies from the U.S. itself, as in 1956-57 [54].

The U.S. policies were designed to provide temporary advantages to Western Europe and Japan and it is ironical that the success of these policies is often cited today as demonstrating the decline of the U.S. This is so, whenever we use statistics on the changing GNP ratios between these countries to suggest the decline of the U.S. These results were intended as such but what went wrong was that the processes which were

meant to be of a temporary nature, have lasted longer than intended. The Japanese economy remained relatively closed to foreign competitors while the domestic manufacturers in Japan continued to take advantage of open markets elsewhere to boost production and productive capacity. This is evidenced in Japanese trade surpluses and which is now the most important factor aggravating the protectionist sentiment in the U.S. Amaya Naohiro, former Vice-minister of MITI and presently publisher of the Journal of Japanese Trade and Industry, wrote that there was a need today to "...search for fair handicaps that will compensate for differing levels of ability and right the structural imbalances in international accounts. The first step is a new round of multilateral trade talks under GATT to review and revise GATT rules and standards and to breathe new life into a threatened but admirable institution" [55].

A more accurate measure of economic decline can be obtained by comparing productivity levels, and this indeed testifies to the problems that the U.S. economy has had since the early 1960s, as the Table below shows.

TABLE 2.1
PRODUCTIVITY GAINS (%)

	1963-73	1973-79
U.S.	1.9	0.1
Japan	8.7	3.4
West Germany	4.6	3.2
France	4.6	2.7
U.K.	3.0	0.3

Source: Sakamoto Masahiro, *Keizai-Iaikoku-do*
Chosen, Nihon Seisan-sei Honbu, Tokyo, 1981.
p. 78.

Although 'industrial strength' is a difficult concept to measure, we may take the long term productivity trends as a fairly reasonable indicator since it points to the movements in a country's competitive position. This is important because a country's competitive position determines its basic outlook on liberal trade and as Harry Johnson confirmed an earlier argument, it may be possible to arrange countries in order of increasing protectionism and decreasing industrial might [56]. Productivity losses could be due to a host of factors but the one that appeals most to the American public is probably the burden of regime maintenance. Sluggish export growth may bite into productivity gains by denying economies of scale but this should not normally be a source of concern in a large market economy. The simple truth is that obsolescent production technology, and poor labour-management relations made it difficult for U.S. companies

to compete ³with foreign producers in their own (American) market. On top of that, American firms were also guilty of not being aggressive enough in their attempts to penetrate large foreign markets, like Japan. This complacency probably arose from the vastness of the domestic market. The trade imbalance is, to a certain extent, a reflection of these underlying factors. However, the high profile of U.S. trade deficits created problems, principally in terms of an erosion of the earlier consensus on liberal trade. Marina Whitman wrote that, "...there are pressures for the United States to forswear not only dominance but leadership as well, and for the reconstitution of the international economic system along, strictly symmetrical lines, in which the United States would occupy no special roles, enjoy no unique privileges, and take no particular responsibility for the viability of the system as a whole" [57].

Some U.S. administration officials, eager to gain support for open trade, were wont to assert that U.S. export competitiveness had actually improved over the past decade. Testifying before a House Ways and Means subcommittee, Bergsten, Assistant Secretary of Treasury for International Affairs in the Carter administration said, "The U.S. share of industrial country exports, ...ended the decade [1970s] slightly smaller than in 1970, when viewed in terms of nominal values. To get an accurate view of the market shares, however, it is necessary to look at these shares in 'real' terms....the very strong export volume growth of 1978 and 1979 resulted in a market share at the end of

decade of 20.4 percent - a full percentage point higher than the 1972 trough, and slightly higher than our share at the start of the decade" [58]. His findings, however, were based on a group of countries lumped together which necessarily concealed movement within the group. Also, all that he managed to demonstrate that the U.S. had done only marginally better than remain stagnant over the decade.

SECTION IV

THE POSTWAR LIBERAL TRADING SYSTEM

In this section, we will look more closely at the specific nature of the postwar liberal economic system and the existing threat to its stability. At its base, the post war liberal international economic order incorporates the two principles of open markets/liberal trade on the one hand, and decentralized decisionmaking on the other. The reality, it needs hardly be mentioned, only roughly approximates these two guiding principles.

Based on the above two principles of the regime, we would naturally exclude from its purview states that have a command economy, the Soviet Union, Eastern Europe, and the People's Republic of China. Although some of the East European countries, Poland, Romania, and Yugoslavia, do participate in GATT, the underlying philosophy of GATT, as Sydney Golt wrote, "....is

precisely to limit, and subject to control and, where necessary, surveillance, the distortion of the market produced by state intervention" [59]. Even in some of the other countries, decentralized decision-making is only partially realized. There exists a vast literature that demonstrates, for example, the Japanese government's interventionism in the domestic economy. Yet, there remains a basic difference between government intervention, as in Japan, and the other command economies, in so far as 'administrative guidance' in Japan was not "mandatory but only indicative...whereas in a command economy, everyone's action is always potentially subject to discretionary, mandatory, and specific direction by government" [60]. The thesis of Japan Inc. was only partially realized in the 1950s. Still, there is no denying that the Japanese government is more active in the domestic economy than the governments of other developed countries. The 'indicative' nature of 'administrative guidance' can, and at times in the past did, take on an authoritarian characteristic, as Chalmers Johnson illustrated with reference to MITI's plan to stabilize steel prices by ordering production cuts by the six steel firms in the mid-1960s and the unsuccessful attempt by Sumitomo Metal to defy the 'recommendation' [61]. It would be unwise, however, to generalize from this. We could cite numerous instances to attest to the failure of MITI to control the direction of industry. If the government had at its disposal the discretionary powers enjoyed in the centrally planned economies, we would probably have had fewer car manufacturers

than the present nine.

With respect to the second principle of free trade, no one is under the least bit of illusion that it has been realized. Rather, as Stein notes, the years of free trade were only "periods of ~~free~~ trade" [62]. From the very beginning, it was agreed that trade expansion would be controlled and managed. These controls were necessitated by the fact that at the close of the war, the economies of Japan and Europe were in ruin and the task at hand was to make them strong enough to stand on their own feet. Western Europe after 1948 and Japan after 1951 were allowed relatively unencumbered access to foreign markets while at the same time discriminating against foreign goods. The U.S. acquiesced in this through the decade of the 1950s and 1960s, even though its balance of payment was consistently in deficit starting in the early 1960s. It was only in 1971, when the U.S. experienced its first trade deficit, that protectionism emerged as a major problem.

The danger was not only in the fact that a heightening of the protectionist mood could weaken the political will to lead but also because protectionism in the leading country had the potential of spreading rapidly. According to Wolf,

The most important role of large market economies in world trade is as the major market on which all can rely and in which global supply and demand can be balanced relatively smoothly. If a major market is suddenly cut off from the rest of the world, especially by quantitative controls, the impact of global supply and demand fluctuations will be felt more sharply in the remaining open markets. Partly for this

reason, such protectionism tends to spread rapidly [63].

The hegemon, by virtue of its large economy, serves as an important vent for releasing the possible tensions arising from periodic global supply and demand imbalances, which if left unresolved might induce states to erect barriers around their domestic economy. To illustrate this, E.M. Bernstein wrote that, "In the past three years, producers in [Europe and Japan] found that the growth of their capacity far outstripped the growth of home demand, and in order to maintain output and employment they increased their exports. As the United States is a very large market for all types of manufactured goods, a deficiency in home demand could be offset by capturing a moderately larger share of the U.S. market" [64].

The protectionist mood in the Congress of the United States was at a critical point, primarily because members must, for electoral reasons at least, appear to be responsive to the demands from their constituents. In 1985, the Congress passed several protectionist resolutions against Japan, and as of late 1985, there were about 360 protectionist bills (300 in the House; 60 in the Senate) pending that sought to provide relief to the various affected industries.

Despite the charged atmosphere on the Hill, the administration itself remained committed to preserve the liberal economic system. President Reagan not only threatened to veto any protectionist legislation coming out of the Congress but also, recently, refused to extend protection to the domestic

footwear industry despite the clever strategy of the Industry to play on the 'hawkish' beliefs of the President: "Improper footwear can lead to needless casualties and turn sure victory into possible defeat" [65].

Beneath the general atmosphere of protectionism, there was, in particular, a strong discontent over perceived or actual unfair Japanese trade practices. There were two underlying factors behind the demand for protection and for retaliation against Japan.

1. that Japanese imports into the U.S. were causing significant damage to American industries. We find such concerns present since the days of the textiles dispute, but with trade conflicts involving the critical areas of the U.S. industrial structure, like steel and automobiles, the level of the protectionist sentiment has increased dramatically.

2. that the Japanese government unfairly kept out American exports from their domestic market. This, too, is a long standing irritant in U.S.-Japan relations centering around a number of agricultural products; tobacco; and telecommunications equipment. But, unlike in the past, current U.S. demands do not focus on any one specific industry. Rather, American demands focused on the inequities within the Japanese economy as a whole. The ballooning U.S. trade deficit led to the belief that piecemeal efforts were no longer enough to eliminate the trade imbalance between the two countries.

The administration has, so far, managed to stave off the pressure from the Congress. On top of the objective conditions influencing the growth of protectionism, the immediate political considerations of the members of the Congress, too, could not be

overlooked. The year 1986 was an election year and 32 Senators, including 22 Republicans, faced the test of re-election. Of the 22 Republicans, 16 had won their first election in 1980, riding the crest of Reagan's popularity, and because their claim on incumbency was of recent vintage, there was a greater danger of losing office. These considerations were enough to tip the balance in favour of protectionism in the Congress. It was not that they were blissfully oblivious to the dangers of protectionism.

The administration's support for liberal trade was based on the position that it was in the general interest of the American economy. Noting that one out of every eight jobs in the manufacturing sector was export based, economist Fred Bergsten wrote, "Our future prosperity at home is closely tied to our success in boosting sales abroad...We must avoid protectionist trade policies, at home and abroad, which would shrink our overseas markets just when we need their maximum expansion" [66]. However, the Congress could not allow itself to appear as having abandoned its electorate and the various interest groups. Also, it must be admitted that the rhetoric flowing out of the Congress was likely to have a sobering effect on the trading partners of the U.S. Foreign governments could not ignore the passions being stirred in the Congress and this, in itself, made them more amenable to listen to the U.S. position in their trade negotiations. This may be as much as the Congress really hoped for.

To placate an irate Congress, President Reagan in early September 1985, promised to take action under Article 301 of the Trade Act of 1974 against Japan, EC, and Brazil unless they ceased their 'unfair' trade practices with respect to certain items by December 31, 1985 [67]. He also outlined a New Trade Policy to include the granting of export subsidies of about \$300 million. No one had the slightest illusion that this token gesture would substantially increase U.S. exports, but it was still good politics.

Having looked at the conditions prevailing within the United States, we will, in the next section, return to our earlier discussion of collective leadership and the future of the liberal economic order, centering specifically on the Japanese role.

SECTION V

JAPAN AS SYSTEM SUPPORTER

It is unlikely that Japan can, today, or in the near future, take upon itself the leadership role, but at the same time there exists the clear consciousness that its future prosperity would be determined largely by whether the liberal trade regime remained intact or not. There is no questioning the fact that Japan's postwar growth was to a great extent made possible by easy access to foreign markets. Writing on the irony of the postwar changes, Professor Morley suggested that by pressuring

Japan to take on a greater burden for maintaining the LIEO, liberalize her economy to American exports, and show a greater understanding for the weakened sectors of the U.S. economy, "...we [the U.S.] are picking up the role Japan played in the postwar period and Japan is being thrust in ours" [68].

Prime Minister Nakasone, noting the importance of external factors in Japan's development, voiced the concern that, "Today...we see that there is an unprecedented rise of protectionism caused by delays in structural adjustment, bringing high levels of unemployment and accompanying large imbalances in the current account, and which threatens to undermine the free trading system." He went on to propose that, "In order to strengthen the free trade system...Japan will need to play a role both important and commensurate with its status in the world economy" [69]. What should that role be? In the words of one senior U.S. trade official, "I sense that many Japanese officials and businessmen are for the first time concerned that they have to do something, though they aren't sure what it is" [70]. One thing, however, is certain. Japan cannot single-handedly take on the leadership of the LIEO although it will be argued that Japan can and has done more to share the burdens of the trading regime, in a role supportive of the United States and which lessens the protectionist pressures. In Chapters 3, 4, and 5, we will consider some of the economic measures taken by Japan as indicative of the readiness of the Japanese government to play a more positive role in the international system. Chapter 6 will

discuss a potential area for concern and the possible Japanese role for dealing with this.

Essentially, the task, at the outset, is to determine some of the significant factors that have contributed to the making of the present crisis of leadership. Apart from the lagging productivity growth of the American economy, the crucial factor was that the commitment to liberal trade was not equally shared and, indeed, was not demanded by the leader. The U.S. remained the most liberal trading country while Japan and Europe continued to protect their economies even after the original rationale for protection was no longer valid. To avert a total collapse of the trading regime, it will be necessary for system supporters to dismantle the existing barriers to trade.

In making the argument that Japanese economic policies in recent years can be analyzed through the use of the concept of system supporter, it is necessary to show a clear break from the past policies of trade liberalization. The process of economic liberalization in Japan has been continuing since the mid-1960s but only in the 1980s do we find a clear understanding on the part of Japanese decision makers that liberalization was not simply to be accepted grudgingly under foreign pressure but rather had to be actively promoted in the interest of preserving the trading system and in its own interest. The earlier period of trade liberalization can be viewed as the Japanese response to U.S. pressure while one can discern a new interest, a self interest, in the liberalization process of the early-mid 1980s.

particularly in the Action Program of 1985. This is not, however, to deny the utility of foreign pressure but its utility is in the somewhat different area of facilitating decision making and in overcoming the constraints of the consensual style of decision making in Japan. Foreign pressure, in the earlier period of economic liberalization in Japan, was instrumental in achieving that objective but its utility today is more of a tactical nature, useful in overcoming the narrow interests of disaffected groups. This argument will be explored further in later chapters.

Six market opening measures in the past have had very little impact on the import side and Japan's import of manufactures, as a percentage of total imports, remains well below similar figures for the U.S., EC, and other advanced economies. Based on past experiences, one may be tempted to place the Action Program of 1985 in the same category of earlier measures but we will argue that it was sufficiently different to warrant recognition as a significant departure from previous market opening measures. We will look at this in greater detail in a later chapter.

Returning now to the question of leadership, it should be made clear at the outset, that we cannot expect the hegemon-supporter framework to be institutionalized. From the Japanese standpoint, it essentially means a couple of things. Firstly, it means that Japan has to cooperate with the United States in helping to reverse the American economic decline, a strategy designed to strengthen or revitalize American

leadership. This aspect is evidenced in the writings of Amaya Naohiro and others. Secondly, it means that Japan has to accept a greater degree of burden sharing and to ensure that the costs do not accrue too heavily on any one individual country. There was the recognition that Japan had not pulled its weight in the international system and that there was a need to correct the imbalance of costs and benefits, which had become a main source of the threat to the stability of the economic regime. There is of course, no guarantee that what Japan does will help to contain or treat the internal rot, but there is no denying that Japan has shown considerable awareness with respect to the problems facing the system and is attempting to take counter-measures. In this, it benefited from the internationalization of the hitherto most conservative arm of the Japanese bureaucracy - the Ministry of International Trade and Industry. The process of change within the MITI started early in the 1970s. When it published its first 'long-term vision' on the industrial structure of the Japanese economy, on November 1, 1974, it explicitly pointed out that protectionist policies could no longer be continued as in the past and that the internationalization of the Japanese economy could not be avoided [71].

Throughout the postwar period, MITI's economic nationalism (to some extent necessary and unavoidable) had been responsible for the proliferation of protectionist measures that virtually barred imports of manufactured goods into the domestic market and provided a safe environment within which the re-industrialization

of the Japanese economy could be undertaken. Chalmers Johnson suggested that the change in MITI came following a prior "realization on the part of the industry that it had to 'internationalize' if it was to avoid isolation" [72]. Within the MITI, the transformation became possible only after a new crop of more internationally minded bureaucrats had taken over the leadership from their more conservative counterparts. The internationalization of MITI does not mean that it is today less concerned about the interests of the domestic industry but simply that, given Japan's dependence on trade and the maturing of the economy, a new set of goals and objectives were required.

Amaya Naohiro, administrative vice-minister of MITI, who played a key role in resolving the U.S.-Japan automobile dispute, later explained his motives saying that the most important thing for Japan was to help in the revitalization of the U.S. automobile industry. Trade disputes with the U.S. have long been a part of Japan's postwar history but as Amaya noted, what had happened over time, was that such disputes had gradually moved closer to the heart of the U.S. industrial structure [73]. And, as we noted in an earlier section, protectionism only begins to assume a threatening shape when the core of the industrial structure loses its competitive edge. The textiles dispute of the late 1960s early 1970s did, for electoral reasons, become a major issue for Richard Nixon but it could not arouse the same popular passions as did the automobile dispute a decade later. This is simply because, unlike automobiles, textiles was a

peripheral industry.

The internationalization of the MITI may have begun in the early 1970s, but we can only find concrete expression of its new sense of responsibility toward the free trade regime using the automobile dispute as the issue separating the new and the old MITI. Unfortunately, this leaves us with only one major incident with which to fathom the change in MITI but we do not think that the resolution of the automobile dispute can be written off simply as a false sign of an early spring. There are two factors that lead to this conclusion.

Firstly, it should be noted that U.S.-Japan trade disputes are not a recent phenomena and as with the automobile crisis of 1981, voluntary export restraints (VERs) had been used in several past disputes. Export restraint was used in the case of textiles in the early 1960s, the steel dispute of 1969, and again with respect to colour TV in the late 1970s. However, in none of these earlier disputes, was there a clear cut case for exercising export restraint to help revitalize the American industry. Only in the case of TV exports was the quota on Japanese exports significantly below actual export figures, but U.S. TV manufacturers had, by that time, already decided to relocate their manufacturing facilities outside the United States to improve their cost structure.

Secondly, at the time the steel dispute flared up again in 1977, Amaya Naohiro was the Director General of the Basic Industries Bureau of MITI, and may have contributed to an early

resolution of the dispute, but it still makes sense to keep it separate from the auto crisis. With respect to the resolution of the textile dispute, I.M. Destler, et al., wrote that by the time agreement was reached on October 15, 1971, Japanese textiles exports to the United States were already on the decline as the result of competition from other Asian countries that had placed them in a position similar to that of their American counterparts [74]. This made them interested in the same kinds of trade restrictions that they had for decades resisted. And, the reason that the Japanese steel industry readily accepted, even welcomed, the Trigger Price Mechanism (TPM) introduced by the U.S. in 1977, was because they really benefited from it since the TPM was based on Japanese CIF prices and which thus prevented the Newly Industrializing Countries (NICs) from taking advantage of their lower production costs at a time when they were rapidly expanding their exports volume. The TPM hurt the NICs more than it hurt Japan. In contrast to these two instances, the Japanese auto industry remained totally opposed to any VER that would lower their export volume, but was forced to go along with MITI and its view that it was essential to provide the American car manufacturers a breathing spell whereby they could regain their competitive strength by modernizing their plant and production facilities. That this was indeed a new direction for MITI to take became clear when we compare this to MITI's position during the textiles wrangle of the 1960s. At the time of the textiles dispute, some officials in the Ministry of Foreign Affairs termed

MITI bureaucrats as 'champions of economic nationalism' [75], for their inability to make concessions in international negotiations arising from their commitment to protect domestic industries.

The change that MITI had undergone, away from its single minded protectionism based on the needs of a 'weak' Japan to a more liberal, internationalist position based on the needs as well as the responsibilities of a 'strong' Japan, was fairly dramatic. However, as we would expect, there remained a wide diversity of opinion even within the official bureaucracy. Also, we should keep in mind that even if it was true, as Johnson suggested, that MITI's internationalization followed that of the private sector, it did not necessarily mean that there was a consensus on both sides of the divide. Partly because of the close 'Amakudari' (literally, descent from Heaven, or the common practice of senior bureaucrats retiring to important positions in the private sector) ties between MITI and the steel industry, resulting from the fact that steel was originally a government owned industry, the steel industry has generally been more supportive of MITI. For example, it supported the MITI view that the automobile industry had to exercise restraint in its exports to the U.S. In contrast, the automobile industry, having fewer and more recent Amakudari ties with MITI, strongly opposed export restraint that would reduce the permissible levels of exports, although they might have been more amenable to accept something more in keeping with established precedents.

In Japan, the concern with the future stability of the LIEO

has been formulated around the question of leadership in the system. The starting point of all such analysis has been the economic decline of the U.S. and its inability to provide leadership, as in the past. Reflecting the Realist perspective, Amaya Naphiro maintained that liberal trade had only been sustained when one country within the system had exercised hegemonic control: under Pax Britannica in the 19th Century, and under Pax Americana after the Second World War. Liberal trade, he wrote, had never been sustained through cooperative arrangements, even though this would be more desirable because of its democratic nature [76]. It was unreasonable to expect nation-states to discard their narrow egoism in support of world order and so, now that Pax Americana had weakened, the trading regime had also been rendered more susceptible to forces that seek to undermine it.

Be that as it may, Japan had to realize that the international economic order was not a God given order, nor one of Japan's creation. It was an order created and supported by the U.S. and neither Japan nor West Germany, despite their economic strength, were in a position to take over leadership in the system. He went on to write that it was essential therefore, "...for Japan to prevent the destruction of 'Pax Americana'" [77], and to assist in the creation of what he called the 2nd Pax Americana. He argued that Japan must be supportive of U.S. attempts to revitalize its economy, even if Japan was not to blame for the industrial dislocation in America. Japan could,

according to Amaya, express its support through, for example, voluntary export restraints and while this would, in the short run contravene the principles of GATT, it would help stabilize the system in the long run. Failure to do so would only invite protectionist legislation and that would certainly lead to the ultimate end of the LIEO. Since Japan benefited the most from the LIEO in the past, and because liberal trade was absolutely critical to Japan's economic prosperity, it had to do its utmost to see that it was preserved. Since the end of the 2nd World War, the U.S. has been the proverbial 'Atlas' bearing the burden of the LIEO, but it had grown weary of its load, and Japan, Amaya wrote, had the obligation to lend the tired 'Atlas' a helping hand [78].

Amaya added the disclaimer that he was not necessarily speaking for the MITI but it remains a fact that he was a powerful and influential member of the policy making structure of MITI. The outcome of the automobile dispute, in which he was a principal negotiator, is clear testimony to that. For the role that Amaya played during the auto talks with the U.S., he acquired the reputation in industry circles of being 'Reagan's mistress', but he believed that if the U.S. auto industry could be revitalized, there would be one less danger to the stability of the liberal trading order. In the next chapter, we will analyze the resolution of the auto dispute and discuss in some detail the logic of Amaya's arguments. In addition, we will analyze the market opening measures of recent years as attempts

by Japan to play a larger role within the system as a system supporter.

A final point that ought to be mentioned here is that while the application of the concept of system supporter to the study of Japanese foreign economic policies is reasonably justified, we should not expect a perfect fit between the model and the reality. The process is still in its evolutionary stage and as we would expect, there are many groups within the society that oppose the thrust of the government's attempt to define a new role for Japan in the international system, on grounds that the social costs would be too great. For example, throughout much of the postwar period, the Japanese government pursued, and was successful in achieving near full employment but now that industrial restructuring and reduction of export dependence have become major issues for the Japanese economy, it is expected that Japan, for the first time, will have to confront and manage the 'Western' problem of structural unemployment. The present unemployment rate of around .3 percent is very low by international standards but unprecedented in Japan, and expected to rise. As that happens, domestic opposition will stiffen and whether or not the government will be able to overcome these potential problems will depend on its ability to forge a new domestic consensus, much like Prime Minister Yoshida did in the early postwar period and which became known as the 'Yoshida Doctrine', with emphasis on economic growth, low defence spending, and close ties with the U.S.

As such, we should keep in mind that the internal constraints may not always enable the government to act in a manner that it would like. At the same time, the demands of system support may also come in conflict with other pre-established objectives and this may, therefore, force a balancing of the competing objectives of the government, resulting in watered down policy outcomes.

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Chapter Three

THE U.S.- JAPAN AUTO DISPUTE

SECTION I BACKGROUND TO THE AUTO DISPUTE

In this chapter, we will look at the most recent and major sectoral trade dispute between Japan and the United States, the automobile dispute of 1979-1981. In the process, it will be argued that the role played by Japan in the resolution of the dispute was consistent with what we would expect of it as the system supporter. As such, while the automobile dispute has been studied in some detail by Winham and Kabashima [1], our focus will not only concern the negotiating strategy of the two parties but will also seek to grasp a measure of the intentions behind the stand taken by the Japanese government. To understand the motivations of the Japanese government, we will rely mainly on the writings of Amaya Naohiro, permanent vice-minister of MITI, who was the key player on the Japanese side.

The theory of hegemonic stability suggests that the stability of a liberal trading regime will depend on the presence of hegemonic control in the system. In the late 1970s and early 1980s, the LIEO confronted a severe threat to its existence as the result of a growing tide of protectionism in the United States, the country that stood in the leadership position. This protectionism could be attributed to a general economic decline and gradual loss of international competitiveness. From the standpoint of the hegemonic stability thesis, it was desirable, therefore, to reverse the course of the American economy and to rejuvenate the industrial structure. In the late 1970s, the

protectionist mood within the U.S. found its major prop in the automobile industry, which was seen as losing out to Japanese competition. The danger was that if the U.S. took steps to block out imports as was being demanded by the auto industry and the United Auto Workers (UAW), other industries, even those on the periphery, could be tempted to escalate their own demands. On the other hand, if the auto industry could be strengthened without resort to overt protectionism, it was felt that this would relieve pressure on the system. Even though the immediate crisis of the auto industry was precipitated by external factors, namely the oil crisis, its decline cannot be isolated from the decline of the American economy. We will present the argument here that the Japanese government acted with due concern to facilitate the reorganization of the auto industry as part of a long-term strategy to maintain the LIEO.

Amaya Naohiro, himself, demonstrates a keen awareness of the hegemonic stability thesis in his writings and his personal convictions must have found an input into the resolution of the dispute. He was, of course, aware that there was a theoretical alternative to hegemonic stability, one based on cooperation amongst members of the regime, but wrote that this, even though more desirable, was not a realistic alternative. Hegemonic leadership, while not the most desirable policy choice, was at least realistic and possible [2].

As mentioned in the previous chapter, protectionist resurgence in the U.S. can be traced to the industrial decline

and loss of competitive strength. Since this type of protectionism is merely a symptom, a correct strategy to deal with it would necessarily have to focus on restoring economic vitality, especially in the core sectors of the economy. It should be obvious that this cannot be achieved overnight and may even require short-term protectionism, if the affected industry is deemed to be of major importance to the overall well being of the economy. This was true of the auto industry.

The auto dispute rose to the surface when the UAW demanded relief from the inroads being made by Japanese car manufacturers and which threatened to disrupt American car manufacturing. The issue was immediately taken up by Congressmen and Senators from the Great Lakes region, despite the fact that almost everyone recognized that the cost of protecting the domestic auto industry would be high and have to be borne by the average consumer.

Senator Donald Riegle, irritated by the growing mass of literature that urged the U.S. to learn from the Japanese experience in respect to production technology, management practices etc., wrote, "...but we might also want to follow their example in closing off their domestic market while they built their modern automobile industry. Perhaps it is time for us to copy that part of their experience and protect our own market" [3]. In January 1981, when Transportation Secretary Goldschmidt submitted a report to the outgoing President on the state of the U.S. auto industry, he spelled out the need for a five year import quota on Japanese cars so that Detroit had a 'breathing

space' to complete the switchover to the production of small cars and the modernization of its production facilities. Senator Riegle was correct in noting that the Japanese auto industry had been built up behind a thick, impenetrable wall of tariff and non tariff barriers but there is a distinction to be made for infant industry protection and stagnant industry protection. 'For a late developing country, or for a country in the position Japan was in, in the postwar period, industrial development could only occur if the fledgling and weak industries were protected from foreign competitors. This rationale could hardly apply to the case of the U.S. auto industry, where decline was the direct result of shifts in demand patterns and consumer preference for small fuel efficient cars as opposed to the 'gas guzzlers' being produced in Detroit. One of the main arguments against protecting a declining industry is that such protection, by providing a captive market, takes away the incentive to restore the ability to compete in a free and open market. It creates a dependence that is unhealthy and examples are not hard to find.

Yet, despite all the known ills, protection cannot always be avoided. Political leaders cannot ignore the demands of organized sectors of the economy and still hope to ensure their political future. In the ~~auto~~ dispute, the U.S. Congress, from the beginning took a protectionist stance, largely because of the growing unemployment problems resulting from plant shutdowns and production cutbacks. Senator Danforth (Rep: Missouri), a strident supporter of protection for the auto industry, wrote

that if politicians told an unemployed auto worker, "Well, we know you used to be an auto worker, you've lost your job, and you are never going to get your job back because our U.S. auto industry isn't going to be employing many people. But we've got good news for you. All you have to do is go to graduate school at Cal Tech, master the art of designing software, and there will be a job for you", they would receive the political equivalent of a blue slip [4].

On top of the political imperative there may even, at times, be valid economic grounds for protection, if the industry can regain competitiveness. The economic consideration would be to avoid large-scale disruption on related industries and the economy in general. This, of course, depends on the centrality of the industry in question. In the midst of the auto dispute, the U.S. Congress passed concurrent resolutions declaring it to be a strategic national industry, considering the fact that one in twelve manufacturing jobs in the country was related to the auto industry and because the automotive sector provided a "market for 24% of the U.S. steel output, 17% of aluminum, 54% of iron, and 59% of synthetic rubber" [5].

Throughout the duration of the auto dispute, the Japanese industry remained opposed to restraints on their export of passenger cars to the U.S. They denied that the American auto industry was an industry in decline and instead viewed its plight as only a transitory phenomenon. Douglas Fraser, president of the UAW, admitted as much but what he objected to was the

"...continued unfair exploitation [by the Japanese] of their current, temporary advantage..." whatever that may mean. He went on to note that if this practice was continued, it could lead to an over reaction of protectionism in the U.S. [6].

In any case, whether Detroit's misfortune was only a temporary set-back or an ominous trend, the task was clearly to reverse the losses. This was important from the point of containing the tide of protectionism in the U.S. and from the point of preserving the LIEO. As Kamijo wrote, "To prevent the possibility of the U.S. taking the protectionist road, it is necessary for Japan to ... contribute to strengthening of the international competitiveness of U.S. industry and to the further growth of its export structure" [7].

In the early postwar period and through to the 1970s, both Detroit's auto manufacturers and the UAW had been strong exponents of the liberal trading order, not surprisingly, since the industry stood as the world leader. In the 1970s, however, they formed the core of the protectionist forces. This was the issue that fired the American Congress more than any other. For Japan, which is totally dependent on an open trading arrangement, the problem of how to contain protectionism and strengthen the LIEO seemed to focus on its response to the distress of the American auto industry. This, I believe, explains why the Japanese government and the MITI were eager to avoid causing excessive damage to the U.S. auto industry, allegedly being caused by Japanese exports. This is not to suggest that this was

the only factor that figured in the Japanese decision making process. There were other factors as well, but most of these could be seen as constant parameters that have always been a part of U.S.-Japan trade conflicts.

Our main thesis of Japan's new world role can only be supported if it can be demonstrated that the nature of the auto dispute was fundamentally different from previous trade conflicts. It is true that Japan had, on several occasions in the past, agreed to exercise voluntary export restraint and so the outcome of the auto dispute itself was no novelty. The difference can be found in the underlying rationale behind the actions of the Japanese government but this then raises the question of why the dispute festered for over a year and a half if the Japanese government was, from the beginning, in support of voluntary export restraint (VER). We will explore this further below but it should be noted that Japan was not simply pressured into reluctantly agreeing to restrain exports. Pressure has been one of the constant features of U.S.-Japan trade conflicts and as will be argued also plays a functional role, given the nature of decision making in Japan and the common phenomenon of 'so-ron sansei; kaku-ron hantai', a concept not much different from what Graham Allison has described as organizational politics, the endeavour by each organization to protect its own turf; maintain, if not enhance, its relative standing in the organizational hierarchy.

Another constant feature of U.S.-Japan trade disputes had

been the inevitable linkage with defence issues and Japan's alleged 'free ride' on the U.S. The American dissatisfaction with Japanese efforts to provide for its own defence has a long history and Japanese sensitivity to this can be used to explain Japanese concessions on trade and economic issues. This stems from a clear recognition by the Japanese government that it can do little to expand defence capabilities because domestic opposition remains high. Article 9 of the Japanese Constitution prohibits the possession of offensive weapons, even defensive capabilities according to a few, and on top of this a cabinet decision in 1976 to keep defence spending to under 1 percent of GNP made it difficult for the Japanese government to agree to American demands for a defence buildup.

The belief that Japan was taking a free ride on U.S. defence efforts troubles many American who see in this a distinct advantage for Japan because it freed resources that could then be diverted to achieve economic ends. Former U.S. Senator Paul Fannin expressed this sentiment as he testified in front of the Senate Committee on Finance in March 1981, in favour of a Bill sponsored by Senator Danforth, to restrict car imports from Japan. In his written statement, he said, "If we had subsidized Chrysler to ~~the~~ extent of 15 to 20 percent of their budget, as we have subsidized Japan and its industries, Chrysler would be prosperous today" [8]. The defence-trade linkage has become widely accepted in Japan. Thus, a day after the Japanese voluntary export restraint on automobiles was announced, the

Nihon-Keizai-Shinbun, (Japan Economic Daily) observed that, because of the inevitable defence-trade linkage, the argument proffered by MITI that the agreement was necessary in the interest of the long term stability of the LIEO was only a superficial explanation (tatemae) [9]. Its conclusion was based on the view that MITI had shifted its position to accept the VER only during the latter part of the dispute. The paper reported that as late as November 1980, MITI officials were of the view that there was no reason for Japan to exercise a VER. In reality, however, MITI had been urging Japanese car manufacturers to exercise 'self-control' on their exports to the U.S. long before that. MITI was never hostile to auto VER and this critical difference from past disputes will be used to build an argument in support of the thesis adopted here.

Aside from the defence-trade linkage, pressure on Japan also exploits Japan's dependence on the U.S. for both imports and exports. Such pressures can be a threat to take retaliatory steps or to withdraw existing privileges, an extreme example of which was the U.S. decision in 1971 to restrict American export of soy beans to Japan.

The presence of pressure has not had an altogether negative effect and, at times, even been welcomed by the Japanese government. Thus, Hugh Patrick suggested, agriculture and other imports had to be liberalized because of U.S. pressure, not because it would benefit the consumers; similarly steel exports had to be restrained because of U.S. threats, not because the

Japanese steel industry itself favoured such export restrictions [10]. This alludes to one very important fact: the utility and, indeed, the necessity of pressure. Still, the exercise of pressure has not been without problems and many in Japan are inclined to view it simply as the bullying of a junior partner. In the U.S., the frequent necessity of pressure has created the impression that Japan cannot be relied upon or trusted to be fair in its trade dealings: that Japan must be told each time of the 'ills' in its economic system, and then pressured to do something about them.

It is true that a sense of positive responsibility has been slow in developing but this is partly because of the unique situation Japan finds itself in. Japan has become the third largest economic power in the world, accounting for 10 percent of the world's GNP but in many Japanese commentaries on the success of economic development, it is not uncommon to find a heavy emphasis on the vulnerabilities of being an economic power without having a concomitant resource base. This latter point was one of the basic themes underlying the concept of 'comprehensive security' which underlined the inadequacy of defining security in purely military terms. The argument was that for a country like Japan, security also had to include the security of stable sources of raw materials supply and that this could not be guaranteed by purely military measures.

One can, however, discern a greater appreciation in Japan of its responsibility toward the liberal trading system and the

resolution of the auto dispute was perhaps its first concrete manifestation. This is not to suggest that pressure has become redundant. Pressure will continue to be important in resolving trade disputes and for breaking out of the stalemate emerging from the nature of bureaucratic and organizational politics. As well, the consensual, bottom-up decision making process, imposes severe constraints on the efficacy of political leadership in Japan. Unlike in the West, many decisions in Japan are usually made at the lower echelons of line management, and then formally approved at the top. Another feature of decision making in Japan is that only when consensus has been reached amongst all concerned parties is the decision given the final seal of approval. Reaching consensus is not easy and, as is well known, decision making is usually an exceptionally time consuming process in Japan. The advantage of the consensual approach, on the other hand, is that once a decision is finalized, implementation is free of the many problems that are encountered in the West. The difficulty of reaching consensus would be considerably eased, if, for example, in trade disputes, the scope of the issue did not transcend ministerial boundaries, but this is rarely the case. Thus, with each ministry trying its utmost to preserve its domain, building a level of consensus is not an easy task. It is in this respect that external pressure can play a functional role. Commenting on the nature of the decision making process in Japan, Deputy U.S. Trade Representative Hormats, states that, "One reason why Japan, despite major import

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liberalization, is perceived to be so protective of its market...is its style of negotiating - its seeming inability to act unless faced with major pressures to do so and then, seemingly, only with the greatest reluctance" [11].

The reason why foreign pressure has sometimes been functional is because decisions usually entail a redistribution of costs and benefits, not always on an equitable basis. This inevitably causes problems in securing consensus within the system. There will be opposition from those who stand to lose as a result of the decision, even though there may be total agreement with the principle underlying the issue at hand. A key characteristic of the Japanese decision making process, as Albert Craig writes, is the careful avoidance of a situation "...in which one man wins and another, who has openly declared his position, is marked as a loser when the decision goes against him" [12]. In disputes that span the jurisdiction of two or more ministries or organizations, it is easier to rationalize concession and 'defeat' if there is outside pressure, thereby preserving the facade, however superficial, of no organizational winners and losers.

Voluntary Export Restraints had been used in the past, but in the case of the auto VER, MITI was positively forthcoming as opposed to its negative attitude during the dispute on TV exports and its neutral stance during the steel dispute. In the case of Japanese colour TV exports to the U.S., an Orderly Marketing Agreement (OMA) was reached in May 1977. Both the colour TV and

automobile industries are high technology industries, unlike textiles, and the agreement reached on both TV and automobile exports brought about an absolute reduction in the volume of exports to the U.S. This is, however, where the similarity ends. The American TV industry was not particularly concerned about rebuilding their production base in the U.S. Most American TV manufacturers, with the sole exception of RCA, were small scale operations and their strategy was to seek cost advantages by relocating outside the U.S.

In 1967, Japan's TV exports to the U.S. totaled only about 320,000 units but in the following year, this more than doubled to 680,000 units. In June of the same year, an anti-dumping suit was filed with the Commerce Department which launched an investigation lasting for several years but then was abruptly terminated. In the meantime, Japanese exports continued to grow steadily, reaching 1.21 million units in 1975. This suddenly doubled again to 2.96 million units in 1976. In September 1976, the domestic manufacturers filed for protection under Article 201 (escape clause) of the 1974 Trade Act [13]. Negotiations started with Japan even while the International Trade Commission (ITC) was investigating the case of damage to the U.S. industry and an agreement was reached in 1977 to limit Japanese exports to 1.75 million units a year. Despite the agreement, however, TV manufacturers in the U.S. continued to shift production overseas. Zenith, in the early 1970s, had started production cutback in its main factory in Illinois and set up new facilities in Taiwan and

Mexico. Most of RCA's colour TV production had also been moved out to Canada. Thus, as Ogura Kazuo wrote, "...by relocating their production abroad, they [the U.S. manufacturers] had clearly indicated that they had given up, from the very beginning, trying to compete with imports through a rationalization of their management and manufacturing processes" [14]. Ironically, while American manufacturers shifted production in other countries, Japanese manufacturers started production in the U.S. In 1979, for example, export of colour TV sets from Japan to the U.S. totaled only 700,000 units while their production in the U.S. was about 3.5 million units. As a result, by the time the OMA expired in June 1980, it no longer had any restrictive effects.

In the case of the steel dispute, as was mentioned in the first chapter, the Japanese steel industry was very receptive to U.S. demands for export restraint. In 1978, three years after the 1969 VER had lapsed, steel exports became, once more, a source of friction between the two countries. At that time, the President of Nippon Steel, Saito Eishiro, and other industry representatives, themselves proposed to MITI that it arrange an OMA with the U.S. Patrick and Sato wrote that there were four reasons why the steel industry was so favourably inclined to export restraint.

1. the interdependent nature of the industry.
2. sense of indebtedness to the U.S. for assistance in the early developmental stage.
3. profitability of VER.

4. fear of losing a large and stable market in the U.S. [15].

Since the steel industry itself wanted export restraint, MITI went along and as a result of negotiations with the U.S., a trigger price mechanism (TPM) was agreed upon, which ultimately proved highly beneficial to the Japanese steel industry, since it took away the competitive edge of South Korea and secured for Japan a stable market share in the U.S.

The export restraint agreement on automobiles was different from all earlier export restriction agreements, although, as with steel and textiles before, it could be argued that the auto VER agreement was possible only because it resulted in increased profitability for the Japanese car manufacturers. This, however, ignores the fact that the auto industry in Japan, unlike steel and textiles, remained strongly opposed to formal export restrictions. Their opposition was due to the belief that the difficulties of the American car manufacturers were of a temporary nature and that a general recovery of the car market in the U.S. was expected even by American sources (See Table 3.5), would improve the sales position of Detroit. Thus, they argued, there was no real justification for restricting Japanese imports. As well, they did not want to be saddled with restrictions in a market that was likely to recover in the near future. The position taken by MITI, on the other hand, stressed the importance of a respite for U.S. car makers from Japanese imports, allowing them reasonable certainty regarding market standing at a time when additional, yet necessary, investment

appeared too risky. Before we look into the specifics of the VER, we will, in the next section, present a discussion of the problems that confronted the American auto industry and how it got to that stage.

SECTION II

THE POSTWAR DEVELOPMENT OF JAPANESE AND AMERICAN AUTOMOBILE INDUSTRY

The motor vehicle industry is the largest single export earner for Japan, earning US\$36.93 billion in 1984 (FOB basis) and accounting for 21.7% of total Japanese exports. Toyota and Nissan have both become synonymous with Japan's industrial strength and a significant landmark was reached in the late 1970s when total Japanese automobile production exceeded that of the U.S. for the first time, though largely due to a steep decline in American auto production. Few, including MITI, which strongly supported the building of an automobile industry, early in the postwar period, could have foreseen the dramatic growth of the auto industry in Japan.

When the question arose about whether to develop an auto industry after the War, there was considerable opposition from within the official bureaucracy. The Governor of The Bank of Japan, Ichimada Hirato, in the early 1950s argued that, "It is meaningless to develop the motor vehicle industry in Japan. Now

is the time of international division of labor. As we can get inexpensive motor vehicles of excellent quality from the United States, why don't we rely on them?" [16]. From the view point of international division of labour and comparative advantage, this made good sense, but comparative advantage has a static as well as a dynamic component, the latter often neglected. From the very beginning, MITI showed a clear understanding that comparative advantage was not simply a natural order but could be artificially created. Against the proponents of instituting an international division of labour, it argued that a domestic auto industry was indispensable for the broad based industrial development because around it would spring up other related industries. The biggest handicap at the time was the size of the domestic market, considered too small to support an efficient auto industry. However, the outbreak of the Korean War in 1950 provided a welcome surge in demand through the special procurement program of the U.S. military. In the early 1950s production in Japan reached an average annual figure of 40 to 50 thousand units, centering around trucks. American production around this time was well over 8 million units.

During the 1960s, liberalization of the Japanese economy was the main task confronting the Japanese government. The government had already announced, in June 1960, that it would take greater steps toward free trade and foreign exchange liberalization. With the pending issue of economic liberalization, MITI's main concern was how to provide effective

protection to the nascent auto industry, composed of about a dozen companies. MITI particularly feared capital liberalization which, when it did happen, would leave the Japanese industry vulnerable to foreign take-over bids. This was considered a serious threat given the low equity position of Japanese firms. The Asahi Journal in the late 1960s, carried an interesting interview with Kawamata Katsuji, Chairman of the Japan Automobile Industry Association, who claimed that the inevitable effect of capital liberalization, if it went ahead as planned, would be the 'industrial colonization' of Japan. However, capital liberalization was the promise under which Japan had joined the OECD in the mid-1960s and when the interviewer suggested that it made no practical difference if one or two people at the top had 'blue eyes' since all the others would still have 'black eyes', and the government would still collect taxes on profits, Kawamata very indignantly brushed aside the notion of obligation and said, "Every country has the right to formulate its own economic policies. We will liberalize what we can, but not what we cannot. The automobile industry cannot be liberalized" [17]. Toyota, the industry leader, most fearful of a take-over bid, took the precautionary measure of barring foreign directors from participating in the management of the company [18].

MITI's response to the impending liberalization of the economy was to encourage mergers so as to strengthen the viability of each individual auto manufacturer. The policy, however, had little success because the industry itself was

generally confident of its ability to survive on its own. The only successful merger achieved by MITI was that between Nissan and Prince Motors Company in 1966, but this after a couple of unsuccessful attempts to merge Prince with Toyo Kogyo (Mazda) and Toyota. Although MITI tried to forge what it believed to be an 'appropriate level of competition' and economies of scale, one cannot help but feel that the auto industry did not lose much and may even have benefited from MITI's failure to achieve rationalization. This may have been because the typical feature of vertical integration of industrial structure in Japan may have more than offset the gains to be had from horizontal integration. As Bain wrote, "Some such integration [i.e. vertical integration] may give rise to economies in production, reflected in the fact that the integrated firm can perform a series of successive productive function more efficiently than they ~~would~~ be performed by a number of individual firms, each of which performed only one function" [19]. More importantly, vertical integration, by giving control over supply of parts, enabled the Japanese manufacturers to operate with low levels of in-process inventory compared to the U.S. industry, thereby improving their cost position. The level of vertical integration in American and Japanese automotive industries is markedly different. When measured by adding manufacturing costs paid to subsidiaries to in-house costs, the vertical integration at Nissan and Toyota was 78 and 73 percent respectively, in 1983, compared to 28 percent for GM, the most integrated American car manufacturer [20].

In contrast to the gains that were made in the Japanese car industry, the American counterpart confronted a crisis of major proportions in the late 1970s. The immediate cause of the crisis was the hike in oil prices in 1979, but the process of decline had begun well before that. For example, labour productivity in the American industry consistently lagged behind wage increases. During the period of 1968-1977, wages rose by 124 percent but annual productivity increase averaged only 3 percent a year. Wages in the automobile industry were above the average for the manufacturing sector in general. The appropriate response to wage increase would have been to try and raise the level of productivity through new investment. Instead, the management responded by building bigger cars which allowed for large price mark-ups. As the size of the car got bigger, there was also a proliferation of models being produced. The trend toward product differentiation had been set in motion in the 1920s. At that time Ford produced only the Model T and the Lincoln but GM started out with a strategy that offered a wide range, from Chevrolet, Pontiac, Buick, Oldsmobile, and Cadillac. As a result, "...after a while, the auto industry was forced to convert to the GM-type strategy" [21]. As the number of models produced by each maker increased, it necessarily meant a smaller production run for each model type. The practical result was a deterioration of the cost structure as smaller production runs meant costly retooling. In terms of the top 10 cars produced, GM came in at No. 10 in 1982 with its Ciera Supreme (production run

of 321,000) while the Toyota Corolla was No. 1 (production run of 574,000). By 1984, however, the situation had improved somewhat: GM's Cavalier came in at No. 5 (400,000 units) and Ford Escort was No. 10 (342,000 units) [22].

As far as profitability of the American car manufacturers was concerned, there was no immediate cause for worry given consistently high demand for big cars. Fuel prices were relatively low by international standards which meant that operating cost, despite poor fuel efficiency, was low. Even after the first oil crisis of 1973, there was little change in demand patterns but the second oil crisis, following the Iranian Revolution and oil production halt in 1978, resulted in a dramatic shift in market demand. Big car sales plummeted and inventories soared. At the time of the second oil crisis, America was embarking on a phase-out of domestic oil price controls. The phase-out started in 1979 under an Executive Order issued by President Carter. We can estimate the difference between the two oil crisis, in terms of impact on the average consumer, by the fact that gasoline prices went up only 6 cents after the 1973 oil crisis but posted an increase of almost 40 cents after the 1979 oil crisis [23].

The quadrupling of the oil prices in 1973 by OPEC had led to a worldwide energy conservation campaign, except in the U.S., where extravagant use of gasoline, 40 percent of total U.S. oil imports, continued as in the past. This inevitably became the Achilles heel for effective Western response to OPEC and there

was considerable criticism of the extravagant consumption patterns being continued in the U.S. The U.S. government did eventually realize that it could not continue to fight the trend of the time and on December 22, 1975, the Energy Policy and Conservation Act was announced which set the target of raising the average fuel efficiency of domestic cars to 27.5 miles per gallon, by 1985, in stages, beginning in 1978, or about double the existing level of 13 miles per gallon. The lead time was essential to allow Detroit the leeway to complete the switchover to the production of more fuel efficient cars. Unfortunately, however, events moved faster than Detroit's transition.

Forced by the requirements imposed by the Energy Conservation Act, Detroit adopted the strategy of gradually reducing the size and body weight of cars. Only a month before the Act was announced, the President of GM, Elliot Estes, had denounced all efforts to restrict the size of cars for conservation purposes, saying that it was a "...badly mistaken notion that America can save its way to energy prosperity starting with automobiles" [24]. Detroit's strategy of increasing fuel efficiency necessarily had to be long term because of the massive investment requirements. It was estimated that the U.S. car manufacturers would have to invest about US\$80 billion over a six year period and the original plan was to redirect profit from the sale of big cars to the small car production technology. There was, as Shimokawa Koichi wrote, a need to make as much profit as possible from the large cars,

which ruled out a faster transition pace [25]. The 1979 oil crisis caught them totally unprepared to meet the sudden change in consumer demand. Perhaps they would have fared better if the government, between the two oil crises, had not been sending out mixed and conflicting signals, for example, imposing fuel efficiency requirements while at the same time continuing oil price controls. In any case, Detroit was now in serious trouble, as the sales figure, below, show.

TABLE 3.1

U.S. CAR SALES (UNIT: MILL.)

	1975	1978	1979	1980	1981
GM	3.75	5.38	4.92	4.12	3.80
FORD	1.98	2.58	2.14	1.47	1.38
CHRYSLER	1.00	1.15	0.94	0.66	0.73

TOTAL	7.05	9.31	8.33	6.58	6.20

Note: The total includes sales of AMC and VW(USA).

Source: Jidosha Sanyo Handbook, Nissan Motor Co., Ltd., 1985 Edition, pp. 278-279.

If we break down the above sales figure by size of car: subcompacts and compacts, and intermediate, and full size, the results are even more dramatic. This break down is given in Table 3.2, below:

TABLE 3.2

SALES BREAKDOWN BY SIZE (UNIT:1)

	1977	1980	% CHANGE
SUBCOMPACTS & COMPACTS	3,179,402	3,345,476	5%
INTERMEDIATES & FULL SIZE	5,227,897	2,911,066	-44%

NOTE: Excludes sales of luxury cars.

Source: Jidosha Sangyo Handbook, Nissan Motor Co. Ltd., 1985 Edition, pp. 282-283.

As can be seen, in just three years, the sales of big cars had declined markedly and while sales of small cars did increase, it did not offset the decline in big cars. The reason that sale of U.S. produced small cars did not show a larger increase was due largely to competition from Japanese imports, which had a definite cost advantage, not to mention their superior quality. We will look at this further below. Table 3.3 shows the annual sales and profit loss picture of the U.S. Big-3.

Chrysler, the smallest of the Big-3, was in trouble even before the oil crisis of 1979, having shown a net loss for 1975. The following two years, it showed some recovery, turning in a profit of around US\$500 million for 1976 and a more modest US\$160 million for 1977, before going back in the red. Both GM and Ford showed a net loss for 1980, the year following the oil crisis although GM did recover in 1981. In 1982, only Ford showed an annual loss, with both GM and Chrysler well along in their recovery.

TABLE 3.3

TOTAL SALES AND PROFIT OF U.S. BIG-3 (UNIT: \$BILL.)

		1975	1978	1979	1980	1981
GM	SALES	35.725	63.226	66.311	57.728	62.699
	PROFIT	1.253	3.508	2.893	-.762	0.333
FORD	SALES	24.009	42.784	43.514	37.085	38.247
	PROFIT	0.323	-1.589	1.169	-1.543	-1.060
CHRYSLER	SALES	18.572	13.618	12.002	9.285	10.822
	PROFIT	-0.260	-0.205	-1.097	-1.710	-0.476

Source: Nissan Motor Co. Ltd.

While the American auto manufacturers were concerned about their profitability, the UAW was more concerned with job security and the depletion of its rank and file membership, as a result of plant closure and industry wide layoffs. Between the period 1978-1980, the employment figure for the Big-3 declined from about 1,000,000 to 774,000, and there was little hope for much improvement in the near future. The first salvo in the auto dispute was fired by the UAW and it subsequently maintained a consistent pressure in the interest of securing employment in the industry. In the early phase of the dispute, emphasis was on getting the Japanese manufacturers to set up assembly plants in the U.S. just as they had in the European countries.

Having looked at the developments in the auto industry in both Japan and the U.S. and the nature of the problem faced by the American car manufacturers, we will, in the next section, trace the major development in the auto dispute. This will be done in a chronological order in order to better understand how

the dispute evolved over the period of the two American administrations, that of Jimmy Carter and Ronald Reagan.

SECTION III

THE AUTO DISPUTE AND ITS RESOLUTION: AN ACCOUNT

Japanese car exports had a lowly beginning with only two units exported in 1955, but the growth since then has been remarkable, though not without the usual jitters. Toyota, for example, had major problems trying to penetrate the American car market with its top of the line Toyopet Crown. Later, with a revised strategy of concentrating on the lower end of the market, it had considerable success. In 1970, a strike at General Motors, lasting over two months, disrupted the production of the small Vega cars and this had the important effect of allowing the Japanese car manufacturers to establish a firm foothold in the U.S. market. As long as the total U.S. car market was increasing, Japanese exports could be painlessly tolerated, but problems began to surface when exports from Japan showed no signs of slowing down even as the market was on a decline.

For auto manufacturers in Japan, increasing export sales had become an important goal since the 1973 oil crisis which had resulted in a decline in domestic car sales in 1974 and relative stagnation thereafter. The 1979 oil crisis further reduced market demand in Japan and there was also a shift in demand

patterns. Demand for small cars, with engine capacity of between 551cc to 2000cc declined in 1980 by 6.9 percent, but there was some increase in demand for light cars with engine capacity of under 551cc, such that total car sales declined by only 2.7 percent in 1980 [26]. In the United States as well, as we saw, car sales declined from 8.33 million in 1979 to 6.58 million in 1980 and down to 6.20 million in 1981. On the other hand, automobile exports from Japan increased from 1.41 million in 1978 to 1.55 million in 1979 (an increase of 9.8%), to 1.82 million in 1980 (an increase of 17.6% over 1979). Thus, imports were taking up a larger share of a shrinking U.S. market. In 1975, Japan's share of the U.S. car market was about 9 percent but this increased to around 21 percent in 1980. The market share figure represents the share of Japanese cars in the total U.S. car market, including full size and luxury cars. When one considers Japan's car sales as a percentage of only subcompact and compact cars, their market share had increased from 29 percent in 1977 to 36 percent in 1980 [27].

Understandably, this was a worrisome development from the point of view of American car manufacturers who feared that if the Japanese inroad remained unchecked, their own share of the market would decline even further making new, and necessary, investment for the production of small cars a very risky proposition. They felt that the profitability conditions of their investment program required not only some assurances against further deterioration in their market share but

preferably some improvement. Otherwise, it was feared that they would simply be adding on excess and redundant capacity.

The U.S.-Japan auto dispute, in its initial phase, proceeded along two interrelated but somewhat separate tracks. The first, as we mentioned, was Japanese investment in the U.S. and the second, import restrictions on Japanese cars. When the issue was first raised in October 1979, Douglas Fraser of the UAW, called for either Japanese production in the U.S. or restrictions on car imports. At that time, none of the Japanese manufacturers had any plans for setting up production facilities in the U.S. even though they had set up production facilities in European countries. Japan's reliance on exports for car sales in the U.S. market was seen as costing American jobs. Of course, by relying on exports, the Japanese manufacturers could benefit from the lower production costs in Japan, but more importantly, there were few, if any, positive incentives to locate assembly plants in the U.S., purely from an economic point of view. A manufacturer decides to invest abroad on the basis of perceived gains from such factors as worker productivity, labour costs, tax benefits, worker-management relation etc. and no matter how one looks at it, there was no major incentive to locate production in the U.S. Of course, the U.S. represented a growing and important market but there is no economic argument to suggest that a large market is reason enough for investment, since demand can just as easily be met through exports. Lacking positive incentives, the UAW pressed for negative sanctions in the hope of attracting Japanese

car manufacturers into the U.S. just as the Europeans had done. In addition, Fraser raised what could be called the 'moral imperative' when he blamed Japanese imports for unemployment in the U.S. He argued that annual sales of about 200,000 units was sufficient economic reasoning to justify setting up production facilities in the U.S. [28].

Up until June 1980, the main thrust of American demand was to pressure the Japanese manufacturers into local production. This point was raised by Fraser when he visited Japan in February, by President Carter when he met with Prime Minister Ohira in May 1980, and again by USTR Askeu during his visit to Japan, also in May, 1980.

On the occasion of his first summit meeting with Prime Minister Ohira in Tokyo, President Carter pointed out that unemployment in the U.S. was becoming a political issue but he also assured the Japanese side that he would not impose any restrictions on Japanese car imports. Instead, he urged that Japan take the following steps to prevent the politicization of the dispute.

1. boost car imports from the U.S.,
2. undertake investment in the U.S.
3. domestic production in the U.S. on joint-venture basis [29].

It was agreed that negotiations between the two countries on the above points would be undertaken when Askeu visited Japan later in the month. As a result of talks with Askeu, the

Japanese government agreed to adopt the following measures.

1. the Japanese government would encourage capital investment in the U.S.
2. the Japanese government and auto parts manufacturers' would conduct a survey of the U.S. market for production in the U.S.
3. improve standards and simplify procedures for U.S. car imports.
4. remove tariffs on auto parts.
5. help increase imports of auto parts from the U.S. [30].

The final two points were part of President Carter's specific request but it is hard to see the Japanese firms significantly increasing their sourcing from the U.S. This is largely because of the structure of the Japanese industry, described above, and the just-in-time inventory system. The Japanese manufacturing system is geared to maintaining a minimum level of in-process inventory, which is one factor behind their cost advantage, and if they were to do more sourcing from overseas, it would mean a significant revamping of their production processes [31].

In time, demands for import restrictions on Japanese cars began to gain strength and Fraser called this a short term necessity. The Japanese view, both official and of the industry, was that it was inappropriate to blame Japan for the misfortune of Detroit. In March 1980, the Joint Economic Committee of the U.S. Congress convened an open hearing on the state of the U.S. auto industry and testifying before it, Suzuki Yasuhiro, Vice-

President, External Relations, Nissan Motor Corp. of U.S.A. stated that, "The current automobile problem is not an issue of imports versus domestics, but large cars versus small cars" [32]. In his testimony, he listed the following factors as reasons why import restriction was not the answer to the problem.

1. it would not put workers back on the job.
2. it would penalize consumers.
3. it would help fuel inflation.
4. it would deny consumers freedom of choice.
5. it would increase fuel consumption and dependence on OPEC.

Articulating the official view, Amaya Naohiro wrote that the misfortune of Detroit was simply the cause of poor demand for big cars and that Japanese exports only helped to fill the gap between domestic demand and supply, which worked to the advantage of the consumers [33].

With respect to the five factors listed above, few would deny the validity of the first three factors. On the issue of restoring employment levels in the U.S. auto industry, the Managing Director of Nissan in a round-table discussion published in the MITI publication, Isusan-Journal, said that regardless of the decision taken by the U.S. on the question of import restrictions, it was unlikely, firstly, that the demand trend

could be reversed to favour big cars, and secondly, since small cars embody lower labour content, the unemployment would continue for sometime" [34]. Also, one of the tasks confronting the U.S. car manufacturers was modernization of their production facilities, and this implied a higher level of automation; not the typical Detroit automation of 'conveyor belts' but robotics and other labour saving technology. As experience since then has shown, despite recovery in the U.S. auto industry, employment fell from 793,000 (total for GM, Ford, Chrysler, AMC, and VW of USA) in 1981, when the VER went into effect, to 723,000 in 1983. During this period, production had increased by 1.2 million units, including both passenger and commercial vehicles. On the final point mentioned by Suzuki, Fraser asserted that U.S. cars were not necessarily less fuel efficient adding that "...the Ford Fairmont [Tempo] and Mercury Zephyr [Topaz] have 1980 EPA ratings of 23 mpg in city driving and 38 in highway driving. Toyota's Corona, Celica, Supra and Cressida models were rated at 20 city and 28 highway." Still, even allowing for this exception, it cannot be denied that average fuel efficiency was above that for American cars but, moreover, it must not be forgotten that what sustained the demand for Japanese cars in the U.S. was not only fuel efficiency but also their perceived superior quality and competitive prices. The difference in quality can be gauged from the number of recalls. In 1979, GM recalled 4.81 million units, Ford recalled 1.4 million units, and Nissan only 290,000 as its first recall in the U.S. [35].

The American consumer seemed to prefer Japanese cars to domestic makes and this can be observed from the sales statistics given below.

TABLE 3.4
PRODUCTION CAPACITY OF SELECTED U.S. CARS, 1981

MAKE	MAXIMUM WITH OVERTIME	STRAIGHT TIME	SALES	CAPACITY UTILI- -ZATION OF STRAIGHT TIME (WITH OVERTIME)
GM CHEVETTE	500,000	415,000	402,000	97% (80%)
GM 'J' CARS	330,000	270,000	164,000	60% (49%)
FORD ESCORT/ LYNX	560,000	435,000	390,000	89% (49%)
FORD EXP/LN-7	190,000	160,000	73,000	45% (38%)
FORD FAIRMONT/ ZEPHYR	440,000	350,000	234,000	67% (53%)
CHRYSLER OMNI/ HORIZON	330,000	270,000	131,000	48% (39%)
CHRYSLER 'K' CARS	650,000	540,000	347,000	64% (53%)

Source: "Issues Relating to the Domestic Auto Industry", Hearings Before the Sub-committee on International Trade of the Committee of Finance, U.S. Senate, 97th Congress, 1st Session on S-396, March 9, 1981, and Jidosha-Sangyo Handbook, Nissan Motor Co. Ltd., 1985 Edition, p. 281.

The U.S. car manufacturers argued that if Japanese imports were restricted, they would be in a position to quickly move in to fill the shortfall in supply since they already had excess

capacity. As the Table above shows, production even in the recession year of 1981 was near full capacity for some of the models, like the Ford Escort and the GM Chevette. There were, however, many other production lines that were relatively idle. Since not all makes were doing equally bad, it could be taken as evidence that Detroit's real problem was not imports but rather, how to restructure production to meet existing demand patterns. There is no denying, however, that restriction on imports would have helped and facilitated the transition process.

During the summer of 1980, the emphasis of U.S. demands shifted to import restriction. On June 12, 1980, the UAW filed a petition with the International Trade Commission for protection for the auto industry on grounds of damage from Japanese imports. The UAW petition recommended that as relief measures, the tariff on passenger car imports be raised from 2.9 to 20 percent and that an import quota be adopted using either 1975 or 1976 as the base year. On the 4th of August, the Ford Motor Company filed a similar petition for relief, suggesting the following concrete steps.

1. Import quotas using 1976 as the base year.

- passenger cars 1.7 mill. units/year.
- small trucks 260,000 units/year.

2. A 25% tariff on small truck imports.

In the interim, the Japanese Prime Minister, Ohira, suddenly died in office and Carter took the opportunity to go to Japan in early July to attend the memorial services. About a week before

his departure for Tokyo, a task force set up in mid-May and headed by Transportation Secretary Neil E. Goldschmidt, submitted a report to the president on the plight of the American auto industry and on relief measures. The report reflected both President Carter's preferred style of decision making and the divisions within the administration. The president had already established the practice that all reports to him list all the possible options available, including the advantages and disadvantages of each but refrain from making a specific recommendation, leaving the final decision with the president. In keeping with this tradition, the Goldschmidt report simply noted the options open to him but did not recommend any specific relief measures. The report also reflected the divisions within the administration, for example, USTR Askew and Chairman of the Council of Economic Advisors, Charles Schultze, were both proponents of free trade, while Secretary Goldschmidt himself, favoured import controls [36]. The options listed covered the spectrum, including sending a 'purposefully indirect' signal to the Japanese that he [the president] was 'very concerned', and at the other end, a negotiated VER, but as the report noted, the latter ran the risk of litigation under the U.S. anti-trust laws. The president chose the milder option and to demonstrate his concern, he made a brief stop over in Detroit on his way to Tokyo. As GM Chairman and Chief Executive, Thomas A. Murphy observed, "This is a very good first step. The fact that the President was here is a demonstration of the importance with

which he views the situation" [37]. In Detroit, the president also announced an aid package easing regulatory standards on auto emissions and safety, and easier credit for auto dealers, promising total savings of \$500 million over a three year period. The plan also promised to set up a tripartite structure between the government, labour, and management, to study appropriate policy responses on each of the five issues of environment, research and development, tax structure, employment, and trade. The President also expressed the hope that the ITC would expedite its investigation of the UAW/Ford petition and hand down its decision ahead of the stipulated time limit. For Detroit, this was perhaps the most encouraging feature of Carter's visit since it could conceivably lead to early negotiations with Japan. Carter, himself, however, was totally opposed to import restriction because it would undercut his goal of curbing inflation and raising fuel efficiency. The New York Times observed that requesting an early ITC decision did "...not imply that the President ha[d] made up his mind, merely that he want[ed] to get the case resolved quickly" [38]. Carter knew that he would have to negotiate with the Japanese should the ITC rule in favour of the petition but it seems that he also expected the problem to disappear if the ITC found no evidence of damage from Japanese imports.

Interestingly, in the period following the UAW/Ford petition, both the U.S. Congress and the Japanese government were working on the basis of their respective worst-case scenario.

For the Congress this was the rejection of the petition and for the Japanese government, if the ITC upheld the petition. Fearing an unfavourable ITC decision, Senators Riegle and Metzenbaum, and twenty-one others, introduced a resolution in the Senate on August 5, 1980 to provide specific authority to the President to begin negotiations with the Japanese government on restricting car imports. Passage of the resolution would have enable the President to begin negotiations without having to wait for the ITC decision. Carter, however, was not keen on this. The following month, testifying before the House Foreign Relations Committee, sub-committee for Asia and Pacific Affairs, senior Administration officials stated quite clearly that the government would only proceed on the basis of an ITC ruling, whatever that might be, and that it would not abide by any resolution passed by the Congress giving the President authority to begin negotiations [39].

The Japanese government, likewise, was preparing for its worst-case scenario. It felt it prudent to do so for a number of reasons. Firstly, the Japanese car manufacturers were doing very well in the U.S. at a time when the American manufacturers themselves were faced with hard times ahead. The UAW also was doing a very good job of portraying Japan as preying unfairly on the misfortune of American car makers. It was also not very reassuring to know that Carter, in May, had been forced to withdraw his nomination of Robert E. Baldwin to fill a vacant ITC seat on grounds of stiff Congressional opposition that Baldwin

was too much of a 'free trader' [40]. In the past, presidential nominations to the ITC had never been opposed by the Congress and this rare incidence was just another indication of the mood of the moment and one that could have been imputed to have some bearing on the ITC decision.

MITI's immediate concern was to avoid exacerbating the situation. However, its options were rather restricted because even though it favoured export controls (but not import controls imposed by the U.S.), the U.S. administration was opposed to any form of trade restraint. Under the circumstances, it did the best it could which was to encourage the Japanese manufacturers to voluntarily control their exports to the United States. The Japanese press reported that MITI began urging the major Japanese producers, Toyota, Nissan, and Honda, from June 1980, to restrain their exports [41]. MITI could not unilaterally impose export restraint because that required some form of inter-governmental agreement, as will be explained below.

In late September, the MITI minister Tanaka Rokusuke, met with representatives of the major Japanese auto firms and urged them to contain their shipments to the U.S. in the October-December quarter to levels below that for the same period in the previous years. It was hoped that this would weaken the protectionist forces in the United States in the critical period before the ITC ruling but the problem of unilateral action became all too obvious when the Department of Justice in the U.S. and the Federal Trade Commission promptly launched an anti-trust

investigation on suspicion that the Japanese manufacturers had formed a cartel to restrict supply in the U.S. [42]. The problem of how to avoid anti-trust suit also became an issue in the final stage of the VER negotiation in 1981. Japan wanted to avoid a repeat of the situation in 1972 when the Consumers Union had filed a suit against the State Department claiming that the VER on steel with Japanese and European exporters was in violation of the anti-trust laws. Although the suit itself was rejected, Patrick and Sato wrote that the aftershock of the dispute was part of the reason why the steel VER was allowed to lapse in 1975 [43]. Later, and when the auto VER was finally implemented, the Japanese government sought, and obtained, formal assurances from the Office of the Attorney General that the restraint agreement would not be regarded as a violation of the U.S. laws.

Throughout the duration of the auto dispute, President Carter's opposition to quantity restrictions was consistent and unflinching. In September 1980, Japanese Foreign Minister Ito went to Washington and after meetings with senior administration officials, including President Carter, he held a news conference where he confirmed that he had received no request for Japan to restrict export of cars to the U.S. Still, he volunteered that, "Japan would continue to make efforts on its own to help maintain the free trade regime" [44].

The ITC, as things turned out, and despite President Carter's wish for an early decision, stuck to its original timetable [45]. Accordingly, on the 10th of November, the ITC

handed down its decision and by a vote of 3-2 rejected the UAW/Ford petition and absolved Japan of any guilt in the decline of the American auto industry. This closed the door for the administration to negotiate import restriction with Japan. Congressional action, however, was still possible. Naturally enough, the ITC decision was greeted with relief by both the Japanese manufacturers and U.S. auto importers but the U.S. auto industry expressed bitter disappointment and vowed to take the fight to the Congress. Had the ITC decision been a unanimous one, it would probably have had some restraining effect on the demand for import restriction, but it was very close and instead of resolving the issue, left it open for further consideration. As an aside, it might be noted that the American tradition, just as the founders of American democracy had intended, is not to accept passively rule/tyranny of the majority, but to demand protection of minority rights and the American auto industry must have been heartened by the close decision which enabled it to continue the fight. Moreover, even those ITC members who had voted to reject the petition, lashed out against imports, either directly or indirectly. Michael J. Calhoun, vice-Chairman of the Commission, stated that the "integrity of the international trading system" required a "certain sensitivity" on the part of overseas suppliers "to avoid achieving their success at too high a cost to the host society." He did not specifically point to the Japanese car industry nor indeed, did he have to when he continued saying, "I have found a disturbing absence of such

regard and sensitivity on the part of particular foreign automobile manufacturers" [46].)

The presidential election of November 1980 resulted in a defeat for President Carter, perhaps an indictment of his un-Democratic policies of pursuing the goal of low inflation even at the cost of high unemployment. In the process, he had managed to antagonize many of the vested interests including the powerful UAW. During the lame-duck presidency and congress, there was not much activity but the Congress went on the offensive early the following year. In the 97th Congress, in 1981, there were eight bills introduced seeking restrictions on Japanese car imports, including the Danforth-Bentsen Bill (February 5, 1981) to limit Japanese imports at 1.6 million units a year, and the Broadhead-Hills Bill (February 19, 1981) to limit imports at an even lower 1.2 million units a year.

The new Republican Administration could not have been oblivious either to the distress in the auto industry or to the mood in the Congress and one of Reagan's earliest decision was to appoint a special task force to study the automobile problem and make its recommendations to the President. The task force was headed by the Secretary of Transportation, Lewis, and the other members included USTR Brock, Commerce Secretary Baldrige, Labor Secretary Donovan, and Weidenbaum of the CEA. Like the earlier Goldschmidt task force, the present task force also seemed divided on the policy response. Because of this division and because the composition of the cabinet seemed to favour 'free

traders', some like Obi Toshio considered it unlikely that Reagan would take any protectionist steps, considering, for example, that 10 of the 14 cabinet members, including Haig, Stockman, Weidenbaum, and Regan, all opposed import restraint [47]. Donald Regan, for instance, had strongly criticized President Carter's aid package announced in Detroit in July 1980 saying to the effect that the cause of the present problem confronting the automobile industry lay neither in Japan nor in Europe, but in Washington, implying the policies of the administration to sustain high interest rates and the emphasis on fighting inflation first. Interestingly, the Reagan administration continued these same policies, even retaining Paul Volcker at the Federal Reserve Bureau. On the other hand, those who favoured import restrictions on Japanese cars included Lewis, Raldrige, and Brock. The Lewis task force, set up on January 28, was charged with the mission of submitting a final recommendation within a two months period. The task force sought to present a unified position favouring VER but opposition from Regan made it difficult to come to a consensus. Finally, in mid-March, a spokesman announced that agreement had been reached within the task force, as the result of concessions on both sides, particularly Regan.

It is perhaps significant that consensus was finally reached at the second meeting of the task force called by Reagan on the 17th and only a few days after a Reagan interview was published in the New York Daily News where he stated that he was in favour

of voluntary export restraint by Japan, as had been advised by both the Commerce and Transportation Secretaries. Donald Regan may have had no choice but to 'soften' his opposition. The agreement reached on the 17th covered the following three points.

1. that a report would be presented to the President outlining a unified policy response.

2. that Brock would go to Japan for VER negotiations [this was to be done informally since the ITC ruling did not permit formal negotiations].

3. that the VER would be for a period of three years [48].

On the 19th, when the report of the task force was formally submitted, President Reagan attended an expanded ministerial meeting where he stressed the following points.

1. support for the liberal trading system.

2. belief that government should not get too involved in the aid of particular industries.

3. the view that the prevailing poor conditions in the auto industry ~~was-not-entirely-its-own-fault~~, and

4. therefore, the government had the responsibility to aid the auto industry [49].

The President thus very nearly overturned the earlier ITC ruling. In late March, Foreign Minister Ito visited Washington again to finalize preparations for Prime Minister Suzuki's visit in May and met with President Reagan on the 24th. The President reiterated his commitment toward preserving the liberal trading order but pointing out the fever pitch protectionism in the

Congress, signalled strongly that it might be necessary for Japan to exercise VER [50]. Maybe because he had already indicated his preferences, Reagan did not deem it necessary, specifically to raise the issue of VER when, on April 7, he announced his administration's plan to revive the auto industry. The plan was presented as part of the Overall Economic Recovery Plan by which the administration hoped to set the economy back on the growth track. But there was one piece of good news for Detroit. It proposed relaxing or removing about 34 auto related governmental regulations concerning auto exhaust and safety, expected to bring manufacturers a saving of US\$1.4 billion over a five year period. The MITI minister Tanaka Rokusuke, at a news conference the same day gave an assurance of Japanese cooperation in the rehabilitation of the U.S. auto industry and said that he fully realized that it was the U.S. desire that Japan exercise VER [51].

While the two governments had at last agreed, in principle, on VER, the Japanese industry remained totally unconvinced, arguing, as before, that the Japanese export surge was only the result of a temporary supply and demand imbalance for American cars. The forecasts made by U.S. car makers themselves pointed to a domestic sales increase to over 1 million units (passenger cars) in 1981 and this promising outlook might have been interpreted as eventually easing the pressure on Japan. For the Japanese car makers, therefore, it was advantageous to await the market trend since they could then hope for a better bargain.

Accordingly, they strongly opposed the government's resolve to settle the dispute before Prime Minister Suzuki's visit to Washington.

Shortly after the Reagan auto recovery plan, the MITI minister met with Ishihara, Chairman of the Japanese Automobile Industry Association (also President of Nissan Motor Co. Ltd.) where Minister Tanaka tried to impress upon him the urgency of the situation. Afterwards, a MITI spokesman confirmed that the two men had reached an agreement recognizing that Congress would otherwise surely take the legislative route [52]. It was not yet clear whether Reagan would veto protectionist legislation or not (see below). MITI and the industry only agreed on the principle and the specifics were still to be worked out. MITI knew there was considerable gap between U.S. demands and what the industry was willing to concede at the time.

With the resolution of the MITI and industry disagreement, at least in principle, a consensus had been reached amongst all the concerned parties. At this point, the ruling Liberal Democratic Party (LDP) ventured on the stage. Politicians everywhere need the support of their electorate and to run a successful election campaign they need also to be well-funded. In Japan, 'money politics' has been taken to an extreme, and despite periodic attempts at reform, the system endures. One result of this has been to magnify the influence of contributors to the party coffers, mainly the big business organizations. The LDP had kept a low profile during the time that the auto industry

itself opposed VER but after it had conceded on this point, Prime Minister Suzuki, on the 9th of April, announced that a LDP mission would be despatched to the States, not only to explain the Japanese position but also to try and help secure an agreement as favourable as possible for the domestic auto industry [53]. This, however, was only the stated intention of the mission, to show that the LDP was doing its best to protect the interests of the car makers, but the real intention (honno), as would become clear, was to impress on the auto industry that it would have to make further concessions. It was a plan, as Kusano Atsushi wrote, to put the LDP firmly behind MITI's support for VER [54]. The delegation, led by Representative Ogawa, left for Washington the following week for a three day period of talks with various administration officials. What the Japanese government feared most was the consequence (import quota legislation) of rupture or excessive delay in finalizing an agreement on VER. When the LDP delegation met with Malcolm Baldrige, the Commerce Secretary, he made no particular attempt to allay Japanese fears and said simply that it was too early to say whether the President would veto the Danforth-Bentsen Bill, if it passed the Congress, but added that the President did wish to see the problem resolved in more amicable ways. At the end of their scheduled stay in Washington, the delegation duly made clear what had been the real intention of the mission. At a press conference, Ogawa said that: "The state of the U.S. automobile industry is fairly critical and we were made to feel

the deep roots of the problem. Unless Japan does everything possible to help, the problem will not be resolved. As soon as we return to Japan, we will report our conclusions to the Prime Minister...." [55].

MITI entered into a final round of negotiations with leaders of the auto industry on the 21st of April and while the industry sources had been insisting upon restraints not below the level of exports for 1980, i.e., around 1.82 million units, a MITI official revealed after the first day of talks that consensus could probably be reached at a level of 1.7 million units [56]. The official U.S. request, according to some sources, was around the level of exports in 1979, or 1.52 million units but at various meetings earlier in March between Brock and Ito, Brock and Amaya, and Brock and Okita (former Foreign Minister) a tentative agreement was reported to have been reached at the level of 1.6 million units, although this was considered very demanding on the Japanese auto industry [57]. Another unresolved issue was the duration of the VER. The Americans wanted the VER to apply for a period of three years, considered an adequate 'breathing space' for Detroit to recover and complete the necessary retooling for transition to small car production. The Japanese auto industry, however, wanted the restraints to apply for only a year since they did not want to be saddled with quantitative restrictions in a market that most predicted was likely to improve in 1981 and thereafter. The U.S. government forecast, though less optimistic than the industry forecast,

still pointed to a steady recovery of sales, as shown in the table below.

TABLE 3.5
U.S. GOVERNMENT ESTIMATE OF AUTO SALES (UNIT: MILL.)

YEAR	PASSENGER CARS	TRUCKS	TOTAL
1981	9.1	2.4	11.9
1982	11.0	2.8	13.8
1983	12.0	3.0	15.0
1984	12.0	3.0	15.0
1985	11.5	2.9	14.4

Source: Nihon Keizai Shinbun (chokan), April 9, 1981.
p. 1.

As had been recommended by the presidential task force, USTR Brock left for Tokyo in late April to negotiate the VER. The final round of negotiations between Brock and MITI began in the early evening of April 30, 1981, which was later described in some detail by Amaya Naohiro, the principal negotiator on the Japanese side. The talks began at 6:30 p.m. with the Japanese side outlining its proposals, as below:

1. the VER would be for a duration of 3 years.
2. Japan would exercise VER in the first year of the agreement, with total permitted exports not to exceed 1.7 million units (April 1981-March 1982).
3. At the end of the first year, there would be fresh negotiations on whether or not to

continue the VER.

4. MITI would be responsible for the allocation of quotas to the Japanese manufacturers, and

5. MITI would oversee the implementation of the VER and take steps to ensure compliance under the Export Trade Control Act should it appear that the quotas would be exceeded [58].

Amaya noted that the Japanese offer represented the maximum possible concession and that there was no fall back position, but Brock, after listening to the explanation provided by Minister Tanaka, said the package was still insufficient to block the passage of the Danforth Bill [59]. The U.S. proposal was for a three year VER at the level of 1.6 million units. The proposed U.S. figure included, besides passenger cars, station wagons and light vans and also included sales in Puerto Rico, all of which had been excluded from the Japanese figure of 1.7 million. Converting the U.S. figure to the Japanese equivalent produced a figure of between 1.45 to 1.5 million, a level that the Japanese industry sources regarded as too low and unacceptable. The talks had deadlocked and there was total silence in the room as each side contemplated its next move. Amaya wrote that the few minutes of silence seemed like a few hours. After a while they agreed that a change in environment and a more relaxed atmosphere might be more amenable in providing fresh ideas. The negotiators adjourned for dinner and drinks, an important phase in official and private negotiations in Japan, where many deals are successfully negotiated and concluded during a night out on the

town. Away from the formal setting of the negotiating table and after everyone had settled in a relaxed state of mind, Amaya took it upon himself to explain to Brock something of the Japanese psyche. The Japanese people, he observed, had both an emotional streak as well as a utilitarian attitude. In the prewar period and during the war, emotions and petty nationalism were the dominant driving force but the disastrous wartime failure brought about a major shift in attitude, away from emotionalism to utilitarianism. Given the delicate balance between the two distinct impulses, it was possible, he argued, that should the U.S. continue to be insensitive and put too much pressure on Japan, the latent emotionalism would be reactivated, to the advantage of neither of the two countries [60]. Amaya hoped that this would have the desired effect of softening the American position. Later, that same night, Minister Tanaka held meetings with leaders of the automobile industry to brief them on the result of the days talks and to prepare a new position for the morning's meeting with Brock. The Minister pleaded with leaders of the industry to make some additional concessions but, according to Amaya, was met with stiff opposition. Amaya took Ishihara aside to make a personal effort and began by suggesting that while it may have inspired 'popular admiration' when Japan, before the war, had walked out of the League of Nations, Japan could not afford a rupture in the auto talks since it would lead to the worst possible outcome - a trade war that could not possibly be won by Japan. If the automobile industry, therefore,

persisted with its hardline position, all would suffer. Amaya, went on to observe that Isihara made no outwardly visible concession but by what was left unsaid, he knew that his efforts had not been in vain [61].

Amaya's negotiating tactic in this final phase was a tried and tested tool of mediation, of threatening each side with dire consequences if agreement could not be reached and presenting to each a picture of the other as totally intransigent, hoping that this would bring forth concessions on both sides. It was a ploy that Keynes had used with some success in the Bretton-Woods negotiations, cajoling and threatening simultaneously the newly installed and inward looking British Labour government to accept the terms he had negotiated with the U.S., and the Truman government for more concessions to appease the 'bilateralism' of the British government, by portraying each as inflexible [62].

The following morning agreement was reached with Brock on the following main points.

1. that the VER would be for a three year period, ending March 31, 1984.
2. the first year quota would be set at 1.68 million units.
3. the second year quota would be at 1.68 million plus a 16.5% share of whatever growth took place in the American market in 1981.
4. discussion on VER for the third year.

The quota of 1.68 million units was the average level of Japanese exports to the U.S. in the preceding two years and the figure of 16.5 percent represented Japan's share of the U.S.

market in 1979, also the average market share for the three years, 1978-1980. This was intended to reserve for Japan a certain market share, given forecasts of growth in sales in 1981.

SECTION IV ANALYSIS OF JAPANESE MOTIVATIONS

In the section above, we provided a chronological account of the automobile dispute, from the start to the its finish with the VER agreement. However, we made no attempt to explain the motivations of the chief actors. This, as stated at the outset, is crucial for the purpose of this thesis and in this section, we will try and explore the motivations of MITI that led it to support VER unlike in past disputes which had also resulted in quantitative restrictions on Japanese exports.

The auto dispute lasted approximately a year and a half, from start to finish. This requires an explanation of why, if it was true that the Japanese position was not the major stumbling block, a solution could not be reached much earlier. In past trade disputes, Japanese resistance had often been held to blame for the delay in reaching a settlement. In the case under study here, the answer lies in the lack of political clarity and direction of the Carter administration. In order to demonstrate this, we will compare and contrast the policies of the Carter and Reagan administration and to add a touch of irony, we are

'fortunate' that the dispute spanned two different American administrations. Also, as the detail in Section III showed, there were two very different approaches to the problem. Patrick and Sato, in their analysis of the steel dispute, briefly touched on the contrasts between the resolution of the steel and auto dispute and observed that in the latter instance, "While the Japanese government (particularly MITI) was prepared to make necessary adjustments, the U.S. government remained indecisive, thus contributing to the prolongation and escalation of the issue" [63]. It is unfair, however, to lump the two administrations together, because the indecisiveness was really only visible in the policies of President Carter. Carter, no doubt, would have liked Japan to initiate VER on its own initiative, but obviously could not bring himself to act in a manner that would compromise the consistency of his domestic programs. An indication of the difference between the two administration was evidenced from the gist of the meetings Foreign Minister Ito held with President Carter in September 1980, and with President Reagan in March 1981, described above.

While MITI was unable to impose VER because of the refusal of President Carter formally to indicate its desirability, MITI did the best it could to contain the flood of exports to the U.S. As mentioned above, MITI had been urging self-control on the part of auto manufacturers and this did have some effect in reducing exports in the fourth quarter of 1980. In the period January-March 1980, car exports to the United States had

increased by a hefty 25.4 percent over the same period in 1979, but under MITI's urging, exports in the October-December quarter declined by 1.8 percent over the same period in 1979. Total exports for 1980 were 1.82 million units and according to MITI sources, without the self-control, the total would have topped 1.9 million units [64]. Table 3.6, below, gives the monthly breakdown of exports over the period 1979-1980. It is true, however, that the decline in exports in late 1980 came too late and was rather too modest to have much impact on the calls for protection in the U.S., but there was not much more that MITI could have done. The action MITI took was to call for 'self-control' (Jishuku) which had no formal binding powers because it did not specify anything in particular. It could not impose VER (Jishu Kisei) because such an action had to be based on some prior government level understanding to avoid the problem of American anti-trust suits. Thus, even if the Japanese auto industry had been favourably disposed to exercise VER, like the steel industry before it, MITI might still not have been able to do much. But the opposition of the auto industry made it all the more important that the U.S. make a formal request so that MITI could use it to force compliance by the domestic industry. President Carter, however, was determined to avoid protectionist measures since a likely outcome of such protectionism would be to undermine the effectiveness of his anti-inflationary economic policies.

4

TABLE 3.6
JAPANESE CAR EXPORTS TO THE U.S.

MONTH	1979	1980	1981
January	112,753 (-2.9)	138,496 (22.8)	167,475 (20.9)
February	119,701 (-9.8)	153,321 (28.1)	167,475 (-1.8)
March	125,010 (-14.0)	169,664 (35.1)	127,699 (-24.7)
April	107,606 (-12.3)	158,908 (47.1)	169,881 (6.9)
May	118,057 (-6.1)	149,573 (26.7)	155,441 (3.9)
June	132,224 (14.5)	162,023 (22.5)	144,766 (-10.7)
July	130,472 (21.3)	162,577 (24.6)	161,810 (-0.5)
August	123,743 (30.7)	139,233 (12.5)	123,727 (-11.1)
September	132,024 (22.5)	149,182 (13.0)	149,628 (0.3)
October	139,124 (25.0)	147,286 (5.9)	133,344 (-9.5)
November	146,744 (34.2)	142,091 (-3.2)	153,546 (8.1)
December	158,672 (33.2)	146,738 (-7.5)	128,707 (12.1)

Note: Figures in parenthesis represent change over the same month the year before.

Source: Japan Automobile Industry Association.

Instead, MITI was caught between a barrage of unofficial pressure and official complacency. President Carter seemed primarily interested in containing inflation. The Goldschmidt

Report of July 2, 1980 had noted that import restrictions at the level of imports of 1979 would cost American consumers an additional \$1 billion in higher prices for imported and domestic cars. Still, it appears somewhat bewildering that President Carter, in an election year, went against the UAW, a natural ally of the Democratic Party. This may have cost him dearly but it was also not an isolated instance. Why was it, asks Charles Schultze, Chairman of the CEA, that Carter did not significantly expand the budget or approve any tax cut, "...in the middle of a recession, in the middle of an election year...It was a very conservative non-constituency oriented campaign..." Poor Jimmy Carter, he wrote, "...was not the world's greatest politician...." [65] The 2nd Goldschmidt Report, submitted to President Carter in early January 1981 did not, unlike the first one, simply list the various options but strongly urged the President to seek export restraint from Japan for a five year period. It argued that the "Government should negotiate an import restraint agreement with the Japanese which reflects the real time period it will take for US automakers to accomplish the transition. This would define a reasonable period of time for our domestic industry to re-tool without facing facing the permanent loss of additional market share to Japanese producers" [66]. However, the recommendation came too late. Carter, having lost the election, had made it quite plain that he would allow President-elect Reagan to seek his own solution to the dispute, rather than negotiate with the weakened powers of a lame-duck

presidency.

There is an interesting article by Kusano Atsushi on the early phase of the auto dispute where the author asserts that Carter really wanted Japan to exercise VER on its own, despite his own opposition to any restrictions in the flow of goods. He wrote of an incident reported to have taken place in May 1980 when responsible MITI officials approached the White House through private channels with a proposal to undertake VER if the U.S. so wished and in exchange for assurances not to implement import restrictions [67]. President Carter was informed of this offer by Eisenstadt in a memo, who sent back the reply that if Japan wished to undertake VER on its own, the U.S. government would neither formally endorse it, nor oppose it, which was taken to mean that he had accepted the MITI offer. The deal, however, fell through when a staff member under Eisenstadt, intentionally or otherwise, reported the incident to the American Embassy in Tokyo, where opposition was raised about why the White House and not the State Department was dealing with the issue. If the incident did take place, it would add support for the thesis presented here but even so there are certain problems, which leads this author to doubt if the incident did take place exactly as reported by Kusano. We can understand why the proposal was transmitted through private channels since the Ministry of Foreign Affairs opposed VER and the authors of the plan, a small group within the MITI, needed time and U.S. approval to build their argument and have it officially accepted. What is

difficult to understand is why MITI officials should have been concerned enough to seek assurances that the U.S. would not impose import restrictions. The chances of Carter supporting import restrictions were not very high since his own opposition to VER was well known and if the Congress did pass such protectionist legislation, not likely at that early stage, Carter would certainly have exercised his veto.

We have argued all along that MITI favoured import restraint by Japan. What remains to be done is to try and demonstrate how far its motivations support the thesis of Japan as a regime supporter. Reading Amaya's writings on the subject, one is impressed with his concern for restoring the ~~Pax-Americana~~ but is this what really motivated him? Within the Japanese culture and society, there is a strong emphasis in differentiating between what is called 'honne' (real intentions, often beneath the surface) and 'tatemae' (up-front intentions). We have expressed the argument that his writings essentially reflect his 'honne' but of course, it cannot be denied that there are others who hold a different view.

Nukazawa Kazuo, Director of the powerful Keidanren (Japan Federation of Economic Associations), in a personal interview remarked that both Keidanren Chairman Inayama and Amaya harboured a strong disdain for GATT and did not see much of a future for a multilateral trade regime, preferring instead to emphasize bilateralism that would at least secure access to important markets, even if outside the GATT agreement. Of the

interpretation presented in this thesis, Nukazawa simply added that it was more 'kind' to Amaya than his own reading of Amaya's real intentions, but agreed that it was simply a matter of opinion. Where opinions diverge, it is necessary to try and fathom the reason behind the divergence and this will be attempted here. However, we shall not pretend to have resolved the differences.

Nukazawa's interpretation, as well as the opinion expressed in the Nihon-Keizai-Shinbun of May 2, 1981 (see above) are deduced from the actual outcome of the automobile dispute, and the outcome itself is analyzed as a single discrete event. The result, it cannot be denied, has restricted the flow of goods across countries and may also be argued to have violated GATT, although not formally (because the VER itself was neither 'officially' negotiated or implemented). However, if we view the outcome as not just a discrete event, but rather as part of a process in evaluation, we think it is possible to maintain that Amaya was indeed concerned with strengthening the liberal economic order. In his writings, Amaya distinguished between the short-term and the long-term and wrote that insistence on strict adherence to the principles of GATT could serve to preserve the GATT system in the short term but would certainly undermine it in the long run. According to Amaya, it was necessary to be flexible and adapt to the reality and that the reality of the American industrial decline necessitated a tactical retreat until the bases on which the trade system was built had been

strengthened. We can discern a similarity here to Lenin's famous dictum of 'one step back; two step forward' but only time will tell if this strategy can work in the field of international relations as well. Elements within the Ministry of Foreign Affairs, in particular the former Ambassador to the U.S. Ushiba, had assumed that this was a dangerous strategy, bound to lead to further retreats and eventual collapse of the LIEO. Amaya later was to brand all those who had opposed MITI's policy of implementing VER as short-sighted 'soap-nationalists' [68].

As Amaya saw it, the liberal trading system could not be maintained without strong and effective leadership in the system, a role that only the U.S. was capable of playing, despite its predicament at that time. His notion of stability and order was based on the social structure of Japan during the Tokugawa period, prior to the Meiji Restoration of 1867-68, although the stability of the system had been undermined well before the actual restoration of the Emperor. From this period of Japanese history, he derived certain lessons for Japan today, which he expounded under the rubric of 'Chonin no Kokka-ron' - the theory of the merchant state [69]. Given Amaya's known penchant for finding solutions to modern day problems in history, this is not at all surprising. David Halberstam related this very well. It was typical of Amaya, according to Halberstam, that when going to attend a summit conference in Washington, while his colleagues would be reading briefing papers, Amaya would almost surely be "...reading instead some esoteric book on twelfth-century China.

The implication was clear: The answers were not in those briefing papers, the answers were in the distant past".[70].

During the Tokugawa period, lasting for 250 years, the Shogun, the effective ruler of Japan, pursued a policy of strict isolation from world affairs barring all but very modest levels of trade through the Dutch intermediaries based on the island of Deshima, off Nagasaki. This policy of 'sa-koku' was designed to protect and immunize Japan from the international forces of change in the interest of the assumed higher objective of social order and stability. This policy was quite successful in achieving its objective and was helped also by the establishment of a hierarchical society. The social order was composed of four separate classes: the 'samurai' who held the reins of political power and ensured peace and harmony internally; the farmers, who with their tax payments propped up the political order; the artisans; and the lowly merchants - the 'chonin' - who increasingly gained in influence despite being on the lowest rung of the social order. The rise of the merchant class was due to a complex set of causes including the spread of money economy as the result of the 'sankin-kotai' system, which forced the local feudal lords (daimyo) to stay for a fixed length of time periodically, in the capital city of Edo (Tokyo), and the inability of the samurai to meet their growing needs from the declining tax revenues. The samurai were forced to look to the merchants for loans to sustain their living conditions. The merchants had wealth but little else since the samurai held

exclusive rights to military, police, and political power. The merchants, as ever, valuing social stability and order, in turn, depended on the samurai to provide this stability and learned to align their relationship with the samurai very carefully and closely.

Thus, when the samurai were no longer able to sustain their extravagant lifestyle solely on the rice tax collected from the farmers, they turned to the merchants, who were willing to make generous loans even with the prior knowledge that the loans might never be repaid. These were costs that had to be borne in the interest of preserving a favourable social milieu. For Amaya, there are similarities in the contemporary international system to the Tokugawa social order. Although the U.S. and the Soviet Union combined all four social classes, Japan since the end of the Second World War had travelled the road of the merchants, but today was at the crossroads where it had to ponder its future direction: whether to acquire political power as well or to continue on the present path. If the decision was to shun the road to political power, then Japan had to be willing to apply lessons learnt from past experience, where and when applicable. Just as the samurai, in the past, created and sustained a stable social order conducive to the growth of internal commerce, the existing liberal trading regime also depended, for its stability, on the United States. When the samurai felt the pinch, they turned to the merchants; today, the U.S. suffered from the pains of industrial decline and Japan had to be ready and willing to

help. For Amaya, the auto VER was just one such sacrifice Japan had to make for the greater good of the international system. Its immediate effect was that it removed a thorn in U.S.-Japan relations but if it could also contribute to the revival of the auto industry in the U.S., it would also contribute to the long term stability of the system. It is in this sense that Amaya's approach can be termed as the long term approach to maintaining the liberal trading system. In elucidating Amaya's view, the purpose has not been to endorse its built-in conservatism in favour of the status-quo and against change but rather to understand the motives behind his actions. We should not overlook, for example, that while the Tokugawa regime was indeed very stable, it was not a very just system.

The Ministry of Foreign Affairs, which had traditionally been very forthright in promoting good U.S.-Japan relations, surprisingly took a position that was not favourable towards VER. The MFA argued that the GATT rules should be strictly adhered to and that deviance would invite further departures from the GATT prescribed framework for the settlement of trade disputes. What it took particular exception to was the fact that VER was a 'gray area' measure, not having a clear status under international law and that it was much better to use the available safeguard measures. It was not necessarily against restricting Japanese exports but it preferred to employ other measures besides VER, in the interest of staying within the bounds of GATT. The problem with this was that since all GATT measures are non-discriminatory

in nature, it was not possible to stay within GATT and at the same time take selective steps against Japanese exports. It is not necessarily true therefore, as Amaya wrote, that the "The views of the Ministry of Foreign Affairs concerning the automobile dispute, can be likened to the MITI views in the earlier textiles dispute" [71]. In any case, the views of the MFA did not have much impact on the outcome of the auto dispute because, from the start to the finish, MITI represented the Japanese side. For example, a day before Foreign Minister Ito was due to leave for Washington, he, on the 20th of March, 1981, met with MITI Minister Tanaka Rokusuke at a city hotel where Tanaka is reported to have told Ito that since MITI had the ultimate authority to negotiate and settle the dispute, the Foreign Minister should not make any commitments and simply 'acknowledge' any proposal that the U.S. might make. The Foreign Minister, reportedly, agreed to this [72].

Some might raise the objection that the interpretation, given here, of MITI's intention, is excessively favourable and ignores other possible explanations. As an alternative, it could be argued that MITI favoured VER only because that would allow it to extend its influence to the domestic auto industry. It was mentioned above that the Japanese auto industry was jealously protective of its interests and resentful of past attempts by MITI to restructure the industry. This commitment to preserve independence from MITI had become evident when MITI, in the 1960s, tried to encourage mergers with the expectation that the

consolidated manufacturers, would be better able to withstand foreign domination and control. Part of the reason why MITI was relatively ineffectual in shaping the development of the domestic auto industry was due to inadequately developed 'Amakudari' ties, given the 'newness' of the auto industry, as opposed to the steel industry. However, to argue that MITI was only interested in VER as a convenient mechanism to influence the auto industry, since it would control the allocation of export quotas, is problematic. I do not deny that MITI was unmindful of the potential for increased influence over the domestic auto industry but it would be unreasonable to suggest that this was the main reason behind its support for VER. If anything, it was simply an additional bonus. MITI could not have been unaware that sectoral control without continued maintenance of the liberal trading regime would have had a seriously detrimental effect on the Japanese economy as a whole, and that was, and remains, its primary concern.

In the period after the VER went into effect, the American auto industry made a remarkable recovery. Although production of passenger cars in 1981 (the VER period ran from April to March, beginning April 1981) was down by 2 percent over 1980, and production in 1982 declined by a further 19 percent over 1981, there was steady improvement after that. In 1983, production increased by about 34 percent and in 1984 the increase was about 15 percent. With the upward trend in production statistics, profitability also returned, in scandalous proportions according to some. The steep bonuses that the management of the American

car industry gave itself in 1985, raised eyebrows not only in Japan but also within the UAW whose members had had to take wage cuts to help the companies through the crisis period. The recovery of the American auto industry has contained and subdued the voices of protectionism, at least within the industry. However, there continues to be some support for the local Content Bill, although it is unlikely to emerge as a main issue as the auto industry itself opposes the Bill which might constrict its ability to procure internationally, and also because all the major Japanese car manufacturers now have firm plans to manufacture in the U.S. or are already doing so.

SECTION V

CONCLUSION

Finally, in this concluding section, we will briefly review the effect that the VER had on U.S. car manufacturers, in terms of their recovery from the economic recession.

The automobile VER was designed to restrict Japanese exports for a maximum of three years, from April 1981 but has already been extended three times. In the first two years of the agreement, it appeared not to have any significant beneficial effect for Detroit. This was due to an absolute decline in market demand and sales. Total sales, including imports, declined from about 8.9 million units in 1980 to 8.53 million

units in 1981 to 7.98 million units in 1982. It was, as a result, argued that the Japanese VER was not having much effect because the market would not have absorbed much more in any event. However, the fact that Japanese exporters were able to increase prices and still ship the maximum allowable numbers, under the MITI allocated quotas, suggests that they would have improved their market share position without a VER. The Table below gives the relative market standing.

TABLE 3.7
SHARE OF U.S. CAR MARKET

YEAR	UNITED STATES	JAPAN
1980	73.3%	21.2%
1981	72.7%	21.8%
1982	72.1%	22.6%
1983	74.0%	20.9%
1984	76.0%	18.3%

Note: U.S. figures include VW (USA) and Honda (USA) production in the U.S. Honda (USA) went into production in 1983.

Source: Jidosha-Sangyo Handbook, Nissan Motor Co. Ltd., 1985 Edition.
p. 279.

The VER brought about an increase in prices of imports but even then there was an excess of demand over supply resulting in long waiting periods before orders could be filled. On the other hand, Detroit had to offer rebates to get inventory moving. One important reason behind depressed capital goods market was the

tight monetary policy that was and remained till 1986 the hallmark of Paul Volcker and the Federal Reserve Board. Higher interest rates were forcing buyers to postpone their purchasing plans. The American auto makers first began offering rebates to consumers in February-April 1981 which did stimulate sales during the period of the rebates but sales slumped once the rebates were withdrawn. In preparation for the new model year, GM began offering its customers car loans at reduced interest rates which in dollar terms amounted to savings of about \$500 per car. Ford and Chrysler followed the GM lead and Chrysler offered rebates of as much as \$1000 [73].

On the investment side of the picture, in the period 1979-1983, the American Big-Four invested a total of over \$51 billion worldwide to build better and more fuel efficient cars. This was almost twice the total investment for the previous five years [74]. It is difficult to make accurate assessments of the effectiveness of the new investment but according to Japanese industry sources, the cost disadvantages of American manufacturers did come down to about half the earlier levels [75].

The VER was, by all accounts, important in the rebuilding of the U.S. auto industry and the ITC recently published a report assessing the impact of the Japanese VER on the American car manufacturers. This is shown in the Table below.

TABLE 3.8
IMPACT OF VER ON U.S. AUTO INDUSTRY

JAPANESE CAR SALES ('000)	ACTUAL	1980	1981	1982	1983	1984
	W/O VER	1822	1845	1774	1861	1950
	DIFF (%)	-	1948	1969	2435	2948
AMERICAN CAR SALES ('000)	ACTUAL	-	-5.6	-11.0	-30.8	-51.2
	W/O VER	6578	6203	5757	6795	7960
	DIFF (%)	-	6128	5629	6436	7342
TOTAL U.S. CAR SALES ('000)	ACTUAL	-	1.2	2.2	5.3	7.8
	W/O VER	8975	8529	7978	9181	10400
	DIFF (%)	-	8551	8035	9372	10743
RETAIL PRICE OF JAPANESE CARS (\$)	ACTUAL	-	-0.3	-0.7	-2.1	-3.3
	W/O VER	6709	7292	7539	8317	9300
	DIFF (%)	-	7107	7180	7486	7962
		-	2.5	4.8	10.0	14.4

Source: Kawaharada, S., "Shin Jidai o Mukaeru Jidosha Kaigai Jiqyo", *Ikkō-Kai*, Vol. 35, No. 9, September 1985, p. 13.

The VER has also brought about significant changes in the structure of the U.S. auto industry. All of the major Japanese car manufacturers will start production in the U.S. within the next couple of years. Japanese auto parts manufacturers have also followed the lead of car makers and started setting up production facilities in the U.S. There is no doubt that the stimulating factor has been the VER. The most aggressive and forward looking Japanese manufacturer has been Honda (No. 5 in Japan in terms of total output, No. 3 in passenger car output) which was the first to invest in the U.S. Its aggressiveness seems to have paid off handsomely. In 1985, Honda overtook Nissan to become No. 2 in the U.S. in total sales, including domestic production. Its export quota under the VER, remained behind Toyota and Nissan. Toyota, the largest of the Japanese

car manufacturer was the last to join the pack and plans to begin production in the U.S. in 1988, at the annual rate of 200,000 units. As a result of the investment already in place and that which is projected, exports from Japan will increasingly make up a smaller share of total Japanese car sales in the U.S. This is shown in Table 3.9, below.

TABLE 3.9

EXPORT FROM JAPAN AND LOCAL PRODUCTION IN U.S.

	1984	1985	1986	1987	1988
JAPANESE PRODUCTION IN THE U.S.					
- NISSAN	-	5	12	12	12
-GM+TOYOTA (NUMMI)	-	6	25	25	25
-TOYOTA	-	-	-	-	20
-HONDA	13	14	30	30	30
-MITSUBISHI	-	-	-	-	18
-MAZDA	-	-	-	24	24
TOTAL (A)	13	25	67	91	129
EXPORTS FROM JAPAN	191	230	230	230	230
TOTAL JAPANESE CAR SALES (B)	204	255	297	321	359
U.S. PRODUCTION AS % OF					
JAPANESE CAR SALES (A/B)-----	6.3%	10.0%	22.5%	28.0%	36.0%

Note: Unit of car sales is 10,000.

Source: Kawaharada, S. "Shin Jidai o Mukaeru Jidosha Kaigai Jigyo", *Ikkō-Kai*, Vol. 35, No. 9, September 1985, p. 13

As a result of these structural changes in the American auto industry, it is unlikely to confront challenges in the future in the shape of imports versus domestics, despite the Hyundai phenomenon. If problems do arise, they are more likely to be of micro-level nature, of inter-firm competition, for example Ford versus Honda (USA). What this means is that although the industry has survived its first major crisis, its future viability will depend on its capacity to compete with Japanese cars produced in the United States. Of course, direct exports from Japan will probably not cease completely, but it will increasingly make up a smaller percentage of total sales in the United States.

On the basis of our discussion in this chapter, it would appear that the auto-VER did have the desired effects. It provided Japanese firms an incentive to invest in the U.S. and, more importantly, created the conditions necessary for the revitalization of the American auto industry. The latter, of course, was the main factor behind the stand taken by the Japanese government in favour of VER. This was premised on the belief that protectionism within the American auto industry had to be contained in the interest of maintaining the liberal trading order. In so far as this was true, it supports our argument that the Japanese government displayed a clear sense of responsibility toward the international system, even though it confronted stiff opposition from sources within the domestic auto industry. Thus, only by recognizing the intentions behind the

VER can we explain why, in the auto dispute, the position of the Japanese government was so different from that in the earlier trade disputes with the United States.

Chapter Four

TRADE IMBALANCE AND IMPORT PROMOTION

SECTION I

THE U.S.-JAPAN TRADE IMBALANCE AND REGIME INSTABILITY

In this and the following chapter, we will look at macro economic issues in the relations between Japan and the U.S., in particular the trade imbalance. The imputed causal variables that had led to the increase in U.S. trade deficit with Japan, from around US\$7 billion in 1980 to US\$40 billion in 1985 had become the primary stimulant to American protectionism. These imputed causal variables included trade barriers in Japan, the Japanese distribution system, Japanese government procurement policies, and low levels of domestic demand in Japan. It needs to be emphasized that, however true these causes may be, they had not been recently introduced. In other words, it is not true, for example, that protectionist barriers had been raised by Japan since the early 1980s, to account for a large portion of the increase in Japanese trade surplus. Nevertheless, in so far as the trade surplus had emerged as a destabilizing force in the system, Japan did recognize its responsibility to do something about it. Our focus will, accordingly, be on measures taken by Japanese government to remedy the trade imbalance. It should be pointed out, however, that absolute balance in trade relations between Japan and the U.S. is neither feasible nor should it be the objective. Ideally, we should not even have to consider bilateral balances, but unfortunately, political realities are not such that we can ignore them [1].

As a result of structural forces, the vertical nature of Japanese trade, and the high savings rate in Japan, experts agree that U.S.-Japan trade is structurally impossible to balance and that Japan will continue to enjoy a surplus for quite sometime. The magnitude of the present surplus, however, can be reduced and it is this that Japanese government measures hope to achieve. Aside from the specific measures, to be discussed further below, we can understand why the Japanese government, given its objective as defined above, continued to exercise voluntary export restraint on automobiles beyond the time frame originally envisaged and what was necessary from the viewpoint of revitalizing the American automobile industry.

The automobile VER, as initially agreed upon, was to last for a period of three years and provide a 'breathing spell' to the American car manufacturers, giving them time to adjust and adapt to the changed demand patterns. However, as we saw in the previous chapter, it did not begin to have a significant effect on the sales position of the American car manufacturers until after the second year. Only then did things slowly start to pick up for Detroit. Because of the late recovery, both countries agreed to extend the VER for an additional, one year. The situation continued to improve through 1984 and President Reagan openly stated that the U.S. government would not seek another extension when the agreement expired in April, 1985. Yet, when the Japanese government announced that it would extend the VER for another year at the expanded quota of 2.3 million units, it

created a tremendous uproar in the U.S. There was displeasure that the Japanese government had boosted the export quota by a hefty 24 per cent and it became obvious that what the U.S. government had really intended to mean was that while formal restraints were no longer necessary, any increase should be kept to within 'reasonable' limits. Perhaps, it had not seriously considered the possibility that imports from Japan could rise drastically after the restraints had been removed. From the Japanese standpoint, MITI issued the justification that without restraints, total exports for the year could reach 2.7 million units, implying therefore, that the new quota was, in fact, a meaningful restraint. The Japanese government was genuinely taken aback by the American reaction and Prime Minister Nakasone went so far as to admit that the decision had been a mistake [2]. The following year, the Japanese government decided to play safe, and in January 1986, MITI announced that the VER would remain in place till 1987, at the previous year's level.

When the United States and Japan negotiated the VER, it was understood by all that the purpose was to help Detroit back on its feet. Since then, however, it took on an additional meaning which helps to explain the yearly extensions. The extensions had come even in the absence of official U.S. request for the same. By 1985, car makers in the U.S. had more or less recovered and domestic demand, too, had picked up. With the prospects considerably improved, there was perhaps no reason for the U.S. to ask for an extension. Japan, however, made two extensions

unilaterally, in 1985 and in 1986. This calls our attention to the new rationale behind the VER. It was obviously no longer simply meant to provide a 'breathing spell' for Detroit but had taken on the additional significance of helping to contain the more general nature of the trade conflict. The auto dispute can, indeed, be characterized as the final chapter in a pattern that had been established in the late 1960s. Beginning with the textiles dispute between the two countries, such disputes had focused on individual industries, as and when they became an irritant in their bilateral relations. However, in the 1980s, attention shifted to macro-level indicators and this reflected the American frustrations of dealing on issue specific basis. After about a decade of dealing on issue specific basis, the U.S. had apparently tired of this piecemeal approach and decided that it was time to wield the 'machette' and put aside the 'scalpel'. The buildup of frustration had been the result of a dramatic worsening of the trade balance. Japan's trade surplus has increased at a very rapid pace in recent years and disputes between the two countries now encompassed the totality of their economic interactions, the imbalance in merchandise trade as well as the imbalance in trade structure.

With the U.S. becoming increasingly impatient with the trade imbalance, the auto VER, once in place, became a convenient tool for controlling the growth of Japanese trade surpluses. The restraint agreement was extended because without such an extension, exports would have risen much faster. In 1985, total

Japanese car exports to the U.S. amounted to US\$19.2 billion, about 30% of total exports, and was also the main factor behind the increase in the Japanese surplus [3]. In 1986, as the MITI Minister Watanabe suggested, without the controls, auto exports would go up by 20 percent to add a further US\$5 billion to the Japanese surplus [4]. Thus, the VER had become attractive of its own merits. One may wonder then, as to why the Japanese government decided to raise the quota by 24 percent in 1985, instead of continuing with the existing levels. An important consideration in this was the strong pressure from the Japanese manufacturers for total elimination of controls, particularly from the smaller companies which had small quota allocation and wished to improve their market position in the U.S. At the same time, General Motors too, wanted the restraints abolished so that it could increase its 'Original Equipment Manufacturer' (OEM) imports from Japan under the GM-Isuzu tie-up. GM had become an importer as well as a manufacturer. Confronted with cross-pressures, MITI chose, what was, by its calculations, a middle road.

In this and the following chapters, we will consider the new phase in U.S.-Japan trade dispute - the problem of the macro-economic imbalance; how it threatens the stability of the free trade regime; and what alleviatory measures have been taken by Japan. To be sure, this is not simply a bilateral problem since many of the European and non-oil producing Third World countries have similar trade problems against Japan. While these

concerns cannot be ignored, we will, focus our attention on the U.S.-Japan nexus because of its relative importance to the liberal trading regime in the context of the framework that we have adopted. Later, in chapter five, we will look at Japanese trade and economic relations with the regional countries of Asia.

In Chapter 1, we noted the importance of a strong and large economy providing easy access to its market for foreign producers, as protectionism in the large economy tends to spread rapidly and also because of the need to provide a mechanism to balance supply and demand of other regime members who may otherwise, in times of economic recession, be tempted to raise protectionist barriers. Tensions build up when this vent for surplus is closed, but the problems become compounded when one large economy itself becomes dependent on another to balance its own supply and demand imbalances.

It is often argued that Japanese government policies had limited the potential of the domestic economy to perform this function by restricting foreign access to the Japanese market. On top of that, Japan is also accused of relying unfairly on the U.S. market, to the detriment of American industry. Thus, Hofheinz and Calder note that in 1979 even though domestic car sales in Japan had dropped by 6.3 percent, production had actually increased by 38 percent. They go on to suggest that "Exports have saved the Japanese automobile industry from the slow death presently being suffered by U.S. auto makers" [5]. It is interesting to note that in 1979, Japan exported about 3

million cars but imported only 64,000 and that happened to be a good year for foreign car sales in Japan.

As evidence of the relatively closed nature of the Japanese economy, we may consider the chronic Japanese trade surplus and the low ratio of manufactured goods to total imports. Therefore, for Japan to play a positive role in the future of the trading system, it will be necessary to even out, as much as possible, the skewed nature of Japanese trade. If the Japanese economy remains closed, or is perceived to be closed, retaliatory trade barriers will inevitably be instituted. Our notion of regime supporter implies and takes for granted the view that the Japanese economy will be transformed into one of the vent for surplus for dealing with future world-wide supply and demand imbalances. The ability to perform this function will depend on market liberalization and the elimination of remaining systemic biases against foreign manufacturers. This chapter will look at the recent market opening measures adopted by Japan, the Japanese distribution system, and also at the provision of the new mechanism to handle and resolve specific foreign grievances on trade practices or those arising from the implementation of established laws.

The point is often made that all of the previous market opening measures were undertaken unwillingly by Japan and only after intense pressure had been applied by foreign countries. This is seen as resulting from an ingrained Japanese insincerity and the desire to avoid sharing in the burden of system

maintenance. To the extent that previous market opening measures had not altered the trade picture in any significant way, this was true, but more importantly this imputes to the Japanese decision makers a lack of the 'proper' mental frame. In analyzing Japan's role as a supporter, it will be important to show not that the recent market opening measures have had or are likely to have a significant imbalance redressing impact but that the decision makers were clearly aware of Japanese responsibilities and were serious in their attempts to liberalize the economy and redress the trade imbalance. It needs to be emphasized, however, that raising the actual levels of import requires not only an open economy but also a concomitant effort and drive on the part of foreign manufacturers to respond to domestic demand patterns. Also, we should not assume that there is a unity of purpose within the official bureaucracy but it cannot be denied that the balance of forces had shifted considerably, to favour the internationalist position. We saw one evidence of this in our earlier discussion of the MITI and the automobile dispute. It is true, however, that the powerful Ministry of Finance (MOF) has remained firmly committed to the pursuit of conservative fiscal policies even in the face of foreign pressure to expand and stimulate domestic demand. This particular point will be taken up in greater detail in the next chapter.

Since the early 1980s, Japan's total trade surplus as well as the surplus in trade with the U.S. had grown at a rapid pace,

as shown in Table 4.1, below.

TABLE 4.1
JAPAN'S TRADE BALANCE (US\$, MILLION)

YEAR	TOTAL (a)	WITH US (b)
1980	2,125 (1)	12,200
1981	19,967	18,100
1982	18,079	19,000
1983	31,454	21,700
1984	44,257	36,800
1985		49,700

Note: This reflects the oil price hike.

Source: a) JAPAN, 1985, Keizai Koho Center,
Tokyo, p. 48.

b) The 1985 figure is taken from
Asahi-Shimbun, 31 January 1986, p. 1.

With respect to some of Japan's other trading partners, we could point out that against the EC, Japan had a surplus of \$12.66 billion in FY1985 and a \$5.61 billion surplus in trade with the Peoples Republic of China [6]. During the period 1980-85, Japan had implemented seven market opening measures in response to American pressure.

Although, as mentioned, American pressure has been of a general nature in recent years, there has not been a total absence of negotiations on specific issues. One of the most prominent has been the one termed 'Market Oriented Sector Specific' (MOSS) talks, centering on leather, medical

instruments, forestry products, and telecommunications equipment. Dealing with detail and specific issues is more to the liking of Japanese negotiators and they would obviously prefer to continue on the MOSS framework. However, the Americans have little patience for this. This difference in the negotiating style of the two countries was brought out vividly by the U.S. Undersecretary of Commerce for International Trade, Lionel Olmer, in his testimony to the U.S. Senate in March 1982. In late February 1982, the Chairman of the ruling Liberal Democratic Party, Esaki, led a Diet delegation to the United States to explain Japan's latest measures to expand imports. Testifying before the Senate, Olmer was asked to evaluate the results of the Esaki mission to which he replied, "...in several discussions when we would lay out our case, one or more members of the Esaki mission would reach into a briefcase and pull out large volumes of data to deal with us on a selective issue or other rather than to discuss in a more general basis what I believe and what the administration believes is a pervasive problem of market access generally" [7]. The preference of the Japanese government for dealing with specific issues stems from the fact that initial identification of the area of concern to the U.S. facilitates the task of pressuring the domestic industry or ministry to make the necessary concessions. Dealing at the abstract level does not allow pressure to be localized which is necessary for it to be effective within the Japanese decision making context. Thus, when the Japanese government complains that the U.S. fails to

show proper understanding, it is not entirely without some justification. As was noted by Timothy Curran, "...foreign pressure is often applied in a wrong way, thus achieving less than maximum liberalization or causing a counter productive backlash in Japan. For example, American demands are often too vague - calling on Japan simply to do something to open its market and ease trade friction" [8].

In January 1986, Japan and the United States reached agreement on the MOSS talks that had begun a year earlier. It has been argued that the reason the U.S. decided to talk on sectoral issues was due to the feeling that the general and abstract market opening measures were not going anywhere [9]. However, that same month the MOSS talks were concluded, a delegation of U.S. Senators, including Senator Danforth (Rep: Missouri), a leading proponent of protectionist legislation in the U.S. Congress, visited Japan. Commenting on the MOSS agreement, Senator Danforth stated that while the agreement itself was satisfactory, it was no longer possible to deal with specific issues, since there were just too many of them. He added, "...I am absolutely convinced that dealing with these sectoral problems in and of themselves in isolation - that strategy of 'ad hocing' the trade problem, is not successful" [10]. But, applying pressure in a generalized way has its own problems since it easily leads to an exaggeration of the problem. It can create unnecessary acrimony and this has indeed been an unfortunate outgrowth of the present crisis in U.S.-Japan

relations. The frustration that many Americans feel with their trade imbalance with Japan has been expressed in a number of ways. One was the article written by Theodore White, in The New York Times Magazine of July 28, 1985, in which he warned Americans to wake up to the dangers of pursuing open market policies at a time when her trading partners did not. He further claimed that there was a Japanese conspiracy to take revenge for the defeat in the Pacific War, by deindustrializing America. It was typical of the perspective that blames the rest of the world for all of America's problems. In early March 1985, when Saburo Okita, Chairman of the Economic Council on Foreign Economic Problems, and a former foreign minister, returned from a visit to the U.S., he reported on the mood of the Americans which he likened to that prevailing on the eve of the Pacific War. Ambassador Ohkawa, returning from a tour of duty in Washington, made very similar observations [11].

Aside from the general trade imbalance, the other Western criticism concerns the low ratio of high value added manufactured goods (SITC 5-8) in total Japanese imports. Table 4.2 shows that while there had been some improvement since the 1980s, the ratio was still very low. Only 30% of Japan's total imports are manufactured goods as opposed to 71% for the U.S., 52% for EC, and 83% for Canada.

TABLE 4.2
MANUFACTURED IMPORTS IN TOTAL IMPORT

	VALUE (\$ BILL.)	PERCENTAGE
1980	\$32.1	22.9
1981	\$34.8	24.3
1982	\$32.8	24.9
1983	\$34.4	27.2
1984	\$40.6	29.8

Source: MITI, Tokyo. (Based on Customs Statistics)

From Table 4.2, we can see that, while in the first four years of the 1980s, there was no significant change in the dollar value of manufactured imports, the ratio did climb steadily. This alerts us to the volatility of the ratio to price changes of primary products, particularly oil, which constitutes a hefty chunk of total Japanese imports. Japan's oil bill, over the period 1980-1984 declined from US\$57.6 billion to US\$45.3 billion, reflecting both a decline in oil prices and the success of the conservation movement. Accompanying the decline of oil prices, the price index of non-oil primary commodities also declined from 100 in 1982 to 81 in 1984 [12]. Going back to the decade of the 1970s, in 1970, the ratio of manufactured goods to total imports was 30.3 percent and in 1972, 29.6 percent. The oil crisis of 1973 and the quadrupling of oil prices lowered the ratio to 20.3 percent in 1975. In 1979, the ratio was 26.7

percent but after the second oil crisis, it again went down, to 22.8 percent in 1980 [13]. It can be argued that since Japan is a resource dependent country and thus unlike all the other advanced industrialized countries, the data presented above distorted the reality to the detriment of Japan, since primary imports will necessarily figure prominently in total Japanese imports. As a more standard gauge, we could look at manufactured imports as a percentage of the Gross National Product. This is given in Table 4.3, below.

TABLE 4.3
RATIO OF MANUFACTURED IMPORTS TO GNP

	1965	1975	1980	1983
JAPAN	2.2	2.3	2.9	2.7
U.S.	1.6	3.4	5.2	5.2
U.K.	6.4	12.1	14.3	14.8
W. GERMANY	7.5	9.8	12.1	13.4

Source: Matsuda, M., "O-Bei Shokoku to no Boeki Mondai no ichi shiten: Seihin Yunyu hiritsu Hijo Yoso no Datosei ni tsuite", Boeki-to-Kanzai, Vol. 34, No. 3, March 1986, p. 35.

Japan's manufactured import was about half to three quarters below the average for developed countries. Matsuda Manabu of the Japanese MOF, suggested a couple of factors behind Japan's low manufactured imports as measured above, besides the import dependence for resources.

1. the fact that there were no industrial

countries in the region, besides Japan, to allow for a division of labour, as had taken place on the European continent, and

2. the fact that Japan had a large domestic market which enabled it to set up and support domestic manufacturing. Therefore, he argued, it was unfair to criticize Japan for importing only as many manufactured products as did Switzerland with a GNP about a tenth of Japan, because the latter obviously could not support a domestic manufacturing base with its small market [14].

He then went on to argue that American complaints that the Japanese market was closed, ignored the fact that Japan was the second largest importer of American manufactured goods, after Canada, and well ahead of the 5th ranked West Germany. Also, he reminds us not to forget that the Japanese ratio was indeed changing for the better. The growth of manufactured goods import for Japan was 16.8 percent over the period 1975-1983 compared to 37 percent for West Germany, but he argued that when this nominal figure was adjusted for exchange rate movements, the true growth rates were 34.9 and 22.9 percent, respectively [15]. This certainly presents a rosier picture for Japan but may be as misleading as the one he wishes to correct. This is because the base values for 1975 are much lower for Japan with the consequence that growth appears faster than for West Germany which had already achieved a higher level of manufactured goods import.

In his above mentioned Senate testimony (1982), Undersecretary Olmer tabled a list of factors that he claimed were behind the trade imbalance between the two countries.

Included among these, besides the plain bias of the 'buy Japanese' policy, he listed the residual quotas, government standards and certification procedures, the government tobacco and salt monopoly, application of sales tax on a CIF basis for imports and on an ex-factory basis for domestic goods, and the MITI [16]. In the period since, there has been considerable improvement in some of the problem areas but others have continued to persist. In 1982, Japan had quota protection for 27 items, including four leather products but which have since been removed following the MOSS talks, leaving 23 items under quota protection. Also, although the market share of American brand cigarettes was still low, it had increased in recent years. And, as we shall see, improvements had been made in the standards and certification procedures. Another problem that is increasingly coming to the surface is in the field of high technology industries. Here, as Kenneth Dam of the State Department observed, despite the fact that the U.S. share of world export was 44 percent and that of Japan only 28 percent, in their bilateral trade, the U.S. still had a deficit of \$3 billion in 1980 [17]. This was attributed to Japan's protection of its domestic industry. For example, IBM had a market share in Japan of 28 percent (in terms of value, in 1984) as opposed to its global average market share of over 50 percent [18].

The Gibbons Report of December 1981 was representative of the drive to sell more agricultural products to Japan. This report was prepared under the Chairmanship of Rep. Sam Gibbons

(Dem: Florida) and it argued that if Japan wished to penetrate foreign markets with high technology products, then it had to, in return, open up its agricultural sector to foreign competition. Industry sources in Japan, too, as for example, the powerful Keidanren, have long argued in favour of this position but one that the LDP has found difficult to accept. The LDP's stronghold is in the rural sector and elimination of protection here could have serious consequences, possibly even unseating the government. To counter the arguments made by industry sources, the agriculture lobby argues that it was unfair that they should be made a scapegoat for excessive industrial exports and that the real problem was not that Japan imported too little but rather that it exported too much.

SECTION II

THE NATURE OF THE U.S.-JAPAN TRADE IMBALANCE

When the visiting Senate delegation met with Prime Minister Nakasone on 11 January, 1986, Senator Danforth explained to him the gravity of the situation in the U.S. and proceeded to place the onus for the preservation of the free trade regime squarely upon him. He suggested that the prime minister had the 'key' to contain protectionism [19]. The prime minister did acknowledge his and Japan's responsibility to continue making utmost efforts but understandably, denied that he had any magic key to solve all

the problems. A common perception in the U.S. is that since Japan is a surplus country, the cause as well as the solution must therefore lie in the Japanese trade policy and practice [20]. The Japanese, to a large extent, feel that American criticism is misdirected and that Japan was being made a scapegoat for problems internal to the U.S., specifically the American fiscal deficit. On both sides of the Pacific, there exists a wide perception gap: the Americans tend to view Japan as more closed than it really is, while the Japanese tend to regard their economy as a model of openness, which it incidentally is, in terms of average tariff rates.

According to Lawrence Snowden, former president of the American Chamber of Commerce in Japan, "...the accusations [against Japan] arise more from companies which have taken a look at the market and decided it was too tough based on old wives' tales they have heard over the years about how bad things are in Japan." He found American business guilty of not doing their home work: "...if they believe that a widget which is made for a six-foot-four Texan or West Virginian sells well to a five-foot-two dark-haired Japanese, they just have'nt understood the market place very well or the consumer, and that's the problem" [21]. The perception gap thesis is frequently taken up in Japan to rebut Western criticisms. Higashi Chikara, a former Ministry of Finance official and presently a LDP Diet member, wrote that U.S. and European critics were not averse to using "outdated statistics and arguments" to

make their point, a theme taken up also by a group of MFA officials who wrote that when U.S. Congressmen and Senators charge that the Japanese market was closed, "one got the impression that the image of Japan of 10-20 years ago was still deeply ingrained in their minds [22]. From a different viewpoint altogether, it could be argued that the old image was more deeply etched in the collective Japanese mentality. Comparing Japan today with Japan of two decades ago will surely give the impression of much progress, but the correct comparison should not be with Japan of the past but with conditions in other countries today. Thus, Olsen argued that even though a lot had been achieved in the intervening period, a lot more still remained to be done [23].

The perception gap is not a new phenomenon. It can exist between countries sharing the same cultural background but when socio-cultural barriers have to be crossed, the problems can become magnified, arising from the difficulty or lack of obtaining accurate information. Snowden, in the above mentioned interview, explains that even today, many American executives looking to set up in Japan are unaware of the liberalization measures of 1979 which allows them to "...do what [they] want in this country in the way of owning a subsidiary." A few years back, the Japanese government set up the Office of the Trade Ombudsman (OTO) and as of 6 November 1985, it had received 221 claims of grievances against Japanese trade practices and law from foreign business organizations of which about 90 were

documented to be a misunderstanding of the actual situation [24].

Of course, as mentioned, there is misperception in both countries. The Japanese find it hard to understand Western criticism of their system, convinced that their market is more open than any other. In terms of average tariff rates, Japan compares very favourably, even though tariffs on selective items are very high. But with an overall decline in the weight of tariff protection, other forms of non-tariff barriers (NTBs) had risen to the top and become prominent. However, Higashi Chikara was convinced that the obstacles to import were only assumed ones, not real. He wrote, "When, in time, they [the foreign critics] accepted the fact that among all industrialized nations, Japan has some of the lowest tariffs, they focused on the assumed non tariff barriers many of which are in reality traditions rooted in the nations unique social and cultural history over which the government has no control" [25]. Although the West is often portrayed as trying to reorder Japanese society to conform with Western patterns, this is perhaps one of the many misperceptions. In reality, all that is being asked is that Japan revise those NTBs which placed the foreign seller at a distinct disadvantage. One example of discriminatory NTB concerns shipping containers, an issue which remains unresolved with the clever use of what one official of the Japan External Trade Organization (JETRO) described to me as the 'giraffe theory' [26].

In recent years, most shipping companies have started using

oversized containers to save on transportation and handling costs and to improve efficiency. The Japanese government has been reluctant to allow these containers into Japan arguing that the oversized containers pose a safety risk on Japan's narrow and congested roads. Ironically, many of these same containers are manufactured in Japan and transported over the road system from the factory to the docks for export. If there is a double standard here, the Japanese government has a very simple and neat answer. It argues that a container for export is itself an export commodity which could not possibly be cut into smaller pieces and still be exported, just as the giraffe's long neck could not be cut off to fit into a smaller container prior to export. However, when importing, the container was no longer the commodity, which was what was inside the container and which could also be transferred into small containers at the port of entry. What this means is additional cost for the importer and a handicap for the foreign manufacturer to overcome.

Non-tariff barriers also include many of the technical standards and certification procedures that are generally considered to be relatively more stringent and cumbersome than in other developed countries, especially those relating to product safety and which have the overall effect of discouraging foreign producers or of negating their relative advantage. Also, a slow moving Japanese bureaucracy is blamed for lengthy delays in product certification that give the Japanese manufacturers time to ready themselves for foreign competition. In a recent

instance, a Swedish pharmaceuticals company applied to the Ministry of Health and Welfare for approval to market a certain drug in Japan which had already become available in the U.S. some years back. The ministry rejected the application citing racial differences why it could not accept U.S. test data, requiring, in effect, for the drug to undergo a three year testing period in Japan. The company moaned that even if it could get approval at that time, it would not benefit much, because Japanese firms would have surely come out with a similar product and at a cheaper price [27]. Similar stories of bureaucratic red tape which work to the advantage of domestic manufacturers are not rare. For example, the U.S. government, in 1982, made the accusation that the Japanese Ministry of Health and Welfare had a list of approved ingredients for cosmetics which however, was not readily available, so that a manufacturer could not know prior to submission for certification what would or would not be approved [28]. At a time when technological innovations appear to take place at a fast pace, delays with certification systems can literally wipe out the potential gains for the innovator of the product.

Many of the standards and certifications, as the Gotoda Commission (an advisory body set up by the prime minister in January 1983) reported, were not only based on tradition and social customs but also reflected the accepted '...role of government within that country'. This is indeed a major source of contention and it is often argued that the Japanese government

had involved itself excessively in controlling the economic system. Prime Minister Nakasone, no doubt influenced by President Reagan, in outlining the Action Program in 1985, suggested that it was time for this to change. However, we should not expect results overnight, nor to the extent of the United States. Acknowledging a need to redefine the role of the government is a major step in itself but actual results will necessarily take time.

Yet, at the same time, the Japanese government has consistently argued that the trade imbalance was, mainly, the result of the high value of the American dollar. It argued that the high dollar had made American exports dearer and therefore less competitive on the world market. Normally, the economic fundamentals, the determinants of exchange rates in a flexible exchange rate system, would tend to suggest a lower value for the Dollar but, it was argued, the value of the American dollar had been kept artificially high as the result of the interplay between budget deficits, high interest rates, shortage of capital for private investment, high demand for the Dollar, and capital flows into the U.S. If we accept this position, correcting the trade imbalance is only possible through a sustained devaluation of the Dollar, which in turn depends, to a large extent, on reducing the federal budget deficits in the U.S. The American government, until the recent G-5 agreement of September 1985, had consistently rejected this line of reasoning, arguing instead that capital inflows into the U.S. were the result of high

profitability in the U.S. and not because of interest rate differentials. In a recent interview published in the *Asahi-Shimbun*, former West German Chancellor Helmut Schmidt, also downplayed the role of exchange rates and suggested that the real cause of trade imbalance was Japan's low defence spending, high savings rate and the consequential low consumption pattern [29]. Fred Volcker, ever since his appointment, as Chairman of the Federal Reserve Board by President Carter, has strongly opposed devaluing the Dollar, believing that the real culprit was low levels of consumption in Japan. We will look at Japanese savings and consumption patterns in the following chapter, but it must be pointed out that consumption levels are partly determined by socio-cultural variables and therefore, are neither amenable to ~~quick~~-fix solutions nor a reasonable point of contention in international negotiations. The importance of low defence spending in Japan's economic success has been variously debated but according to Professor James Morley has had only a marginally positive effect. Furthermore, increasing Japanese defence spending by any significant level is not socially feasible, and if we leave it out of our discussion, we can identify three main factors that could probably be held responsible for the trade imbalance.

1. a closed Japanese market and resistance to imports,
 2. an overvalued dollar and undervalued Yen, and
 3. low domestic demand in Japan, resulting in export push growth.
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Of these three factors, the American government emphasizes the first and the third point as being the real culprits whereas the Japanese government blames an artificially high exchange rate for the dollar. In the remainder of this chapter, we will take up the first two points and leave the third for the next chapter. This will allow us to break down the focus of the two chapters in terms of expanding imports, on the one hand, and reducing exports, on the other. The second point, of course, impacts on both the export and import side of the trade equation and will also be referred to in the next chapter.

SECTION III

JAPANESE MARKET OPENING MEASURES

Up until now, Japan had undertaken market opening measures seven times but the fact that so many separate actions were necessary, Kamijo admits, testified to the ineffectiveness of each [31]. The piecemeal, cautious manner in which the problem was tackled only increased frustration levels in the U.S. and the announcement of each new measure was met with anticipation of the next. The process, it was suggested, resembled an infinite progression, where the goal was never quite attained. But if the goal had not been realized, it was because there was no consensus on the processes leading to the goal.

In terms of tariff liberalization, the process began in the

mid 1960s, when Japan became a member of the OECD and accepted the obligations imposed by Article 8 of the International Monetary Fund. Today, Japan has lower average tariff rates than the U.S. or the EC and in effective tariffs as well, there has been considerable liberalization. The Japan Economic Research Institute, however, in a report released in 1984 was willing to admit that tariff and capital liberalization have usually been premised on the state of the local industry. In the case of automobiles, the report observed, the industry was not liberalized until after it had emerged as an export industry and that in electronics, "While it is difficult to evaluate the timing of liberalization in such industries as electronics where technological innovations develop rapidly, it is not erroneous to consider that such industries were liberalized only after they had been fully fostered as competitive ones" [32].

While tariff restrictions in Japan are, on the average, of only marginal significance, it is argued that the invisible trade barriers, like the standards code and certification procedures established by the government, have continued to restrict access to the Japanese market. The difficulty of dealing with standards and certification procedures is that there are few internationally agreed codes. The Tokyo Round Agreement on Technical Barriers to Trade stated in very broad and general terms (Article 7.1) that, "Parties shall ensure that certification systems are not formulated or applied with a view to creating obstacles to international trade. They shall

likewise ensure that neither such certification system themselves nor their application have the effect of creating unnecessary obstacles to international trade" [33].

The impediment to achieving an internationally accepted code, arises from the natural inclination to have these standards and certification systems correspond to the local conditions. For example, road traffic regulations in Japan are very strict and understandably so because of the traffic conditions. An internationally uniform set of standards would be ideal but the difficulty is in reconciling the specific, often divergent, needs of each individual country. For our part, we shall concentrate on those sets of standards which appear to be of a discriminatory nature.

In January 1982, as part of the first phase of measures to simplify standards, the Japanese government announced a revision of 67 items. These 67 items were part of the 99 NTBs that had been registered by foreign governments and other agencies as requiring improvements. Most had to do with import testing procedures. The discontent with the measures announced was quick to be registered. Senator Heinz, as only he could, termed it as "...a thin gruel masquerading as beef stew" [34]. The second phase measures did not fare any better and when Nakasone replaced Zenko Suzuki as the new Prime Minister later in the year, there was much anticipation in the U.S. that more significant improvements would be implemented. On 13 January 1983, several days prior to Nakasone's visit to Washington, the Ministerial

Conference for Economic Measures released the duly awaited package of measures to liberalize imports. The package contained a liberalization program for a number of tariff and non-tariff barriers.

On tariffs, it was announced that there would either be a reduction or elimination of tariffs on 47 agricultural and 28 manufactured products, bringing to 323 the number of items on which tariff reduction/elimination was to be implemented, from FY1983 (the 323 items included 215 items covered in the measures adopted the year before). While the package was not as radical as expected, it did include such items of interest to the United States as tobacco, biscuits, and chocolate.

With regards to NTBs, it was agreed, for instance, that the government would accept foreign test data on electrical appliances, animal pharmaceuticals and food additives, obviating the need, as before, for retesting and inspection. Such test data, however, had to be generated by foreign laboratories that had been inspected and approved by the appropriate Japanese authorities. Despite the cumbersome procedure of approving foreign testing agencies, it was still an improvement over the system that refused to accept any foreign data as valid. Another area where improvement was made was in the import procedures for automobiles. Under the system in place, auto imports of 100 units per model type qualified for simplified handling procedures and this maximum limit was now raised to 300 per model type. If this appears to be insignificant, it was not so by Japanese.

standards. In 1982, Japan imported 463 passenger cars from France, 1275 from Italy, 1 from Belgium, and 876 from Sweden. The largest exporting country was the U.S. with 3051 units, and Canada exported only 103 units. It was reported that as the result of the changes announced in this area, there would be a 30% reduction in the number of documents to be submitted to the authorities [35]. Much of this documentation referred to inspection certificates that attest to compliance with the many safety and anti-pollution regulations. Compared to the low volume of imports, a 30% improvement does seem to be a significant concession.

It was also announced that standards would be modified following a review of 40 related laws and that import procedures would be revised in respect to 16 items [36]. Accordingly, a committee was set up under the Chief Cabinet Secretary, Gotoda Masaru, and charged with the preparation of a final report by the end of March. When the Gotoda Commission formally submitted its report, it was somewhat more modest than what it had originally set out to do. It proposed revision of only 7 existing laws and the government explained that, "...the principle of equal treatment can be maintained without changing many of them" [37]. The revision of the laws was to "...ensure legal non-discrimination between nationals and non-nationals in certification systems; to ensure transparency of standards; to promote internationalization of standards; to promote the acceptance of foreign test data; and to simplify and speed up

certification procedures" [38]. Transparency refers to clarity and openness of standards, considered to be a problem with the existing system, as Undersecretary Olmer had pointed out with reference to standards established by the Ministry of Health and Welfare. On May 18, the Diet approved and amended the necessary laws and these became effective as of August of that same year. A few concrete examples of the improvements made are listed below.

1. A foreign manufacturer exporting to Japan could now apply directly for certification, where such certification was required by law.
2. Where a foreign manufacturer had already obtained proper certification, an importer of the products was to be waived from certification requirements [39].
3. The obligations specified under the law would apply equally to both domestic and foreign manufacturers.

Prior to the revision of the certification system based on the Gotoda Commission report, the existing law specified that certification of foreign products could only be obtained by a Japanese company, i.e., the importing agent. This had the practical effect of reducing the foreign manufacturer to a position of being a virtual hostage of the local importer, and, if for some reason, the importer broke off an existing agreement, the manufacturer was automatically forced to cease exports until such time as it had found a new importer and that new importer had applied for and obtained certification. The effect was particularly disadvantageous for the foreign manufacturers where

it had entered into a sole agency agreement. The revision of the law freed the manufacturer to switch importers if it was dissatisfied with its existing Japanese agent, since it and not its agent held the certification.

Another improvement was in the law pertaining to type approval for certain products. For example, the Consumer Product Safety Law [40] enacted in 1973, and among the 17 laws that were amended, specified that certain products like pressure cookers, cribs, roller skates and mountain climbing ropes, deemed to bear on the safety of the consumer, had to be inspected and carry a special seal of approval issued by the relevant testing authority in Japan. In Article 4, the law stated that either the foreign manufacturer or the Japanese importer could submit the product for inspection, but it barred the foreign manufacturer from applying for type approval for the product. This made it necessary for each import shipment to be inspected separately. In practice, the Japanese importer would submit the product for inspection but there was always the risk that the product in question might not pass the rigorous inspection, in which case the importer would be left with a shipment of goods that could not be sold. In the revised law, Articles 32.2 to 32.5 specifically provided for type approval for foreign manufacturer with the same application procedures as for the domestic manufacturers. A foreign manufacturer, which had obtained type approval could affix the approval seals at the factory and prior to actual shipment. Under this law, in 1985, the Lobo Industrie

of France received registration as manufacturer and type approval for the export of protective helmets. Under the Electrical Appliances and Material Control Law, Rexair Inc., and Ekco Housewares Inc., of the U.S. received registration as manufacturers of AC motors and electric heating devices, respectively. Also, in 1985, Creative Appliance Corp. Ltd., of Canada was granted registration and type approval for electric kettles [41]. The above is just a sample of the manufacturers that had received registration or type approvals but the total number is still very small - 15 registrations and 7 type approvals under the Electrical Appliances and Material Control Law. A revision of the Motor Vehicles Act also made it possible for foreign car manufacturers to obtain type approval, thus removing the need to submit each car for individual test and inspection.

While a system for type approval was introduced and some foreign manufacturers were able to obtain such approval, the total number remains limited. This was the result of the requirement that prior to granting type approvals, a thorough inspection had to be done either by an approved foreign testing agency (like, for example, the Underwriters Laboratory), or by an inspector sent from Japan. Granting of inspection authority to a foreign testing agency also depended on inspection by an inspector sent from Japan, and all the costs had to be borne by the foreign party seeking inspection.

To ensure transparency of standards and national treatment

of foreign products, the Gotoda report stated that, "Opportunities to hear the opinions of interested parties both domestic and foreign will be provided from the initial stages of the standard-drafting process so as to fully reflect their opinions in the process". It was not that this equality was denied before, for the Cabinet decision of 22 May, 1975 made clear that advance notice would be given to all interested parties, including foreign, prior to initiating revisions of safety standards [42]. Somehow, however, it did not work as effectively as it should have and it remains to be seen whether the renewed commitment will make for any improvement.

The process of market opening measures did not end with the Gotoda report. On 21 October 1983, a set of Comprehensive Economic Measures was announced and two External Economic Measures were adopted on 27 April, 1984 and on 14 December, 1984. These measures constituted further steps to promote imports through, for example, expanding the scope of the import financing role of the Export-Import Bank of Japan, and by strengthening the import promotion function of the Japan External Trade Organization (JETRO), that had, in the past, busied itself exclusively with the expansion of Japanese exports.

Even with the improvements that were being implemented in such rapid succession, the overall trade picture continued to deteriorate. As the Japanese surplus increased, so did the levels of American hostility toward Japan. Anti-Japanese sentiment was particularly strong and vocal in the Congress. On

28 March 1985, the House of Representatives passed a unanimous resolution condemning Japan and this unprecedented action was followed up with a similar resolution on 2 April, in the Budget Committee of the Senate.

On 9 April 1985, the Advisory Committee for External Economic Measures, led by Dr. Okita, and including such eminent personalities as Morita Akio of Sony and Maekawa Haruo, former Governor of the Bank of Japan, submitted a report to the government. In light of the gravity of the trade situation, the report emphasized the imperative for quick and more effective measures.

To avoid a crisis in the world of free trading system and to ensure global economic progress and stability, Japan must take concrete measures... in such areas as improving market access, fostering sustained economic growth driven by domestic demand...and encouraging manufactured imports. The basic approach must be a bold one of 'freedom in principle, restrictions as exception', one designed to open Japan to the world [43].

On 30 July, 1985, the Government-LDP Headquarters for the Promotion of External Economic Measures finalized the 'Outline of the Action Program for Improved Market Access' and on that same day, also set up a special committee to oversee and facilitate the implementation of the Action Program, headed by the Chief Cabinet Secretary.

In interviews conducted with various MITI and MFA officials, all were quick to classify the Action Program (AP) as a package totally different from those that had preceded it and not

entirely without justification, as we shall see further below. However, whether it will be sufficient to close the trade gap is difficult to assess, for that, will inevitably take time and a concerted effort in other areas as well.

The Action Program was different not only in the sense of being a more comprehensive measure but also because it pointed to an eventual readjustment in the state-society relationship. The latter will probably take much longer than the three year time span for the implementation of the Action Program. The entire package contained concessions and improvements in such areas as tariffs and quotas, standards and certification, government procurements, financial and capital markets, services and import promotion measures. The principal features are outlined below.

For tariff reduction or elimination, the government list contained 1850 industrial and agricultural items; 36 for tariff elimination. Most of the items slated for tariff elimination were products in which Japan had a strong competitive advantage, like cameras, auto parts, T&T equipment etc. A 20 percent tariff reduction was also proposed for 1670 industrial and mining products, and 110 agricultural products, to be phased in over the period of the program. The reductions however, were made subject to the safeguard clause (GATT, Art. 19), in other words, the tariff reductions could be withheld or withdrawn if it resulted in significant damage to the local industry [44].

To further simplify the standards and certification procedures, a total of 88 amendments to 23 laws were proposed.

3

MICROD

The main objective was to expand the scope for self certification, "...to allow manufacturers to check compliance with standards, instead of inspection and other check-ups by the government or other entities" on specific products [45]. The ceiling on motor cars qualifying for simplified import procedures was raised to 1000 units which, because of the low Japanese automobile imports, promised to "...bring virtually all imported vehicles within the scope of the simplified certification system" [46]. This will probably not have more than a minor effect on the import of foreign cars in absolute terms, because of the low existing levels of imports. In percentage terms, however, auto imports for the first nine months of 1986 did increase by approximately 25 percent over the corresponding period in 1985 [47].

To facilitate the import of pharmaceuticals, it was decided that, "foreign clinical test data shall be accepted for all examination/testing items except for the following three items not immune to differences between Japanese and foreigners: comparative clinical trials; dose finding tests; absorption, distribution, metabolism and excretion tests." This was no doubt an improvement but it is still hard to understand the rationale behind the exceptions, based on biological differences between the races. At the time the AP was being formulated, there was some contention on this point between the Economic Planning Agency (EPA), responsible for the overall content of the AP, and the MHW. When pressed by the EPA, the MHW produced test data to

show, for example, that because of dietary habits, the average Japanese had longer intestines, by as much as 20%, and that this had to be taken into consideration since it bore directly on the absorption rate of drugs. The EPA eventually had to defer to the MHW, recognizing their competence in this area.

There were two particular features in the Action Program that separated it from the market opening measures of the past and which could prove to be the most promising aspects of it, from the point of view of foreign manufacturers. These were:

1. redefinition of the role of government,
and
2. national treatment of foreign products.

The first point above does not mean the end of industrial policy-making in Japan but rather referred to certain specific aspects of the micro-level regulatory intervention in the economy [48]. Traditionally, the role of the government within the Japanese society had been wide and unquestioned. The government enjoyed far greater latitude than in any of the Western democracies, a fact that can be gleaned from the highly regulated and ordered Japanese society. In the economic sphere, the government had established a wide range of product safety standards to protect the interests of the consumers, and the consumers in return have come to look upon the the government to provide this function, which it did, through its testing agencies.

Although international comparisons of governmental

regulations are difficult, about 15 percent of all Japanese laws, as of November 1984, were judged to be regulatory laws and in terms of the weight of the regulated sector of the economy, that made up approximately 53 percent of the Gross National Product in 1980. The weight of those areas of the economy where governmental regulations were particularly severe was 26.2 percent in 1975 but had declined to 25 percent in 1980. In the United States, the weight of the regulated sector of the economy was 23.7 percent in 1975 but as the EPA's report, from which these statistics are taken, cautioned, strict comparability should not be assumed since regulatory mechanisms in the two countries differed. And, as we mentioned in Chapter 2, with respect to the automobile industry, the U.S. under both the Carter and Reagan administration undertook substantial relaxation/elimination of regulations such that the present weight of the regulated sectors of the U.S. economy would be smaller than the figure given above [49].

To illustrate the difference in the Japanese and Western conceptualization of the role of the government, we can look at the regulations governing certification of foreign automobiles. For much of the post war period and until very recently, the Ministry of Transportation refused to allow self-certification by foreign auto producers feeling that, "...the Ministry, rather than the foreign firm, would be at fault if an error was made and an accident resulted" [50]. Whatever the merits or demerits of this system, it did work to the disadvantage of foreign firms

working in a less regulated environment.

The AP report contained the important point that, "On the basic standpoint of 'freedom in principle, restrictions only as exceptions', government intervention shall be reduced to a minimum so as to leave the choice and responsibility to consumers" [51]. Of course, this does not cover all products, nor does it mean that the government will lower or eliminate the standards that are already in place, but that it would leave it as the responsibility of the manufacturers to ensure compliance with the standards. Whereas in the past, the government would, based on its own tests, ensure compliance, the AP announced that the government would be willing to accept test results generated by the manufacturers themselves to determine whether the products complied with the established standards. The government would reduce its role of testing and granting of permission to affix quality seals certifying minimum quality standards. The consumers would be left to make their own choices and market forces would be given greater play in determining product success or failures. For example, it was decided that the Industrial Standards Law would be reviewed with the aim of reducing the number of products that currently required the 'JIS' quality seals. This, for products under the jurisdiction of the MITI, but the scope of self certification was to be expanded to other areas as well, like fire-fighting equipment (Ministry of Home Affairs), Microwave cookers (Ministry of Post and Telecommunications), etc. On 13 December, 1985, the Diet

accordingly revised three laws covering consumer goods, gas supplies, and fire prevention equipment [52].

With respect to the second feature of 'national treatment', it is true that in the past, Japanese buying habits had been strongly influenced by the 'buy Japanese' policies (kokusan hin aiyo). This was true for government procurements, and for the individual consumer. Attempts to change this had not gone much beyond verbal exhortations and understandably, with little effect. Prime Minister Suzuki, in May 1982, urged his countrymen to change their outlook on imports, saying, "We have not shed our misperceptions that export is good, import is bad. Instead of discriminating against foreign products, we should adopt a more welcoming attitude" [53]. Nakasone went a small step further. In his Television address announcing the government's intention to formulate the AP, he not only urged viewers to buy more imports, but also suggested a shopping list to help them spend an additional US\$100 on imported goods.

To increase corporate purchase of imports, the MITI minister Murata called in representatives of Japan's leading firms in April and again in August 1985, to urge them to increase their planned imports for the year including their own corporate procurement of parts. In an interview afterwards, the minister said that the time had come for Japan to move away from the 'buy Japanese' to a 'buy foreign' policy [54]. The 134 companies to which MITI had made the special appeal reported that they intended to increase imports by an estimated \$7.4 billion in FY

1985 as compared to the year before [55]. Their FY1984 imports had been about \$97.3 billion. In a follow up of their import performance in late March 1986, it was learned, however, that their imports would increase by only \$3.1 billion, less than half of what had been initially anticipated [56]. It was explained that the shortfall in achieving the target was due to the rapid decline in the price of oil and of other primary commodities which together make up a large portion of Japanese imports and which could now be purchased cheaper because of the fact that Japanese trade was still largely dollar denominated. Also, in so far as procurement of foreign parts was concerned, the difficulty here was the practice of intra-group buying in Japan and the policy of maintaining low inventory levels to ensure maximum cost efficiency. This would not be possible if manufacturers in Japan were to rely more on foreign parts since they would have to maintain higher levels of fixed inventory to account for possible shipment delays etc. According to Commerce Secretary Malcolm Baldrige, the practice of intra-group buying was a major hurdle for foreign companies to overcome and one that the Action Program had not touched upon [57]. However, since this also applied to those Japanese firms standing outside the group, one cannot readily denounce it as discriminatory.

Government procurement policies, too, have been resistant to change. Here, the main dispute between the U.S. and Japan has focused on the procurement policies of the Nippon Telephone and Telegraph (NTT), which until 1984 was a public monopoly. NTT's

procurements had almost wholly been restricted to domestic suppliers and at one time the NTT Chairman Akigusa had arrogantly brushed aside American pressure to buy American telecommunications equipment saying that the only things that the U.S. could offer the NTT were 'mops and buckets' [58]. The U.S. interest in selling to the NTT was part of a general strategy to boost its high technology exports to Japan. The U.S. argued that Japanese procurements should be as open as they were in the U.S. or Canada, to which the Japanese counter argument was that procurement policies in the U.S. and Canada were the exceptions rather than the rule. Such an argument, understandably, made little sense in bilateral negotiations and confronted with increasing pressure, the Japanese government had to concede to the American demands. NTT's foreign procurements have shown rapid growth in recent years although still low in absolute terms. Over the four year period, 1981-1984, NTT's procurement from the U.S. registered an eight-fold increase although procurement in the final two years appeared to have levelled off. Also, as the statistics show, the U.S. accounted for nearly 90 percent of all foreign procurement by the NTT.

TABLE 4.4

NTT FOREIGN PROCUREMENTS

YEAR	TOTAL	FROM U.S.
FY1981	Y4.4 BIL.	Y3.8 BIL.
FY1982	Y11.0	Y8.6
FY1983	Y34.8	Y31.2
FY1984	Y36.0	Y32.0

Source: MFA, Tokyo, Japan.

The absolute amount of NTT foreign procurement is still quite small, considering that in 1982, total NTT procurement was about Y700 billion. Also until recently, the NTT had not purchased any core equipments. The first major purchase was in December 1985, when it decided to purchase digital switches from Northern Telecom.

To assess the impact of the AP, it should be emphasized that the most hopeful feature was perhaps the fact that it tried to establish new directional objectives. At the same time, there should be no illusion that it will be easily achieved. To give an example, with respect to the elimination of the 'JIS' marking system, only about 10% of the total number of products under MITI jurisdiction will be affected in the three year phase of the AP [59]. Also, bureaucratic foot dragging in the implementation phase cannot be ruled out either. The bureaucracy's attitude to the entire process will be largely determined by its

interpretation of the political will. Bureaucratic foot dragging could result from a number of other factors as well, including the preservation of traditional prerogatives. For example, the AP stated that all standards and certification requirements not based on specific laws, i.e., those based on public notification (kokujī) or directives (tsutatsu) issued by the various ministries will be abolished and that the Committee to Promote the Implementation of the Action Program (Chairman: Gotoda) would complete all the necessary procedures by November 1985. This prompted considerable bureaucratic opposition because it could result in the reduction of special institutions that currently oversee the observance of these directives and thus also jeopardise the 'Amakudari' [60] chances of senior bureaucrats. The opposition was rationalised on the belief that this was an area of little relevance to import promotion and because there had been little or no foreign criticism of these practices. As a result, agreement on the implementation phase of this part of the AP was only reached in March 1986 and it was decided that such standards would now be abolished in July 1988.

Problems in the implementation phase could also arise because while the Action Program was formulated by the Economic Planning Agency (EPA) which is attached to the Prime Ministers Office, implementation would depend on the cooperation of the regular bureaucracy and here special interests could delay the process. It is possible that undue delays may lead to a negative interpretation of the government's sincerity in the West, and

mindful of this, the Keidanren, in a recent report, urged particular attention to the task of carrying out the implementation according to the original schedule, "...so as not to betray the expectations, domestic and overseas, and realize the originally intended effect" [61].

In the next section, we will look at the distribution network in Japan and the role it plays in determining market access for foreign manufacturers.

SECTION IV

THE JAPANESE DISTRIBUTION SYSTEM AS AN IMPORT BARRIER

No study of the problem of expanding Japanese imports would be complete without touching on the complicated distribution system in Japan. Foreign business often complain that the distribution system in Japan is closed and largely responsible for the low penetration of foreign goods in the Japanese economy. The Japanese distribution system, like the economy in general, can be classified into two categories: the efficient modern sector; and the more numerous and inefficient traditional sector. The former, because it is usually controlled by the large manufacturers, is difficult for an outsider to penetrate while the latter is much too inefficient to handle large sales volume. This dualistic feature of the distribution system has been the crux of the problem for foreign manufacturers wishing to enter

the Japanese market. Although the Committee on Distribution within MITI, prepared a guideline in the late 1960s to rationalize/modernize the cumbersome distribution system, the program appeared to have had little major success. Anticipating the difficulties in achieving this rationalization, Yoshino noted the following as one major problem area:

Given the strong traditional orientation toward large-scale manufacturing firms, it is by no means certain that those charged with the distribution programs will enjoy the most influential position, even within MITI [62].

Interestingly, the distribution system in Japan, has also been a handicap for many Japanese firms. The most prominent examples would be Sony and Honda, which were forced to rely on export sales because of the difficulty of breaking into the domestic group-oriented distribution network. Presumably therefore, an open distribution system would work both to expand imports, and reduce export dependence for many local firms. To illustrate the difficulties faced by foreign and non-group manufacturers, let us take an example in the electronics industry. In 1982, there were about 60-70,000 electronics retail outlets of which about 40,000 carried Matsushita (National) products, exclusively or otherwise and only 3000 carried Sony products [63]. The barrier for new entrants into an established industry, like Sony, was the domination of the distribution system by the 'Keiretsu' (intra-firm) groupings which block out the products of companies outside the Keiretsu group. According to Woronoff:

The distribution keiretsu tied up the market even tighter as regards most consumer goods. Where manufacturers controlled the wholesalers or retail outlets, they would determine which articles were sold and easily veto the sale of imported products that competed with their own. Indeed, in many of the distribution networks the rule was exclusive dealers, and even in some supposedly independent outlets, the owners would be wary of upsetting his customary supplier. Where wholesalers dominated the retailers, and either belonged to, or themselves owned manufacturers, they would refuse to serve as channels for competing imports or, at most give them second-best treatment [64].

The 'keiretsu' is a former legacy of the Japanese economy and one area that the Allied occupation forces failed to reform, although this was on their original agenda.

Because of distribution problems, the sales volume of foreign products was typically small and this fostered the practice of over pricing. This, in turn, meant that foreign goods had to be adorned with an exclusive 'brand' image to make the product salable. An interesting example of this was the Johnnie Walker Red Label scotch whisky which, when it was priced high and therefore 'exclusive', was the best selling scotch whisky in Japan, but as its price dropped it also lost its market standing.

Foreign products were thus surrounded with an air of exclusivity that left them out of competition with equivalent Japanese substitutes. It is often argued that lowering prices of imports would have only a marginal effect on sales volume because Japanese substitutes were readily available. There are exceptions of course, like Kodak and Proctor and Gamble, which

have been very successful in Japan, but even here it is not uncommon to hear murmurs of discontent.

One measure of the efficiency of a country's distribution network is the W/R ratio which is the ratio of total value of wholesale sales to the total value of retail sales. A high W/R ratio would thus indicate a lengthy distribution process or a lengthy intermediary stage before a commodity reached the retail level. This would naturally be reflected in a higher retail price. The Table below compares the W/R ratio of Japan and a number of other advanced industrialized countries.

TABLE 4.5

W/R RATIO

	JAPAN	US	UK	FRANCE	W. GERMANY
	1982	1982	1983	1982	1979
W/R RATIO	4.21	1.87	2.03	1.57	1.67

Source: 'Yunyu hin no Ryutsu Oyobi sho Kanko ni tsuite',

Bukka antei Seisaku Kaigi Seisaku Bukai, March
28, 1986. p. 16

Even allowing for discrepancies in cross-country statistics the high W/R ratio in Japan indicates a more complicated and lengthy distribution stage. Of the five countries, France, had the most efficient distribution network as measured in terms of the number of stages before a product reached the retail level. We should, however, be careful in our use of such comparative statistics. The Republic of Korea, for example, had a W/R ratio

of only 0.7 but this was mainly due to the fact that the distribution system is not well established and many retailers buy directly from the manufacturers, thus by-passing the wholesale stage [65].

The W/R ratio, as given above, does not discriminate between domestic and imported products and, indeed, if equal treatment is given to all, regardless of country of manufacture, the system, even if inefficient, cannot be called unfair. In late 1985, the EPA, in coordination with MITI and MOF, conducted a survey to assess whether imported products received the same treatment as the domestic, or whether they were discriminated against, as foreign manufacturers allege. The survey was conducted over the period of July to September and the final report and conclusions were released in November 1985. The report acknowledged that the small number of product categories included in the survey could not be the basis for a definitive conclusion, but it nevertheless felt confident enough to conclude that while the distribution system tended to overprice imports more than domestic products, the margin retained by wholesalers and retailers was about the same [66]. The disadvantage of imports over domestic products, however, can clearly be seen from the table below, compiled from the survey results. The table compares the mark-up resulting from the distribution system, in other words the percentages represent the weight of the distributors margin to the retail price of the products.

TABLE 4.6

DISTRIBUTORS MARGIN AS WEIGHT OF RETAIL PRICE

PRODUCT CATEGORY	IMPORTS(A)	DOMESTIC(B)
GLASS PRODUCTS	61-63%	30%
CUTLERY	60-65%	60%
POTS AND PANS	66-74%	45%
BEDDING	42-57%	50%
FURNITURE	51-66%	35%
ATTACHE CASE	68-69%	35%
TOYS	64-67%	45%
MEN'S COAT	56-71%	35-38%
SHOES	61-71%	35%
SPORTS SHOES	60-65%	50%
SHIRTS	67-71%	40%
TIRES	40-46%	50%
MUSICAL GOODS (SPEAKERS)	55-60%	23%
SPAGHETTI	29-64%	28%
BOTTLED & CANNED GOODS	36-45%	45%

Notes: (A) Survey of 2-3 products.

(B) Survey of 1 product.

Source: Compiled from 'Yunyu hin Ryutsu Jittai Chosa Kekka no Matome', EPA, Nov. 1985. pp. 257-285.

There is a wide margin in the mark-up on particular product categories but if we looked at the average, domestic products received a mark-up of 40 percent while the mark-up for imports

ranged from 54 to 64 percent. Another criticism of the Japanese distribution system is that it is too inflexible to pass on benefits to the consumers. Even after the rapid devaluation of the dollar against the Yen, the reduced price for imports had not been passed on to the consumer but rather been retained by importers and distributors. A MITI survey which examined price changes between the period August 1985 and March 1986 found that in spite of the decline in import prices of such products as jeans, athletic shoes, electric razors and watches, the prices of these goods at the retail level remained unchanged. This essentially made it difficult for exporters of products to Japan to increase their sales volume and market shares. It should be mentioned however that not all foreign manufacturers are equally concerned about increasing their market shares. For the giant chemical company, Du Pont, the devaluation of the dollar has been used as the long awaited opportunity to recoup profitability after years of operating with small profit margins when the dollar was inflated [67].

The government, understandably, has little control to alter the distribution system because it reflects the special socio-economic condition of Japan. However, a recent report release by MITI expressed the hope that the distribution network would more clearly balance the interests of the producers and the consumers. One feature of the distribution system, as noted above, was its domination by the major 'Keiretsus'. Obviously, therefore, the distributors were more sensitive to the interests

of the producers resulting in a restriction of products handled and consequently constraining the choice available to consumers. In its 'vision' for the distribution system, MITI observed that with the increasing internationalization of the Japanese economy, the distribution system should more accurately reflect the diversity of 'needs' of the consumers and respond in a like manner, hopefully resulting in expanded imports of manufactured goods [68].

Earlier MITI policies of rationalization/modernization of the distribution system had been directed at the traditional sector which, by its very nature, was less amenable to 'direction and control' given its numerical and regional diversity. The present outline of the 'vision' was aimed at the modern sector dominated by large manufacturing concerns and because MITI's clout with big business is greater, its chances of success should be much improved.

SECTION V

OFFICE OF THE TRADE OMBUDSMAN

As part of the January 1982 market opening measures, the Japanese government established an Office of Trade Ombudsman (OTO) to handle and process complaints from foreign companies and other interested parties on Japanese import procedures, inspection systems, or any other specific issue. The OTO was an

inter-ministerial mechanism with the secretariat located within the Economic Planning Agency (Prime Minister's Office, --PMO).

Its main purpose was to ensure that the market opening measures were faithfully implemented and in this it depended on foreign exporters and importers in Japan to bring to the government's attention any discrepancy in principle and practice. The principal functions of the OTO are listed below:

1. strive to reduce government intervention in the economy
2. internationalization of standards and certifications.
3. simplification of import procedures [69].

From the very inception of the OTO, there were complaints from foreign sources on the structure of the OTO, who argued that it was impossible to expect the bureaucracy to respond to and handle complaints on the practices of the bureaucracy in a fair manner. Even though the secretariat of the OTO was in the PMO, the secretariat was only responsible for coordination and did not have any authority or jurisdiction over the respective bureaucracies. The actual and/or perceived problems as to the fairness of the OTO prompted the government to set up, in January 1983, an Advisory Council to the OTO, to oversee its activities and ensure fair handling of complaints. It is difficult to imagine, however, how the Advisory Council can do more than oversee the procedural aspects of problem resolution. The Advisory Council is composed of private individuals, although its Chairmen, to date, have had past association with the official

bureaucracy. Although, the OTO Advisory Council does not have any administrative authority Okita Saburo, the current Chairman, wrote that that, "...the stature of its members gives it considerable influence within the Government of Japan" [70].

As of February 1986, the OTO had received 234 complaints (88 in 1982, 50 in 1983, 25 in 1984, 68 in 1985, and 3 in the first two months of 1986), of which 119 had been filed domestically. In terms of the general nature of the grievances, the Table below provides a summary.

TABLE 4.7

NATURE OF OTO COMPLAINTS

MINISTRY CONCERNED	NO. OF COMPLAINTS
1. MHW (Pharmaceuticals, Shokuhin Eisei etc.)	98
2. MITI (High Pressure Gas etc.)	48
3. MOF (Import Procedures)	41
4. MOAFF (Live Animal Inspection)	24
5. MOT (Shipping Containers)	9
6. Others	36
TOTAL	256

Note: The total exceeds the no. of cases, 213, because some complaints concerned more than one ministry.

Source: "OTO no....ni tsuite", p.7

It is not surprising that the Ministry of Health and Welfare had the most number of complaints because it must contend with the vested interests of the powerful and conservative Japan

Medical Association. The JMA had not been very receptive to the government's attempt to open up the pharmaceuticals industry to foreign competition and, according to one report, the JMA even refused to accept foreign test data on pharmaceuticals even though these were included in the Action Program. One EPA official, however, conveyed the determination of the government to proceed with the measures contained in the Action Program although he acknowledged that opposition of the JMA could hold back the sale of imported prescription drugs [71].

In terms of the resolution of the complaints lodged with the OTO, according to figures available, 224 of these had been resolved, mostly to the satisfaction of the aggrieved party. The breakdown of the outcome of complaints is given below.

TABLE 4.8
OUTCOME OF COMPLAINTS TO THE OTO

CAUSE OF COMPLAINT REMOVED	79
COMPLAINT RESULT OF	
MISUNDERSTANDING	93
- REMOVAL OF MISUNDERSTANDING	
HAD IMPORT FACILITATING	
EFFECT	(65)
- OTHER	(28)
EXISTING PRACTICE CONTINUED	56

Source: "OTO no Saikin no....", p.8

It is worth noting that a majority of the complaints were the result of misunderstanding. This suggests that there was

considerable confusion concerning the legal structures, and import regulations. In providing a venue for the removal of misunderstanding, the OTO does seem to have a role to play in the Japanese economic system, and as Okita observed: "There is nothing quite like it anywhere else in the world and it is hoped that foreign manufacturers and governments will take advantage of the OTO's availability" [72]. This quotation sums up the strength of the OTO but it also points to its existing weakness.

The complaints to the OTO have come mostly from foreign manufacturers even though many were lodged domestically, by foreign subsidiaries and the like. However, for the OTO mechanism to be fully effective, it will be necessary for the local importers to get more closely involved since they are in a better position to understand the problems confronting imports. Of the 234 complaints that had been lodged with the OTO, 119 had been from within Japan, but a senior MITI official confirmed that hardly any of the 119 complaints had come from Japanese companies. Indeed, in the initial stages, the OTO specifically denied access to Japanese firms but in early 1983, this restriction was removed to allow both foreign and local business equal opportunity to voice their complaints, either directly or through the Chamber of Commerce. The latter option was provided so as to ensure anonymity but this did not allay the fears of domestic companies. Japanese firms have been reluctant to utilize the OTO for fear that they could be subject to persecution or harassment from the bureaucracy, making things

even more difficult for them. The other reason why Japanese firms have been relatively absent from the list of complaintee can be attributed to cultural values. The OTO is a formal apparatus for handling disputes but social values in Japan have a distinct bias in favour of informal means.

The cultural barrier may be difficult to break but officials tend to emphatically deny that by resorting to the OTO, Japanese firms leave themselves open to harrassment. However, the perception may be too deeply ingrained and this may prove to be a long term disadvantage for the OTO although, as it is, it still serves a useful purpose, but mostly for foreign companies.

SECTION VI

EXCHANGE RATES AND TRADE IMBALANCE

It should be emphasized that there are some differences of opinion between Japan and the United States as to the real significance of market opening measures. For Japan, they are just that, i.e., measures to facilitate the entry of foreign products into Japan. For the U.S., however, no market opening measure is complete unless it also translates into expanded imports. From the Japanese point of view, the latter is outside the scope of the government, and Western expectations, therefore, unreasonably high. Both the EC and the U.S. have been urging Japan to establish import targets and work to its fulfillment.

[73]. One MFA official reacted to these demands in the following words, "They, perhaps, are under the impression that we are a communist country" [74].

The Japanese government also insists that it was not entirely up to Japan to bring about a balance in trade. Prime Minister Nakasone repeatedly asserted that a portion of the blame must be apportioned to American businesses that had not made 'sufficient' efforts to penetrate the Japanese market. Thus, even in the case of the Action Program which was unveiled with such fanfare, the most optimistic assessment was that it would lead to some increase in imports over time if the implementation phase proceeded smoothly and provided the foreign manufacturers took the Japanese market more seriously than they had in the past.

As mentioned earlier, the trade imbalance cannot be attributed to any one single factor and it will be necessary to tackle the problem on all fronts. One area that the Japanese government had emphasized was the macro-economic policy differences between the two countries, tight fiscal and easy monetary policies in Japan, and easy fiscal and tight monetary policies in the U.S. First, let us take a look at budgetary trends in the two countries.

TABLE 4.9
BUDGET DEFICITS IN U.S. & JAPAN (\$, BILL.)

	UNITED STATES		JAPAN	
	BUDGET DEF.	OUTSTANDING	BUDGET DEF.	OUTSTANDING
	-----	---DEBT---	-----	---DEBT---
1980	59.6	914.3	78.7 (14170)	391.7 (70510)
1981	57.9	1,003.9	71.7 (12900)	457.1 (82273)
1982	110.6	1,147.0	78.0 (14045)	480.5 (86482)
1983	195.4	1,381.9	74.9 (13486)	609.4 (109695)
1984	175.4	1,576.7	71.5 (12865)	676.1 (121694)
1985(e)	203.0	1,841.9	64.9 (11680)	738.3 (132900)

Note: Figures in parentheses are Japanese Yen @180=\$1
1985 figures are estimates.

Source: JAPAN 1985, pp. 82-83.

The above table does somewhat exaggerate the annual Japanese budget deficits for the early 1980s because of exchange rate movements. If we use the average exchange rate for the year 1980 which was Y226.74=\$1, Japan's budget for the year is somewhat lower at \$62.5 billion, but still more than the U.S. deficit for that year. The trend, however, has been unmistakable. With the massive increase in U.S. federal spending, together with the tax cuts in 1981, the first year of the Reagan administration, the American deficits had literally soared. During this same period, the Japanese government succeeded in bringing down the yearly deficits, with strict fiscal austerity. This period also corresponds to the rapid deterioration of the trade imbalance

between the two countries. One result of the continuing U.S. deficit has been the phenomenon of 'crowding out' in the financial markets, and the effect was particularly noteworthy since private sector investment needs had increased with the economic recovery and growth beginning in 1983. Domestic personal savings in the U.S. has always been low and declined even further in 1983 [75], and even though corporate savings rate has traditionally been high, the imbalance between gross domestic savings and investments continued to worsen, pushing up interest rates in the process. The IS (Investment and Saving) imbalance can be seen from the table, below:

TABLE 4.10

U.S. SAVINGS AND INVESTMENT

	TOTAL NET SAVINGS(1)	GROSS DOMESTIC PRIV. INVEST.
1980	405.9	401.9
1981	484.3	484.2
1982	408.8	414.9
1983	437.2	471.6
1984	551.0	637.3

(1) Net of Personal & Business Savings; and
Federal & State/Local Deficits/Surplus.
All figures are \$, billions.

Source: Economic Report of the President,
February 1985. p. 262. Table B-25.

In Japan, on the other hand, helped by a high rate of personal savings, and low domestic investment demand, both public and private, the economy has enjoyed a net capital surplus. The

capital shortage in the United States and the surplus in Japan is reflected in interest rate differentials, see Table 4.11.

TABLE 4.11

INTEREST RATE DIFFERENTIALS IN JAPAN AND U.S.

	O.D.R.	T-B RATE	O.D.R.	CALL RATE
	-----	3 MONTHS	-----	NO. COND.
1980	13.0	11.43	7.25	10.93
	12.0	14.03	5.50	7.44
1982	8.5	10.61	5.50	6.94
1983	8.5	8.61	5.00	6.39
1984	8.0	9.52	5.0	6.10
1985	7.5	-----	4.5	-----

Note: O.D.R. stands for the Official Discount Rate.

The O.D.R. is for the year end; the short term rate is the year's average.

Source: *Economist* (Tokyo), September 17, 1985. p. 101.

Although, interest rate differentials are not the sole determinants of international capital flows, they do influence such movements and it is no surprise that Japan's basic balance has consistently been in deficit with the U.S. The demand for the U.S. dollar also inflated its value beyond the levels that would be reasonable given the economic fundamentals, trade deficits etc. Needless to say, a high dollar value made imports cheaper and exports costlier and this deterioration of the competitive position had made a correction of the trade imbalance even more difficult. The IS imbalance and the high demand for the dollar could be traced back to the fiscal splurge which, in essence, meant that no solution would be complete unless it was

also accompanied by fiscal order in the U.S. Indeed, this was one of the articles of agreement at the recent G-5 meeting.

According to a recent U.S. Data Research Institute (DRI) report, a 1 percent interest rate differential between the U.S. and other countries results in an overvaluation of the dollar by about 4 to 5 percent [76]. The DRI had been commissioned by the U.S. Congress to assess the impact of the 40 percent increase in the value of the dollar since 1980. The report, released in March 1985, concluded that there had been an adverse impact of the American balance of trade to the tune of \$60-70 billion, since an overvalued currency is a tax on exporters and a subsidy for importers. It also argued that Japan's cost advantage, as a result, had improved from 88 in 1980 to 71 in 1984 (U.S.=100), reversing the trend of the previous decade.

TABLE 4.12

JAPAN'S MANUFACTURING COSTS (US=100)

	1965	1971	1975	1980	1984
LABOR COSTS	60	54	92	79	60
CAPITAL COSTS	95	64	51	90	96
ENERGY COSTS	184	168	192	243	188

OVERALL	72	60	86	88	71

Source: "Bei-koku no Kokusai Kyoso Ryoku"

~~Chosa-Gappo~~ (Ministry of Finance), Vol. 74, No. 8, August 1985, p. 47.

To counter the argument that interest rate differentials were responsible for the growing trade imbalance, the U.S. argued that the trade imbalance had grown despite a narrowing of the differential in recent years. To curb capital flows to the U.S., it argued that the Japanese government should be more flexible in its fiscal policies and reflate the domestic economy. According to this position, the restraint on fiscal spending in Japan had forced the Japanese economy into an export-led growth pattern when, in fact, it should act as the engine of growth to lift the world economy out of the recession. There is ample evidence to suggest that Japan's own economic recovery has been based on the American economic recovery. During the latest recovery period, 1983, the contribution ratio of export to GNP growth was much higher than in the earlier recovery periods of March 1975 and October 1977. The export growth had gone mainly to the U.S., pulled in by the boost in consumer spendings there. Exports to the United States increased by an enormous 45 percent in FY1984 [77]. The income elasticity for import in the U.S. is a high 1.75 as opposed to only 0.65 in Japan, which makes it rather unlikely that Japan could serve to pull the world out of the recession, unless of course, the rate of economic growth was very high and led by domestic demand.

In all previous recoveries from recessionary periods, Japan's economic growth has been led by exports. This dependence on export led growth has been explained in terms of the commitment to permanent and secure life-long employment in the

modern sector of the economy. Due to the fact that employers were constrained from laying off workers during a recession, labour costs for a typical large Japanese firm are treated as a fixed cost rather than as variable costs. This meant that during a recession, when there was surplus productive capacity, the marginal cost of production was very low and firms would try to take advantage of this by a concerted export push [78].

In the U.S., autumn has become an especially difficult time for defenders of free trade. The administration releases its trade figures for the fiscal year ending in September and with little to be cheerful about, there is always the possibility of tipping the balance in favour of the protectionists. The year, 1985, was a particularly ominous year, partly because of the anticipated worsening in the trading position but also because the Congress, in censuring Japan so strongly earlier in the year, held out the spectre of more concrete steps to safeguard the U.S. economy from the flood of imports. This worried both the Japanese and American administrations, equally committed to avoiding legislated protectionism. As we saw, the measures taken by the Japanese government to liberalize its economy provide no firm guarantees of improving the trade situation in the short term and any beneficial effect will only become visible in the longer run. This made it essential to devise ways and means of overcoming the protectionist forces during this transitory phase. No matter how significant the Japanese market opening measures, unless the transitory period was carefully managed, the potential long term

benefits could not be realized. It is in this background that I think one can analyze the decision taken at the G-5 meeting in New York to adjust international currency rates. This is not to suggest that there was no basic maladjustment in the exchange rates for the dollar was clearly over-valued, but it does help to explain why the agreement was reached when it was, considering that the U.S. had adamantly opposed it prior to that time. The change in the U.S. position can partly be attributed to Japan's consistent emphasis on this point and partly to the nomination of James Baker as the new U.S. Secretary of the Treasury.

Under a system of floating exchange rates, we would expect trade imbalances to be automatically adjusted by appreciation in the value of the surplus currency and depreciation in the value of the deficit country. But even though the fixed exchange rate system collapsed in the early 1970s, adjustments have not been smooth and it is argued that this is due in large part to the magnitude of capital flows between countries, which can negate or override the general picture of trade flows between countries. Capital flows today are less determined by the flow of goods as they are by differential interest rates and by varying levels of profitability. The increase in speculative capital flows across national boundaries made it less likely that exchange rates, as determined by the market, would accurately reflect the trade picture. Ever since the global trade imbalance became a threat to the system, the surplus countries of Europe and Japan argued on the need to take joint action to bring about exchange rate

changes. However, the United States, in particular the Federal Reserve Board, was less than sympathetic to this argument fearing that a lower dollar value would lead to a resurgence of inflation at home. This had indeed been the American experience in the decade of the 1970s. However, beginning in 1979, the Federal Reserve Board (FRB), under Chairman Paul Volcker, instituted tight monetary policies and succeeded in bringing down inflation levels. In 1983-84, the rate of inflation in the U.S. was below 4 percent compared to 9 percent in 1981. Quite understandably, the FRB had been extremely reluctant to deviate from what it considers to be good policy.

The fear that a lower value of the dollar would revive inflation was based on two assumptions; first, that it would translate into higher import prices and second, that an increase in export demand for American products coupled with consumer substitution of import demand with domestic would create an excess of demand over supply, at least in the short run because supply could only be expected to increase with a time lag. This was the standing argument of the FRB against using exchange rates as an instrument of policy although, it is reported that Paul Volcker has been reduced to a minority position with recent Reagan appointments to the Board by President Reagan. The U.S. administration is under pressure to demonstrate to the Congress that active measures are being taken to reduce the trade deficit, and exchange rate adjustment is the most efficacious way of doing so.

At the G-5 meeting meeting, the five member countries agreed to intervene in the financial markets to lower the value of the dollar relative to the other currencies. The agreement had an immediate effect and the dollar went on a nose dive, declining 30 percent by March 1986 and 40 percent by August 1986. The table below, shows the movement of the Dollar against the Yen.

TABLE 4.13

EXCHANGE RATE CHANGES BETWEEN YEN AND DOLLAR

January 4, 1985	Y252=\$1.00
February 25, 1984	Y263=\$1.00
July 18, 1985	Y236=\$1.00
September 20, 1985	Y242=\$1.00
October 4, 1985	Y211=\$1.00
November 25, 1985	Y200=\$1.00
January 28, 1986	Y195=\$1.00
March 10, 1986	Y179=\$1.00

At the G-5 meeting, it was also agreed that Japan and West Germany would implement policies to raise domestic demand levels. It is this aspect of the agreement that the FRB was particularly careful to emphasize. Testifying before the Subcommittee on Domestic Monetary Policy of the House Committee of Banking, Finance and Urban Affairs in November 1985, Staff Director for Monetary and Financial Policy, Board of Governors of the FRB, S.H. Axilrod, said that members of the G-5 had agreed on the "need for more fundamental macroeconomic policy adjustments here

and abroad...Intervention and exchange rate changes are no substitute for sound underlying policies" [79].

Despite the wary, cautious approach of the FRB, the administration has been rather forthcoming on the issue. In February 1986, Chairman Paul Volcker and USTR Clayton Yeutter, testifying before the Congress, hinted to the lingering disagreement. Yeutter expressing the views of the administration suggested that the dollar should decline even more but Volcker contradicted him by saying that the decline had already gone far enough. It was also Paul Volcker who, at the London G-5 meeting in January 1986, ruled out a concerted cut in interest rates, sought by Japan, fearing that such a move would revive inflation by lowering the value of the dollar and boosting domestic consumer spending. The dollar, however, continued to decline still further and Japan felt confident enough to cut its own discount rate unilaterally.

Japan had been under considerable pressure from domestic sources to lower interest rates to avoid a recession induced by the revaluation of the Yen but it also did not wish to widen interest rate differentials that might lead to an increased demand for the dollar. - The 0.5 percent rate cut had no visible impact on the exchange rates and the dollar continued to fall. By late January, the Yen had appreciated to under the Y200=\$1, exceeding the anticipated increase in its value. Industry sources bitterly complained that they would not be able to compete if the Yen continued to rise and there was consistent

pressure upon the government to cut the discount rate even more. On the earlier occasion, the Japanese government was concerned not to strengthen the dollar but the second time the discount rate was reduced, there was at least the implicit hope that it would lead to a stabilization of exchange rates.

The rationale behind using the exchange rate as the mechanism to bring about trade adjustments was that it provided a degree of certainty, although, by usual estimates, the effect takes from four to six quarters to work through the system. This is known as the 'J' curve effect. Accordingly, an improvement in the U.S.-Japan trade situation could only be expected in the latter part of 1986 or in early 1987. As to the extent of the corrective effect of the rise in the value of the Yen, C.F. Bergsten, former Assistant Secretary of the Treasury, and currently Director of the Institute for International Economics, suggested that it would eventually produce a reduction of about \$20 billion in the U.S. trade deficit with Japan. Speaking before the Japan Society of New York on 12 March, 1986, he said a further Yen rise is desirable, to about Y160 to the dollar, citing the sharp drop in oil prices as one factor why the currency should be further revalued [80]. Apart from the normal balance of payments effect, the American business magazine *Fortune*, noted another favourable effect of the currency revaluation. A stronger Yen, it argued, "...would make it cheaper for Japanese companies to buy land and cement and pay wages in the U.S., speeding up the Japanese expansion of

manufacturing in the U.S. The Japanese industrialization of America may do more than anything else to bring trade into balance" [81].

SECTION VII

CONCLUSION

With all that had been done to improve market access and the continuing progress being made, it still seems overly optimistic to hope that the trade imbalance will be rectified in the near future. Most analysts agree that Japan will continue to have surpluses for quite sometime to come, especially in trade with the United States. The American demand is not that the surplus be totally eliminated but simply that it, at least, be brought to within reasonable limits and as USTR Yeutter has often remarked, the U.S. government neither demands nor expects the trade imbalance to completely disappear. Leaving aside the value of focusing on bilateral trade when the correct perspective ought to be multilateral, it has also been suggested by Ohmae Kenichi that even the obsession with trade statistics is misdirected and that we should, instead, focus on market penetration. Here, he said, there was rough balance between Japan and the U.S., statistically, represented by the fact that in 1984, Japan's per capita purchase of American products was \$583 (imports plus local production) whereas the American per capita purchase of Japanese goods was \$298. Factoring in the population figures, the only imbalance was in the ratio of export and local production. However, if

trade imbalance was at all to become an area of concern, Ohmae suggests a three point plan for action.

1. Ask the U.S. firms to leave Japan.
2. Japan should buy land in the U.S., produce rice and import it back into Japan.
3. U.S. should sell Alaskan oil to Japan [82].

Presumably, the first two were stated facetiously. The third option was one that Japan had pursued but the obstacle was Congressional legislation that prohibited the export of Alaskan oil. The ban on exports was put in place in 1973 when Congress enacted the Trans-Alaskan Pipeline Act and was further strengthened in 1977 when the Export Administration Act was passed. The ban provided a windfall gain for the previously shrinking American tanker industry because of the necessity of transporting the Alaskan crude to the American Gulf Coast for refining. This small vested interest effectively held up repeal of the ban, even though as Hoyer argued, removal of the ban would benefit the U.S. on each of the following points: economic efficiency; federal deficits; national defence; energy security; consumer prices; unemployment; and gains from trade [83].

There is some evidence that the Congress was ready to reconsider the ban but even if the sale of oil is approved, it will only contribute to a correction of the trade imbalance in dollar terms and will do little to ease the frustration that the Japanese market remained closed to manufactured goods. What Ohmae failed to mention, and which I believe is the most logical

solution to the trade friction, was a greater reliance by Japanese manufacturers not on exports but on local production in foreign markets. This is already taking place and we can expect the exchange rate adjustments to further stimulate this trend.

At this stage, it is necessary to assess the extent to which the material presented above on market opening measures constitute evidence of system support. In the case of the auto dispute, we argued that an analysis of MITI's intentions and support for VER could be taken as clear indication of the recognition of Japan's responsibility in maintaining and strengthening the Liberal Economic Order. Aside from the intentions behind the VER, the policy was also effective in terms of its objective but only because the American car manufacturers did undertake the investment necessary to regain international competitiveness. But, regardless of whether the VER actually achieved its objective, a simple analysis of the intentions would still be sufficient to show that at least the Japanese government was trying to support the system. It provided the opportunity, the breathing space, but it could not, obviously, be held responsible for the actual revitalization of the American auto industry. Similarly, in assessing the significance of the market opening measures, we could use either one of the following two criteria:

1. actual reductions in U.S. trade deficits with Japan.

2. market opening measures as an independent criterion.

The protectionist sentiment in the United States is being fueled by the growing trade imbalance with Japan and a solution to the present crisis would, logically, have to come through an easing of the trade imbalance. However, the difficulty with this is that the U.S. trading imbalance is a global phenomenon and not just restricted to trade with Japan. The deterioration in the U.S. trade balance over the period 1982-1986 extends beyond Japan to Western Europe, Latin America, and the Asian newly industrializing countries. While the trade deficit with Japan widened from US\$19 billion in 1982 to over US\$55 billion in 1986, in trade with Western Europe, there was a reversal from a surplus of US\$5 billion to a deficit of over US\$30 billion over the same period. On the basis of the general nature of the problem, it would be unfair to single out Japan as the source of the problem. The global nature of U.S. trade deficit suggests that there must be factors internal to the U.S. that are also responsible for the worsening of its trade position. In the G-5 agreement, the respective finance ministers and central bank governors, recognizing the destabilizing nature of the trading imbalance, agreed on a two point formula to restore balance. The first was currency readjustment and the second was fiscal responsibility in the U.S. Since the G-5 agreement, the dollar has depreciated by about 50 percent against the Yen but there is no indication to

suggest that the U.S. government has been able to tackle the massive federal fiscal deficit. (The budget deficit in the U.S. is an important factor behind the U.S. capital account surpluses and trading deficits.) Since international capital flows are closely inter-linked with flow of goods, both have to be dealt with if the deficits in merchandise trade are to be reversed. The blame cannot be placed entirely upon Japan and Japanese government actions alone would, therefore, be insufficient to balance trade.

With respect to the second evaluative criterion, we should mention at the outset that blame on Japan resulting from the trade imbalance is intermediated by the perception of a closed Japanese economy. However, with respect to tariff and quota barriers, at least, Japan is as open, if not more open, than the other advanced industrialized countries. As such, the perception of a closed Japanese economy can be related to other invisible trade barriers like, for instance, the system of standards and certification. Standards and certifications, in any country, are based on an acceptable and traditionally defined state-society relationship. In Japan, the state has generally played a relatively more intrusive role and the absence of well-developed societal consumer interest groups has forced the state into a role where it is seen as protecting the minimum interests of the consumers. This function has been performed through an elaborate (safety) certification system and the standards are often so strict as to become an effective barrier to imports from other

countries, which rely more on market forces to determine product survival.

In the discussion on the Action Program, we suggested that the two features of the Action Program that could be seen as important for foreign manufacturers were (1) a clearly defined commitment to reduce state intervention through a revision of the standards and certification procedures and, (2) national treatment of foreign products. The Action Program, drafted and formulated by the Economic Planning Agency which is part of the Prime Minister's Office, reflected a willingness on the part of Japan's political leadership to play a more supportive role in the international system. However, since the Action Program was drafted outside the normal bureaucratic structure, problems could arise in the implementation phase. As we indicated, it is not yet clear that all the concerned ministries are equally committed to implement it in conformity with the principles contained therein. It is also clear that political leaders in Japan have much less control over the bureaucracy than do their counterparts in other countries. The relative autonomy of the bureaucracy in Japan and the lack of well-defined consensus could detract from the effectiveness, at least in the short term and until a consensus has been formed. But, in so far as an initiative has been taken, it indicates a new-found sense of responsibility, although the government now faces the difficult task of consensus building.

Nevertheless, unless there is some improvement in the trade

situation, it is unlikely that the foreign perception that the Japanese economy is closed to imports will change. Since it is the perception that is indirectly contributing to protectionism, it is unlikely that the trade regime could be stabilized without changes in Western perception about Japan. Such changes in perception will, furthermore, depend on at least reversing the trend of growing Japanese surplus. It may not, therefore, be sufficient to indicate good intentions. As mentioned in the main body of the text, we can expect some improvement to take place as the result of currency adjustments and also as the result of demographic changes. No one expects trade to balance completely for the U.S.-Japan trading imbalance is part of the structurally determined Japanese surplus against the West to compensate for Japanese deficits with the primary and raw material exporting countries. Additionally, as we shall discuss in the next chapter, we can also expect improvements flowing from the government's policy to reduce domestic savings and raise real consumption levels which should both reduce the pressure to export and contribute to expanded imports.

The Western frustration today is not that the Japanese market remains as closed as before but that changes were taking place at a slow pace. There is no denying that improvements had been made and further change for the better can be expected. The problem is that during periods of change, the expectation of change often runs far ahead of the change itself. Radical change will do much to solve the problem but it has to be admitted that

practice and custom established over the years cannot be done away in one fell swoop. Given that pressure has been functional, there is also a need to exercise patience and understanding. Western critics understand well the usefulness of pressure, even though, at times, it seems to run out of control, but for the importance of patience, they might want to learn from their own past history.

At the end of the First World War, the United States, instead of accepting responsibility concomitant with its economic strength in the world economy, withdrew inside its own shell and only started to take a more positive role after the Second World War. The British experience was quite similar. At the close of the Napoleonic Wars, and the beginning of the 100 years of 'peace', Britain was the strongest economic and industrial power but, in the beginning, the earlier mercantilist spirit continued to dominate trade issues. Even as the British government realized the wisdom of trade liberalization, the Parliament continued to hold steadfast to the protection of domestic industry. Imlah provided an example. He wrote, "The President of the Board of Trade, Frederick J. Robinson, frankly admitted in Parliament in 1817 the harm which import restrictions worked on British export trade but lamented that whenever he proposed to lower barriers half the manufacturers in the country presented petitions and sent delegations against any liberalization of the laws" [84]. Things began to change for the better in the mid-twenties following the business upswing but it was not until

a couple of decades later that the principle of free trade was realized.

The evidence indicates that Japan is making a concerted effort but it needs time before the efforts will start to bring any effective result. There are no easy short-term solutions but the big unknown is whether the West will patiently wait for long-term solutions to become effective. After all as Keynes once remarked, in the long-run, we are all dead.

Chapter Five

INDUSTRIAL RESTRUCTURING

AND

DEMAND EXPANSION

SECTION I

FOREIGN DEMAND AND JAPANESE ECONOMIC GROWTH

In the previous chapter, we focused on the import side of the trade imbalance and to complete the analysis, this chapter will look at the export side of the equation as well as the issue of economic restructuring in Japan. In the context of Japan's responsibility toward the international system, economic restructuring essentially means a reduction in the dependence on exports and reliance instead on internal stimulus for economic growth. The export dependence of the Japanese economy, in terms of its contribution to GNP growth, had deepened during the late 1970s and early 1980s, as the result of poor business climate at home and the lack of demand expansionary measures by the Japanese government. As well, we could cite the strong dollar as contributing to Japan's export dependence. The decline of the value of the dollar since late 1985 will reduce this dependence but demand expansion remains important because of its potential benefit to the international system through global economic revitalization and promotion of imports. This same course of action was attempted once before in 1978 when, under the so-called 'locomotive thesis', the United States pressured Japan and West Germany to reflate their economies and thereby act as locomotives of growth, in conjunction with the U.S. to pull the world out of the recessionary slump. The U.S. could not do so on its own because of the fear that it might worsen its trade

imbalance [1]. Germany carried through on its commitments but Japan reneged on its promise to achieve a 7 percent economic growth in FY1978. In the mid-1980s, the recessionary fears were not so menacing and Japan was not being asked to expand demand and act as a locomotive again but rather to expand demand and reduce dependence on foreign demand, particularly American demand, which had sustained Japanese economic growth in recent years. The U.S. pressed for this because a reduction in Japanese exports and a boost in their own exports to Japan would help revitalize the American economy.

Throughout this thesis, we have applied and tried to determine the utility of using the concept of 'system supporter' to analyze Japanese economic policies. This concept had found expression in both official pronouncements and academic writings in Japan. We found supportive evidence both in the resolution of the automobile dispute and in the market opening measures adopted by Japan in recent years. We looked at the Action Program to promote imports and discussed the conscious redefinition of the state-society relationship and the role of the government in so far as government standards and certification systems were concerned. Nevertheless, we also pointed out that import promotion and easier market access alone could not be expected to bring immediate results as long as the U.S. dollar itself remained substantially overvalued, relative to the Japanese Yen. This was the rationale behind the exchange rate adjustments that were agreed upon in September 1985.

In this chapter, and continuing with the theme of restoring relative balance to international payments position, we will consider the remaining dimensions of demand expansion and economic restructuring. The objective in both cases is to reduce exports and promote imports, the difference being that while the former is more of a short term measure, the latter refers to the long term consequences. Some economic restructuring can be expected as the result of market mechanisms and revaluation of the Yen which provided incentives for the domestic manufacturers to locate production facilities in foreign markets. Demand expansion is important for two reasons. Firstly, it could create new demand for imports, and it should be obvious that if market opening measures and exchange rate adjustments were to bring positive results, it was necessary also to create the additional demand to absorb imports. Secondly, in the absence of demand expansion, a likely short term result of exchange rate adjustments was economic deflation, and slow down of the domestic economy could also consequently dampen import requirements. On the other hand, demand expansion and reflation of the economy could contribute to increased import requirement and there were repeated calls from Western sources for Japan to stimulate its economic growth.

Similarly, there was considerable domestic pressure to increase demand and thereby compensate for the expected decline in foreign demand for Japanese goods. This pressure came from both the industry sources and from within the ruling Liberal

Democratic Party. We would, accordingly, expect that since demand expansion was being proposed by both internal and external sources, the task of the government would have been that much easier. In reality, however, the government found it very difficult to act. Firstly, there were critics of demand expansion, like Shinohara Myohei of the Institute of Developing Economies, who cautioned against the dangers of reviving inflation and who argued that Japan should stop pandering to the wishes of its trading partners, especially since Japan was not entirely to blame for its trade surplus. Secondly, the Ministry of Finance was hesitant and apprehensive because fiscal expansion could jeopardize the objective of restoring fiscal balance by FY1990. The MOF was not necessarily opposed to demand expansion as such but wanted instead to rely on non-fiscal means.

However, since fiscal expenditure is generally considered more effective in stimulating economic activity, the lack of a fiscal component in the initial demand expansionary measures could suggest that the government was weak hearted in its attempts to respond to the domestic and international pressures. It might appear also that the Japanese government was reluctant to take on a greater responsibility for system stability and instead had decided to conform to its outstanding commitment to balance the budget.

Fiscal measures were eventually adopted in September 1986 and the question arises as to why the government chose to wait for so long. We would expect that as 'system supporter', it

would be more forthcoming to undertake what many analysts agreed was necessary to preserve international harmony. In this connection, it should be pointed out that, however logical, Western pressure on demand expansion was never clearly inter-linked with fiscal expansion. This might have given the government the excuse to continue with fiscal austerity but, at the same time, it also raises the more fundamental question of why a would be 'supporter' should have to wait for foreign pressure to crystalize before acting. The answers to these perplexing questions were elaborated upon in Chapter Two but it will be worthwhile to briefly review them at this point.

Firstly it cannot be denied that there is no clear cut consensus in Japan on its role in the international system. Given the decision making style in Japan which emphasizes consensus amongst all participant within the decisional system, disagreement from even one solitary source is enough to block decision making. The lack of consensus is true both within and outside the the government although, as we would expect, consensus within the government is more crucial, in most cases. The persistence of the Ministry of Finance in emphasizing government debt reduction meant that the government could do little at an early stage and until some form of consensus had been hammered out. There is dissent from outside the government as well and the government has been engaged in an attempt to forge a greater understanding that would be supportive of a positive role in the international system. All democratic

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systems are constricted, to some extent, in their foreign policy making by internal constraints and the Japanese consensual style of decision making makes the internal constraints more difficult to manage and overcome. Consensus building is an on-going process and its thrust could be clearly discerned both in the Maekawa Commission report that we shall discuss below, and in the tax reform proposals announced in December 1986. On the latter, the Far Eastern Economic Review commented that "The boldness with which Nakasone and his aides pushed through a controversial tax-reform proposal in early December exemplified the party's new-found readiness to challenge public opinion on sensitive issues" [2]. The proposal was controversial partly because of the decision to eliminate the tax incentives on savings but it was also necessary from the international point of view. Nakasone was not only challenging public opinion, he was also trying to reshape it. Furthermore, before fiscal measures could be taken, the position of the MOF had to be reconciled. In this regard, we believe it was significant that in the Cabinet reshuffle after Nakasone was granted a one year extension of his term of office, he appointed Miyazawa Kiichi as his new Finance Minister. Miyazawa was Nakasone's rival for leadership of the party and according to one interpretation, the appointment of Miyazawa as the Finance Minister was a political move to silence his opponent by putting him in charge of a Ministry committed to an 'unpopular' position. This interpretation would be credible only if we could expect a second extension of Nakasone's term in

office but this was unlikely given the nature of factional politics within the LDP. A more likely explanation would be that Miyazawa's appointment was an attempt to force a change in the MOF position as Miyazawa had already indicated his position in favour of fiscal expansion, when he met the Prime Minister in March 1986 and presented to him a list of proposals for demand expansion. Prime Minister Fukuda had done much the same in late 1977, when he appointed Miyazawa as the Director General of the Economic Planning Agency, hoping thereby, to strengthen the hands of the fiscal expansionists in the government [3].

Secondly, and as we emphasized in Chapter Two, especially when there is a problem of consensus building, foreign pressure not only becomes functional, but also welcomed as a way of breaking the deadlock. In the auto dispute, MITI used foreign pressure to obtain concessions from the domestic auto industry. In so far as fiscal expansion was concerned, while there was pressure on Japan to increase demand, there was no specific pressure to raise fiscal spending [See below, on Baker-Miyazawa meeting]. This enabled the MOF to insist on delinking fiscal and demand expansion.

To fully appreciate the issues of demand expansion and economic restructuring, it will be necessary to look at the nature of the constraints, particularly the determinants of the high savings rate in Japan and the fiscal crisis. But first, let us briefly look at the nature of the export dependence of the Japanese economy. The figure below (Fig. 5.1) shows the

contributing share of foreign and domestic demand to GNP growth in Japan from which it is easy to assess the importance of the foreign sector. In FY1976, for example, when Japanese economic growth had recovered to about 6 percent, after two years of slow growth, it was mainly led by foreign demand as domestic consumption remained sluggish. In contrast to the Japanese experience, the U.S. recovery during this period was primarily led by domestic demand [4]. Again, in the 1980s, according to The Wall Street Journal, without Japanese exports to the U.S., there would have been no economic growth in Japan since 1983 [5].

FIGURE 5.1
FOREIGN/DOMESTIC DEMAND COMPONENT IN GNP GROWTH

Note: Darkened area is the foreign demand component.
 Light area is the domestic demand component.
 Trend line is real GNP growth over previous period, seasonally adjusted.
 Source: Asahi Shinbun (Chokan), Sept. 21, 1985, p. 1.

Also Japan's export dependence tends to be sectorally concentrated and in Chapter 3, we looked at one specific industry, the automobile industry, as symptomatic of this tendency. It is often suggested that postwar Japanese economic policies have been dominated by mercantilist ideals that glorify exports and relegate imports to a necessary evil which should be kept to a minimum. In fact, in the early 1970s, Japan's export dependence was low compared to the other advanced industrialized countries but grew rapidly as export growth continued to outstrip GNP growth. Average export growth during the period 1976-1980 was 18.6 percent a year while GNP growth in the period 1977-1980 was only about 5 percent a year [6].

In real terms, exports made up 10.1 percent of the GNE (1975 prices) in 1970, but went up to 13.8 percent in 1975 and to 17.8 percent in 1980, reflecting the increased dependence on exports for economic growth. Exports were replacing private domestic investment as the stimulant to economic growth. Private investment which had played the lead role in economic growth in the 1960s, declined from 19.6 percent in 1970 to 16.4 percent in 1975, recovering slightly to 16.9 percent of GNE in 1980 [7].

As alluded to above, Japan's trade problems with other countries are the result of a dual imbalance in the Japanese trade structure. Not only was there an imbalance of the overall levels of trade, as reflected in the Balance of Trade position (See Table 5.1), there was also an imbalance in the composition and direction of trade.

TABLE 5.1
JAPAN'S TRADE WITH THE WEST

	EXPORTS	IMPORTS	TOT. BALANCE
1981	62.97(41.4)	36.59(25.6)	9.20
1982	57.42(42.0)	33.00(25.9)	9.33
1983	70.06(45.8)	37.60(29.0)	23.33
1984	84.41(49.7)	39.77(29.0)	35.09
1985P-----	90.46(51.5)	38.10(29.4)	46.15-----

Notes: Unit: US\$, Billion. Figures within brackets are % of total exports and imports.

Source: Compiled from *Zaikai-Kaosoku*, NRI, March 1986, p. stats. 3.

In the last chapter, we saw that Japanese imports were heavily concentrated in favour of primary products and raw materials with relatively low levels of manufactured imports, lower still if we considered only finished products, excluding semi-processed items. In contrast to this, even though West Germany also enjoys a trade surplus, its trade structure is more evenly balanced. This is not to suggest that trade, at the micro level, must always be symmetrical. Indeed, Britain's foreign trade in the 19th century was not balanced. The difference between Britain then and Japan today, however, is that the former, to compensate for low manufactured imports, liberalized the agricultural sector of the economy while Japan continues to, for political reasons, maintain high tariff and non-tariff barriers against agricultural imports.

Looking closely at the imbalance in the Japanese export structure, we find that only a handful of industries accounted

for the bulk of total exports. In the decade of the 1960s, the export concentration was mainly in heavy industries and petro-chemicals. In the 1970s and particularly since the oil crises, there was a shift in favour of precision goods and high technology industries. In any event, the industries at the leading edge of the economy predominated export trade. For example, the top ten leading industries accounted for over 50% of Japanese exports [8].

The direction of exports shows a similar concentration in terms of destination. This concentration, instead of weakening over time, has become more pronounced. In 1981, 26 percent of Japanese exports went to the United States, but this increased to 36 percent in 1984, and, by provisional estimates, to 37 percent in 1985. Several factors can be cited for this concentration, most important perhaps being the fact the U.S. economy was more open than the European markets and the overvaluation of the dollar. After the automobile dispute and following the VER with the U.S. in 1981, an effort was made to develop new markets in the Middle East and South East Asia but this had only a limited success. In 1979, Japanese automotive exports (cars and commercial vehicles) to the U.S. held a 45 percent share of total exports to the U.S. and while it declined to 37 percent in 1983, the share had crept back up to 42 percent in 1984. Export destinations of other export commodities are similarly concentrated in the U.S. and this high penetration of the American market explains why trade disputes usually start in the

U.S., and later spin-off to other areas.

This created no major problems for the Americans initially, but as economic performance faltered, there was a general backlash against what was perceived to be excessive Japanese penetration of the American market, to the detriment of American industry and levels of employment. Critics were incensed that Japan not only failed to improve access for others to its own robust economy and helped to take the sting out of world recession, but that it was, in a negative sense, exploiting the weakness of the weakened leader.

SECTION II

DOMESTIC DEMAND AND EXPORTS

In this section, we will consider some of the factors that led to the deepening of export dependence which, in turn, will help us to understand how a more balanced economic structure can be created. In the main, we will center our discussion on an analysis of the low consumption levels in Japan (i.e., the causes behind the high savings rate) and on the issue of the debt burden of the Japanese government.

The high savings rate is often been blamed as the cause behind Japan's export push growth. The personal savings rate in Japan in 1982 was about 17 percent compared to only 5 percent in the U.S. In the early postwar period, the high savings rate was

the forte of the Japanese economy because it made available capital for plant and manufacturing investment when the economy was in the high growth phase. Since then, as the economy entered a slow growth phase, investment demand for capital declined but savings remained at the earlier high level. The continued high savings rate kept domestic demand low forcing the industry to become more reliant on foreign demand. The surplus capital which flowed overseas helped in increasing exports by keeping the value of the Japanese Yen down. It was natural, that in time, this pattern of economic growth in Japan would come in for criticism from its trading partners. Accordingly, it became necessary for the government to try and lower the high savings rate such that economic growth could be based more on domestic consumption.

The possible explanations for the high savings rate include, among others, the relatively under developed old age security and welfare system, high real estate prices, and the pay structure. In Japan, a large portion of the annual income is received in the form of semi-annual bonuses that often exceed six months salary and in specific business sectors, insurance for example, may approach a year's salary. This, however, is variable income and since expenditure and consumption is usually budgeted in terms of fixed income, the bonuses received often end up as saving, which because of the size of the bonus can be a considerable amount [9]. Also, land prices in the urban centers of Japan are several times that in the U.S. or Canada, and now that the 'my home' age had superseded the 'my car' age, there was a strong built-in

incentive to save. There are culturally based factors as well, that may help to explain the high savings rate in Japan. The competitive individualistic Western society that emphasizes not only keeping up with but exceeding 'the Joneses' has a ripple effect boosting consumption patterns whereas the emphasis on group conformity in the Japanese society provided no such stimulus. Also, since simplicity is one measure of aesthetical standard in Japan, an increase in income levels only adds to PDI available for savings. While there is no major discrepancy between Japanese and Western ownership of consumer durables (Colour TV 99.1%; Washing Machines 98%; VCRs 28%, Refrigerators 98.4% etc., in 1985), because of space limitation and cultural factors, Japanese homes are rather simple and bereft of furniture. Many of these socio-cultural determinants to high savings in Japan are beyond the legitimate control of the government and there little it could do in this regards. Western critics, however, were more likely to attribute the high savings to specific policies of the government and this will be considered in some detail, below.

The tax incentives to save provided by the Japanese government have attracted much critical attention. In Japan, interest earnings on savings of up to Yen 3 million (\$17,000 approx.) per type of financial institution, is non-taxable which means that an individual can put in about Yen 6 million in postal savings and bank deposits and receive tax free income. On top of that, if we include bond holdings, it is believed that with

prudent money management, an individual can save up to Yen 10 million and not pay taxes on interest income. This system of tax incentives was the opposite of that in the United States which encourages personal consumption beyond the parameters of PDI by making interests on borrowings tax deductible.

Since raising private consumption is related to lowering the savings rate, the logical place to begin would be with the tax incentives to save. The dilemma for the Japanese government was that such a move was fraught with potential dangers. Removing the tax benefit was politically difficult and could only be attempted as part of a major overhaul of the entire tax structure. Reform of the tax structure did become a major issue in Japanese politics and an Advisory Tax Committee was established in September 1985 to study way of reforming the existing system.

Under the existing tax structure, set up during the Occupation period, the weight of direct tax to total revenue has increased and made up 73.4 percent of total revenue in 1985 [10]. Those on fixed income find this unfair even though the average tax burden of the Japanese was only about 36 percent (including social security component) in 1985, certainly not unbearably high by Western standards. The feeling of 'unfairness' resulted from the fact that the self employed (not on fixed income) were better able to utilize the tax loopholes to lower their total tax burden, for example, by shifting income earned to members of the family. Because the tax structure itself is relatively more

progressive in Japan, it is possible to benefit from a more than proportional tax break by moving into a lower tax bracket, an avenue not open to those receiving fixed incomes such as the salaried worker. As a measure of the inequitable distribution of the tax burden, the National Tax Agency reported the result of a survey in September 1986 which showed that while 89 percent of the salaried workers paid taxes in FY1985, only 42 percent of the self-employed and 22 percent of the farmers paid any taxes at all [11]. As this perception of unfairness became more widely entrenched, the tax break on 'small' savings acquired more than a symbolic value, not to be easily tampered with. One possible solution would be to balance the tax burden of each group by increasing the scope of indirect taxation as in European countries (sales tax, value added tax, whole sale tax etc), but this could only bring about 'fairness' if it was accompanied by a lowering of the tax burden of 'salary men'. As presently constituted, indirect taxes bring in only 26 percent of government revenue (FY 1896 budget). However, there is strong opposition to any simple measure that only imposed indirect taxes on top of the existing tax burden, as Prime Minister Ohira found out the hard way when he proposed levying a general consumption tax modelled on the European VAT, in late 1979 and took the country to the polls.

Thus, it was not surprising that when the earlier Tax System Study Group (Zeisei Chosa Kai, Chairman: Ogura) submitted its final report to the prime minister in late 1983, it recommended

that the government should consider the possibility of expanding the base of indirect taxation, given the low average tax burden in Japan, but added the cautionary statement that such taxes should only be introduced with the understanding of the people and with maximum regard for fairness of the system [12].

The Committee set up in 1985 was composed of about 50 members. One member of Tax Reform Committee, Sakaiya Taiichi, expressing his position agreed that the incentives on savings had outlived their purpose and that at least a part of the interest income should be subject to a uniform tax. In return, he advocated lowering the income tax and corporate tax burden by about Yen 5 trillion, the lost revenue to be made up by expanding the tax base [13].

The report of the committee was submitted in late 1986 and shortly thereafter, the Liberal Democratic Party, in early December 1986, announced tax reform proposals that contained two important features. Besides simplifying the tax structure, it proposed the introduction of a value added tax (VAT) and a total abolishment of the tax incentives on savings. The proposals are to be tabled before the Diet in Spring 1987 and implemented from FY1988. To make sure that this did not simply end up as a tax increase package, and thereby adversely affect consumption levels, the government also lowered personal income tax rates from the maximum of 70 percent to 50 percent and corporate taxes from 53 percent to 49.99 percent [14].

Aside from these government level incentives, savings are

also likely to decline as the result of on-going demographic trends. Japan, at present, has a relatively young population structure which in effect, means that the ratio of the working population to the total population is relatively high. Because of the large work force, we would naturally expect a high total savings. The last 'baby boom' was in the early 1950s and since then the birth rate has declined drastically to where the current birth rate is around one of the lowest in the world. As a result, the population is aging rapidly and this trend will be vastly accelerated as the baby boom generation moves out of the work force. See the figure below, for a graphic presentation of the changing population structure.

FIGURE 5.2

JAPAN'S POPULATION STRUCTURE

Population Pyramid

Source: '82 Japan. Prime Minister's Office. 1982.
p. 5.

For comparative purposes, the figure below compares the trend in Japan to several other Western countries. It is expected, that by the turn of the century Japan will have a larger percentage of the population above 65 years than the U.S., U.K., France, and West Germany, a population group that tends to be consumers not savers.

FIGURE 5.3

RATIO OF PEOPLE 65 YEARS AND ABOVE TO POPULATION

Source: Nihon Keizai no Genkyo, 1985, Keizai Kikakucho, Tokyo, p. 193.

As the population ages, the absolute savings level will necessarily decline (non working population tends to be consumers, not savers), and we can expect this to redress the IS imbalance. The Economic Planning Agency, in its annual survey of the Japanese economy noted, "It is anticipated that with the rapid aging of our population, and provided that investment levels are sustained, the savings-investment balance will move from the existing surplus of savings to where savings are inadequate. Together with this, our international balance of payments structure and the current account structure as well will change from the existing surplus to deficits" [15].

The surplus of capital, which increased from 3 percent of GNP in the late 1970s to about 5 percent in recent years, mainly flowed to the United States, attracted by a shortage of investment capital resulting from the fiscal expansion and 'crowding out' of capital from the private sector. Within Japan, the decline in investment demand resulted, firstly, from the decline in economic growth but also from increases in corporate tax rates, and reduction of tax reserve provisions. According to Noguchi Yokio, however, the most important factor had been the low rate of inflation, below 2 percent in recent years, with a few exceptions [16].

The alternative to private sector investment demand is to expand fiscal expenditure. However, the Japanese government, already burdened by a high debt ratio was unwilling to add more to it and neither did Japanese trading partners push hard on

this. At the G-5 meeting and again at the Baker-Miyazawa meeting of October 1986, the Japanese government agreed to undertake demand expansion measures, but through measures to encourage private sector consumption without spending public money. It should be emphasized, however, that on neither occasion [the G-5 agreement or at the meeting between Baker and Miyazawa] did Japan agree on fiscal measures to boost demand, and neither was it pressed to do so. At the Baker-Miyazawa meeting in September 1986, for example, Treasury Secretary Baker requested the Finance Minister to do only as much as he could [17]. Also, at the G-5 meeting of September 1985, Japan explicitly agreed only to use monetary policy and other measures to enhance private sector consumption. Japan did follow through on this commitment with three successive rate cuts by The Bank of Japan that lowered the discount rate to 3.5 percent.

The priority for the Japanese government has been to balance its budget. According to a self-imposed time table, the government is committed to eliminate the practice of financing the budget deficits through deficit bond issues and to lower the overall dependence on government bonds by FY1990 [18]. The argument was that this would restore fiscal stability necessary to meet future contingencies. At the end of FY1975, total outstanding bond issue was Yen 15 trillion but it grew rapidly thereafter, rising to Yen 70 trillion in FY1980 and up to Yen 110 trillion by the end of FY1983 [19]. Several factors can be noted as having contributed to the deteriorating fiscal condition.

1. decline in tax revenue as the economic

growth slowed down following the oil crisis of 1973.

2. fiscal expansion to combat deflationary tendencies after the oil crisis.

3. increased government expenditure to improve the social welfare system [20].

The Table below gives an indication of the Japanese fiscal crisis as compared to other countries.

TABLE 5.2
STATE OF PUBLIC FINANCES

	% OF BOND ISSUE IN TOTAL REVENUE	RATIO OF 'OUTSTAN- DING LONG TERM GOVT DEBT TO GDP	PER CAPITA OUTSTANDING LONG TERM GOVT DEBT (¥10,000)	INT. PAY. AS % OF TOTAL BUDGET SPENDING	NAT. TAX REVENUE/ TOTAL BUDGET SPENDING
JAPAN	22.2 (FY1985)	48.4 (FY1985)	126 (FY1985)	18.8 (FY1985)	73.4 (FY1985)
U.S.	19.4 (FY1985)	33.8 (FY1984)	120 (FY1983)	14.4 (FY1985)	77.3 (FY1983)
U.K.	5.2 (FY1984)	43.6 (FY1982)	96 (FY1982)	6.6 (FY1984)	83.7 (FY1983)
FRG	9.8 (FY1985)	19.6 (FY1983)	52 (FY1983)	11.4 (FY1985)	78.5 (FY1984)
FRANCE	14.0 (FY1985)	5.3 (FY1980)	16 (FY1980)	8.4 (FY1985)	84.7 (FY1984)

Source: Matsuzawa, T., "Keidanren's Viewpoint on Government Spending and Future Administrative and Fiscal Reform", *Keidanren Review*, No. 95, October 1985, p. 3.

As can be seen, the fiscal condition in Japan is considerably worse than in other countries and one can well understand why the government feels impelled to do something about it. At its peak, the government's dependence on bond issue to finance the general accounts budget had reached a high of

about 35 percent in FY1979. Since then, a concerted campaign to hold down fiscal spending had succeeded in reducing this dependence to about 24 percent in FY1985 and to 20 percent in the initial budget for FY1986 [21]. Until recently, the belt tightening measures had been relatively painless because the economy had performed fairly well, especially since 1983. But the economy had performed well precisely because of the close articulation with the American economy through a constant stream of exports. In order to discharge its responsibility toward regime stability, the past practice could not be continued and the government had to create conditions that would increase the share of domestic consumption in GNP growth and lead to expanded imports. It is generally recognized that fiscal policy is more effective for demand management than monetary policy but the Japanese government was already committed to fiscal austerity and now had to choose between one or the other. The reason fiscal austerity and budget balancing was given so much emphasis was primarily because of the view, particularly strong within the Ministry of Finance, that this was essential to meet future contingencies. The fact that an aging population and the likely emergence of structural unemployment resulting from industrial restructuring would create additional demands on the government over the next decade or so meant that the government had to be prepared, financially, to respond to those demands. The social welfare system in Japan is rather rudimentary by Western standards and the government anticipates having to make

considerable financial outlays in the future which necessitated strict austerity to bring the present fiscal crisis under control.

The external pressure for demand expansion came mainly from Japan's trading partners in the expectation that increased domestic demand would translate into higher demand for imports. For some length of time, however, the government continued to resist fiscal expansion, unable to overcome the opposition from the powerful Ministry of Finance. And since Western demand was on demand expansion, in general, the government tried to keep the issue of demand expansion separate from fiscal expansion in the belief that non-fiscal measures to boost private consumption would be sufficient to raise overall demand. At the same time, with the declining oil prices, the Japanese government felt less urgency about the need for fiscal expansion. The Economic Planning Agency, weighing up the positive (import) and negative (export) aspects of the Yen rise, concluded that they virtually cancelled each other out. However, if the lower oil prices were taken into consideration, the results, according to the EPA, would be, on the whole, beneficial to the Japanese economy [22]. Even so, the question of fiscal expansion became increasingly more difficult to ignore as private forecasts indicated growth rates of substantially below the official target rate of 4 percent GNP growth. Conflicts within the official bureaucracy, also became more pronounced, especially that between the MITI and the MOF. MITI, the deacon of conservatism until the early 1970s and now a

Model of internationalist vision, seems to be fighting the MOF, still wedded to a set of conservative fiscal programs. Commenting on the rivalry between the MITI and the MOF, the International Currency Review noted that, "...in an unprecedented dispute between the major pillars of Japan's bureaucratic establishment, MITI is carrying its campaign for aggressive reflationary action into the open, even to the extent of giving press briefings warning of the severe consequences which would ensue in the event of fiscal inaction" [23].

The intra-bureaucratic friction created a dilemma for the Prime Minister. For much of his term in office, he had strongly backed the MOF and its objective of balancing the budget but that was before the international circumstances had changed. Still, he found it difficult to sharply break away from his past policies and found himself caught between the contradictory pressures to stay true to his past policy objectives, on the one hand, and to adapt to the international circumstances, on the other. At a news conference in March 1986, he definitely appeared to be leaning in favour of fiscal measures when he commented that he had a 'free hand' on fiscal expansion, only that he had not felt it necessary to exercise that option in the past.

Having looked at some of the domestic factors impinging on the low levels of domestic private and public consumption, we will now look at some of the concrete steps taken by the government in the period following the G-5 agreement.

SECTION III

DEMAND EXPANSION MEASURES

As a first step, the Japanese government on October 15, 1985, announced a set of demand expansion measures aimed at stimulating consumption patterns. The government claimed it to be the largest demand expansion package, at Yen 3.12 trillion, but it was not particularly well received because it had no public works component. However, since aggregate demand is composed of personal consumption, private housing investment, private capital spending, and fiscal outlays, the government could have targeted any of these to achieve the results. Naturally, we would expect the effects to vary depending on the particular set of measures adopted. According to an analysis prepared by MITI of the potential effects of a Yen 1 trillion demand expansion package composed of either investment/income tax cuts or expanded public works, the net effect on the trade balance would be significantly different, as the Table below shows:

TABLE 5.3

DEMAND EXPANSION & TRADE SURPLUS

EFFECT OF YEN1 TRILLION PACKAGE	1ST YEAR	2ND YEAR
INCOME TAX CUT	-580M	-1340M
PUBLIC WORKS EXP.	-450M	-790M
INVEST. TAX CUT	-2010M	-730M

Source: Asahi Shinbun (Chokan), Oct. 11,
1985, p.8.

From the estimates, it would appear that an investment tax cut would be the most useful but it also most likely to lead to an export growth over the longer run as increased investment leads to higher productivity. On the other hand, both an income tax cut or an expanded public works program have been deemed problematic because of the budgetary constraints. The actual package agreed upon (Yen 4.1 trillion, including the multiplier effect) was composed of the following measures.

1. promotion of public housing investment and urban development.
2. promotion of private investment in plant and equipment.
3. activation of private consumption [24].

The package also included relaxation of regulations on various aspects although only a miniscule of the 150 odd regulations governing housing investment were thus affected. To promote housing constructions, the government announced that it would expand both the amount and the number of housing loans approved by the Housing Loan Corporation (HLC). The amount of individual loan was to be raised by Yen 1.5 - 2.5 million per borrower and the number of these loans were to be increased by 20,000 from the existing 490,000 units. The HLC loans are made at slightly lower interest rates than private banks, involving a monthly savings of between Yen 3000-6000, but these loans are still not very popular and in the two application periods in FY1985 there were only 165,000 applications as opposed to

191,000 for the same period the year before. There are several reasons why the number of loan applications have declined but one that figures prominently in this is no doubt, the application fee of Yen40,000 introduced in 1985 [25]. Because an application does not guarantee that loan would be approved, the fee had become a deterrent to potential applicants despite the fact that such loans, when approved, inevitably lowered the debt repayment burden. Even the Construction Ministry admitted that, at best, the new measure would raise housing investments to the levels of the year before [26]. The government's focus on stimulating housing construction was justified with the explanation that it was least likely to contribute to export increase which might result if the emphasis had been on stimulating private sector capital spending, since that would inevitably result in productivity growth.

On the second item on the list of demand expansion measures, the government stated that it would encourage the utilities companies to undertake investment in plant and facilities and in such areas as laying underground electric cables etc.

The last item contained mainly guidelines for banks and financial institutions to make credit available for consumption purposes and to operate the cash dispensing machines on Saturdays that the banks are closed. Cash dispensing machines are currently operated from 9-6pm on weekdays, 9-3pm on Saturdays that the banks are open, and no service is provided on Sundays. Whether extending the hours of operation would raise consumption

is doubtful but in so far as this would be an improvement in services, it ^{is} certainly worthwhile. In Appendix 2 of the Measures, the government also outlined the desirability of implementing a five day work week based on the assumption that increasing the opportunity to consume would also in fact raise consumption levels. It noted that the annual number of holidays in Japan was only 102 days as opposed to 111-114 days in the U.S. and Europe.

From the gist of the package, it was obvious that the government had chosen to stimulate private consumption with indirect measures not necessitating the expenditure of public funds. A spokesman for the EPA explained the absence of fiscal measures in the following words, "With respect to personal consumption, we really wanted to include tax reduction or lowering of interest rates, but both are difficult which resulted in the small steps taken" [27]. Thus, while the potential value of the package was not insignificant, the EPA estimated that it would lead to an increase in imports of only about 2 billion [28], primarily in the form of lumber imports for housing construction. The total trade effect is indeed small and unlikely to make more than a minor dent in the total balance of payments. The government at a later date did implement monetary policies, i.e., reduce interest rates, but the absence of fiscal and monetary measures from this first demand expansion package can be explained by perhaps the fact that deflation was not yet a critical concern, since the Yen had only appreciated by about 10

percent to date. Also, interest rate reduction could not be made unilaterally because it would widen interest differentials that might, in turn, undermine the purpose of the G-5 agreement. Later, however, interest rates were reduced in concert with similar reductions by the American government.

However, as the Yen continued to appreciate, the need for anti-deflationary measures was more clearly obvious. Accordingly, the government announced a second demand expansion program on the 28th of December 1985. Although, the total sum of the package was smaller than that of the first, it did contain some public works expenditure which was to be implemented in FY1986. The scale of the package was only Yen 1.6 trillion with the multiplier. This time, however, the government did not provide any estimate of how much the measures would contribute to import growth but was deemed to be only marginal, according to one EPA official who was interviewed. The increased general expenditure was to be financed through the Fiscal Investment and Loan Program which is regarded as Japan's second budget, and which uses the postal savings as the source of funding for investments by special corporation and public companies. The December package contained the following measures:

1. Promotion of housing construction and urban development.

2. Promotion of plant and equipment investment and technical development.

3. Expansion of public investment [29].

Since the public works projects were to be funded in the FILP programs, the government could continue with its austere fiscal policies. Furthermore, when we look at public works expenditure in the general accounts budget, there was a noticeable 2.3 percent decline in FY1986 compared to the year before. There was some improvement, however, if we combined both the FILP and the general accounts budget. In that case, the total public works expenditure in FY1986 showed a 4.3 percent increase over the previous year as compared to a 3.7 percent increase in FY1985 [30].

The two major projects taken up in the December package, to be constructed as 3rd sector projects, i.e., involving public as well as private sector funding, were the construction of a tunnel across the Tokyo Bay to facilitate traffic between Tokyo and Chiba, and the bridge over the Akashi straits separating the main island of Honshu from the southern island of Shikoku. With these two large projects, to be taken up in FY1986, the government hoped to impress upon the leaders of the advanced countries the seriousness with which Japan was fulfilling its international obligations.

The issue of demand expansion has been formulated within the framework of restructuring the Japanese economy, to make it less dependent upon exports by raising levels of domestic consumption.

Prime Minister Nakasone, eager to project the right image, has expressed his determination to press ahead on this front: "To any country, restructuring its economy is no easy task, but I am determined to rise to the challenges" [31]. Economic restructuring, unlike industrial restructuring, is something new. It could involve encouraging direct foreign investment by Japanese companies but if this was not to result in a downturn of economic activity, there had to be some emphasis on raising the level of domestic consumption.

To raise domestic demand levels and restructure the economy, the MITI, in its annual white paper on international trade (1985), observed that it was necessary to do the following.

1. increased private consumption and housing investment.
2. continued and steady addition of social capital.
3. increased levels of private domestic investment [32].

In the field of social capital, there is general consensus that Japan should put a lot more emphasis on improving the quality of life and to bring it up to a level comparable to that prevailing in the West. Housing and living conditions lag well behind the West, as is indicated in the Figure below.

FIGURE 5.4

LEVEL OF CAPITAL STOCK IN SELECTED COUNTRIES

	Housing	Sewage	Roads	Parks
Japan				
U.S.				
U.K.				
F.R.G.				
France				
Sweden				

Notes (A) Housing: Average no. of people per room
 Sewage: Percentage of population with access to sewage.
 Roads: Paved roads/total road length.
 Parks: Area of park space (square metre) per person.

Source: *Tsusho Hyakusho*, 1985, *Tsusho Sangyo sho*, Tokyo, p. 238.

To stimulate personal consumption, government and EPA officials openly expressed their desire for substantial wage increases in the Spring 1986 wage offensive (Shunto). According to EPA estimates, the rate of wage increase had lagged about one percentage point behind annual productivity growth rates over the period 1980-84 and it felt, therefore, that employers could afford a larger than usual wage increase [33]. The problem was that in the annual wage negotiations, the trend setters are usually the unions in the large exports industries, like steel and automobiles, and it was unlikely that these industries would be willing to make major wage concessions, when growth prospects were bleak and since they all hoped to ride over the impact of the high Yen by taking advantage of productivity gains. Thus, as the Chairman of Nikkeiren, a business organization, stated, it was unreasonable to anticipate a 7 percent wage increase when economic growth was expected to be only about 3 percent [34].

To raise private investment levels and achieve IS balance, domestic consumption has to increase and by some significant measure to compensate for the expected decline in foreign demand. In the past, domestic investment decisions were often determined by factors relating to foreign demand. This is illustrated in the figure below:

FIGURE 5.5
SHARE OF FOREIGN & DOMESTIC
DEMAND IN PRIVATE INVESTMENT

Notes: Dotted area is foreign demand component.
Horizontal lines represent the domestic demand component.
Crossed area is the residual.
Trend line is the real private investment growth over the previous period.

Source: Tsusho Hyakusho, 1985, Tsusho Sangyo sho, Tokyo, Japan. p. 241.

It is expected that the corporate tax reduction proposed in the LDP tax reform proposals will have some effect in stimulating private investment. However, the tax reforms are to be implemented in FY1988 and in the meantime, the government in September 1986, announced an eight point demand expansion package that promised to boost GNP growth by about US\$23 billion for the fiscal year. The package, part of the supplementary fiscal budget for the year, contained a \$15 billion increase in public works expenditure and government also decided to raise additional revenue by issuing new Construction Bonds to the tune of \$3.4 billion. As the result of this additional public works spending, the government's dependence on deficit financing would increase beyond the originally proposed levels for FY1986. It would appear therefore, that the Japanese government had finally decided to deemphasize fiscal austerity in favour of fiscal expansion. According to estimates of the Nomura Research Institute, this latest demand expansion package was likely to add 0.5 percent to GNP growth for the year [35].

However, we look at it, a key component in the economic restructuring of Japan is related to the expansion of domestic consumption. This, together with the revaluation of the Yen, constitutes the two track policy to control the trade surplus. The efforts to raise levels of consumer spending have had some positive effect. Consumer spending in August 1986 rose by 3.4 percent, in real terms, over the year before, marking the fifth consecutive monthly increase in private consumption [36].

Sometime after the G-5 agreement to readjust currency rates, the prime minister, on October 31, 1985, set up a private commission to study the problem of economic restructuring. The 17 member advisory groups on Economic Structural Adjustment for International Harmony, commonly known as the Maekawa Commission, after its Chairman Haruo Maekawa, former Governor of the Bank of Japan, became much talked about in both domestic and foreign circles, as the beginning of a long awaited process. Hopes were high because of reports in the press that an overall consensus had been achieved within the Commission on "...various 'new' ideas, such as a target year for Japan to bring its trade surplus to zero, or boosting government spending to stimulate the economy" [37].

When, however, the commission reported its findings on April 7, 1986, many analysts immediately pounced on it as a prime example of bureaucratic meddling and regurgitation of old and established facts. The critics argued that the report went no further than simply compile the various bureaucratic interests and garnished with a plethora of high sounding noble declarations, with no mention of the means to be used to achieve those objectives. The respected vernacular Nihon Keizai Shimbun, in its editorial the following day, summed it up simply as a report that exudes the smell of typical bureaucratic undertaking. Critics also charged that the whole notion of industrial restructuring which the report emphasized contained nothing new or revolutionary. All this, however, missed the point that the

report was not meant to lay down a concrete guide to action but rather elaborate on the more fundamental philosophic issue of reorienting the economy with a view to promoting international harmony. The report, observing that the time had come for a 'historical transformation' of the economy, recommended that the government try to reduce current account imbalance in the medium term and initiate as soon as possible steps to restructure the economy. The fact that the report did not propose any specific measures should not be seen as detracting from its utility. One of its main objective was to help lay the groundwork for a new domestic consensus that would support a more positive role by Japan in the international system. As the Far-Eastern-Economic-Review observed, "...for the first time in the history of such efforts, the focus is almost entirely on what Japan needs to do to set things right by way of domestic economic reforms and not on the need for foreigners to 'try harder' to penetrate the Japanese market." It added that the report made a potentially major change in the 'psychological climate' surrounding the 'Japan problem', meaning the position of Japan within the system [38]. As specific steps, the report suggested these should focus on housing development, consumption increase and significantly, gradual withdrawal of protection of the domestic coal mining industry so as to stimulate imports [39]. More specifically, the report contained the following recommendations:

1. Expand domestic demand.

- a) promote housing construction by easing regulations and expanding tax deductions.
 - b) stimulate private consumption through wage increase, tax cuts, and reduced work hours.
 - c) increase the role of local government in public works.
2. Transform Japan's industrial structure.
- a) encourage investment in manufacturing overseas.
 - b) rationalize depressed industries.
 - c) ease restriction on agriculture imports.
3. Continue to improve market access.
- a) streamline distribution network.
 - b) implement Action Program.
4. Liberalize capital and financial markets.
5. Expand Japan's overseas cooperation.
- a) promote ODA.
 - b) promote GATT New Round.
 - c) expand imports from the LDCs [40].

Although, not mentioned in the final report, Maekawa, at a press conference the same day suggested that the committee also favoured removing protection from two other 'sunset' industries - aluminium and ship building [41]. The fact that this was not contained in the text of the report points to the pressure to harmonize bureaucratic interests. This is also evident from the position taken on fiscal spending and fiscal austerity. The committee, mindful of MOF interests, somehow managed to support

each of the two goals of fiscal expansion and budget balancing and it was only at the news conference that Maekawa candidly revealed that his group did, "...not favor the fundamental governmental goal to balance the national budget by 1990" [42].

The American reaction to the Maekawa report was very favourable. The Under Secretary of State for Economic Affairs, Allen Wallis, termed the Maekawa report a "...watershed in Japan's postwar economic history" [37]. Following two days of talks with President Reagan, the Japanese prime minister remarked as follows:

...I believe that Japan must tackle the epoch-making task of structural adjustment and transform its economic structure into one dependent on domestic demand, rather than exports leading to a significant increase in imports, particularly of manufactured products. Recently, my private advisory group produced a report containing many variable recommendations in this regards. In order to translate the recommendations into policies, the government will set up a promotion headquarters which will formulate the work schedule very shortly [44].

In the period after the U.S.-Japan summit and prior to the Tokyo Summit in early May, it was widely reported in Japan that the two countries had come to an agreement to stabilize exchange rates and on Japan's commitment to economic restructuring, as per the Maekawa recommendations. Later events, however, showed that the nature of the agreement had been blown well out of proportion. The stabilization of the Yen was, as suggested in the last chapter, a serious policy concern for the Japanese government, after having tolerated a major revaluation. The U.S.

especially the Treasury Department, did not see eye to eye with Japan on this. Thus, in late April, the Treasury Department sent a formal note of protest to the MOF asking it to desist spreading the false impression to reporters that Japan and the U.S. had an agreement on exchange rates [45]. Indeed, after the Tokyo Summit, when Japan could not squeeze out a commitment to stabilize the dollar, it was quickly perceived to mean a U.S. desire to see the Yen rise further and this is exactly what happened.

Concerning the second part of the alleged agreement on economic restructuring, when Nakasone returned from the U.S., he immediately came in for much criticism from within and outside the party for allegedly having made a commitment to upgrade the Maekawa plan as government policy. Party members questioned the wisdom of raising economic restructuring as an issue in an election year and at a time when the business sector was still reeling under the impact of the high Yen. In fact, Nakasone had made no formal commitment. Looking carefully at the remarks made by Nakasone in Washington, it is obvious that he took care to emphasize the private advisory status of the Maekawa commission. The U.S. also acknowledged that Japan had made no specific commitment. Still, it also cannot be denied that he had offered a personal commitment to do his best which the prime minister later reconfirmed at a news conference on the 28th of April. He stated that the Maekawa Commission report did not constitute an international agreement but he went on to add that, "We will

formulate policy in line with the report" [46]. This was not the first time Nakasone had landed himself in trouble domestically following a visit to the U.S. The most noteworthy such occasion was when he allegedly pledged to transform Japan into an 'unsinkable aircraft carrier'.

The prime minister has not transformed Japan into an 'unsinkable aircraft carrier' but he did try to implement a number of major steps, including a secrecy bill which was rightly rejected by the Diet as being too draconian. But, he did achieve the other important goal of removing the 1 percent ceiling on defence expenditures. The 1976 Cabinet level agreement to contain defence spendings to under 1 percent of GNP was finally lifted by another cabinet level agreement in December 1986. The prime minister may not be able to achieve transformation of the economy as readily as the U.S. might hope but this would not be for lack of effort but because it is necessarily a more long term undertaking, not to be achieved overnight.

We would expect a certain measure of economic transformation to take place automatically as the result of Yen rise. With the higher purchasing power of the Japanese Yen and the improvement in the country's terms of trade, exports are certain to decline over time. Also, Japanese firms are likely to undertake foreign investment in greater number to consolidate their market shares in foreign countries. Only a few years ago, the analysis would have been considerably more pessimistic, as was James Abegglen in his discussion of Japanese foreign investment in the U.S. In

1984, he wrote that production investment in the U.S. was "...likely to remain small and to have little impact on the trade balance" [47]. Since then the G-5 agreement and the sharp revaluation of the Yen, had created newer opportunities and a positive incentive to locate production facilities in the major markets overseas. In the case of automobiles, local production was expected to make up over a third of total Japanese car sales in the U.S. ^N by 1990, compared to less than 7 percent in 1984. In this instance, the VER had the major effect but other industries are likely to follow suit given the stronger Yen and in the interest of preserving their market share in the U.S. Certainly, the initial establishment costs are now much lower. Mr. Nukazawa of the Keidanren, in a recent interview with the New York Times said that, "So far investment overseas has been political[...Now it will be more of an economic response" [48]. And overseas investment will have an impact on export statistics. In a report prepared by the MITI, it was suggested that if overseas investments increase at the annual rate of 12 percent, there would be a reduction of the trade surplus by about \$53 billion by the year 2000 [49]. Twelve percent annual growth may seem a tall order but there has been rapid growth of foreign investment in recent years.

TABLE 5.4
JAPAN'S DIRECT OVERSEAS INVESTMENT

	AMOUNT	% GROWTH
FY 1980	\$4,693M	
FY 1981	\$8,931	90%
FY 1982	\$7,703	-13%
FY 1983	\$8,145	5.7%
FY 1984	\$10,155	24.6%

Source: Japan 1985, Keizai Koho Center, p.56.

Of course, the decision to invest will also be determined by conditions in the host country. At present, a number of states in the U.S. (five, including California) have a unitary tax system where taxes are levied not just on the profits of the foreign subsidiary but rather on a percentage of global earnings. The intention of the unitary tax system is to prevent foreign operations from evading tax payments by creative accounting procedures to show losses but this can also deter investment, as it results in double taxation for some. Since 1980, there had been four attempts to repeal the law in California but each time this was unsuccessful [50]. Despite the unitary tax, however, California has been the largest recipient of Japanese investment in the U.S. It is possible though that this is keeping out investments at the margin. A survey conducted by Keidanren of its 866 member companies, of which 348 submitted valid responses, concluded that for some companies a decision to invest in

California would be contingent on the future course of the unitary tax [51].

SECTION IV

CONCLUSION

This chapter has looked primarily at the issue of demand expansion in Japan. As mentioned, the importance of stimulating domestic demand lies in the potential not only to expand imports but also to reduce the export dependence of the Japanese economy. In the early to mid-1980s, the foreign demand component in annual GNP growth in Japan had deepened considerably and in this chapter we looked at some of the steps initiated by the Japanese government, like eliminating the tax incentives on small savings and fiscal expansion, to dampen the export-push growth pattern. This was partly responsible for the burgeoning Japanese trade surplus during this period and, we argued that, rectifying this would allow the Japanese economy to play a role commensurate to that envisioned in the concept of system supporter by removing one of the sources of the trade imbalance and which might thereby lower the protectionist threat to the system.

We might note that the task of demand expansion proved rather difficult for the Japanese government because it conflicted with the objective to balance the budget and because there was no overwhelming pressure from outside Japan to expand

fiscal spending. Nevertheless, the government did implement a number of measures, including fiscal expansion, although—at a later date. Because the earlier demand expansion packages contained no fiscal spending on public works, analysts were generally skeptical about the efficacy of these packages. But even then, the measures aimed at stimulating housing construction did have a better than anticipated result. Reviewing the effects of these measures, the Chief Economist for Nomura Research Institute, Kagami Nobumitsu, stated that if we looked at construction figures for the period following the adoption of the measures, we would see that they "...had very favorable effects" [52]. Similarly, in his estimate of the potential effect of the fiscal expansion program adopted in September 1986, he suggested that it would add 0.5 percent to expected GNP growth for the year, even though it would not be enough to achieve the target growth rate of 4 percent. Thus, while demand expansion had been undertaken, the total impact was still likely to fall short of government targets.

Here, it might be worthwhile to briefly review how the task of consensus building on Japan's international role had progressed over the period the Japanese government was engaged in reflating its economy to meet with foreign expectations. Unlike in 1977, when the Japanese government had to flatly abandon its commitment due to pressure from the MOF, this time at least, a number of expansionary measures were taken. The Ministry of Finance even acquiesced to fiscal expansion and this might be

taken as an indication that there had been significant progress in overcoming the obstacles that stood in the way of the realization of Japan's international role. The actual progress, however, was much more modest. While the MOF did agree to expand fiscal spending and while the new expenditures meant that the government was not likely to remain within the originally scheduled deficit financing ratio, the objective of balancing the budget had not entirely been discarded. Even with the additional spending, the MOF could still maintain that the budget remained the top priority. The deficit financing ratio for the fiscal year would exceed the original limits but would still remain marginally below the level for FY 1985. Thus, there was no wholesale abandonment of fiscal austerity.

Consensus building, in the best of times, is a slow process, but in times of economic uncertainty, the problems are compounded. For a country like Japan, the lack of full consensus rendered decision making all the more difficult. Finally, given the state of the fiscal condition in Japan, one may conclude that the government had done rather well in responding to international expectations.

Chapter Six

JAPAN AND THE ASIA-PACIFIC

SECTION I

THE REGIONAL-GLOBAL DIVIDE IN JAPANESE FOREIGN POLICY

In the previous chapters we have focused primarily on the U.S.-Japan nexus. The reason for doing so was because the main threat to the liberal trading regime was the economic and trade conflict between the two largest economic entities in the system. We argued that if Japan was to emerge as a system supporter, there had to be an easing of trade conflict between the U.S. and Japan. Accordingly, we concentrated on how Japan had attempted to manage its relationship with the United States. In the case of the automobile dispute, the restoration of the viability of the American auto industry was a main guiding concern of the Japanese government. Similarly, the whole issue of U.S.-Japan trade imbalance was largely concerned with the removal of impediments to Japanese imports and restructuring of industry. Continuation of the trading imbalance, it was postulated, only provided ammunition to the forces of protection and this, in turn, undermined the stability of the free trade regime. We did not argue that the hegemon must always enjoy a trade surplus for it to remain interested in the leadership role, but obviously a problem existed, if one country was consistently responsible for a seemingly irreversible and growing trade surplus ~~vis-a-vis~~ the regime leader. Theoretically, a surplus or deficit on bilateral trade should not be given too much weight but when the bilateral deficits make up an inordinate share of the total, and when this

is perceived to arise from an unfair trading arrangement, it may be politically impossible to ignore bilateral balances. Many people in the United States seriously believed that Japan was the problem and that the cure to the American economic malaise lay in the resolution of trade problems with Japan. It was natural, therefore, that our focus should have been on interactions between Japan and the U.S. As an indication of the success of the policies implemented by Japan, we could note that the high pitched protectionism in the U.S. during the period 1980-1985 had somewhat subsided.

In this Chapter, we wish to identify a potential problem area that may, at some future date, emerge as a major challenge to the stability of the trading system. For many analysts, it is not merely a potential threat but rather a very distinct possibility. The challenge that they refer to is the export dependence of the Association of South East Nations (ASEAN) and the Asian Newly Industrializing Countries (ANICs), on the United States which, could, if present trends continued, become a significant destabilizing force in the system. Concerned that this was inevitable, Robert Wescott of the Wharton Econometric Forecasting Associates suggested that "The Pacific Rim is the next trade battleground" [1]. Most of the ASEAN and ANIC group of countries had consciously implemented an export oriented growth strategy and, like Japan, they too relied on the U.S. as their principal export market. Japan, as we saw, was trying to reduce its dependence on foreign demand as the motor of economic

growth, but for these other regional countries, this is much more difficult because of their own limited market size and unless other export markets become available for export diversification to occur. Yamazawa et al. noting that much of ANIC export had gone to the United States and Western Europe, suggested that it was time "...to search for possibilities for more active intra-Pacific trade" [2]. If we included ASEAN exports to that of the ANICs, the trade picture is more evenly balanced but only because Japan was an important market for such raw material exporting countries like Indonesia and Malaysia. However, even within ASEAN, one finds a growing emphasis on manufactured exports and in so far as this was concerned, the direction of export was very lop sided. In this Chapter, we will determine how the potential problem could be averted. Dependence on the U.S., as noted, is already high, but not yet of critical proportions.

Japan's postwar foreign policies have emphasized friendly relations with the U.S. because of its importance as a trading partner and because of the U.S.-Japan Security Treaty. As such, the attention span of the Japanese government was largely taken up by various issues in their bilateral relations. Regional concerns, although not totally ignored, did not receive priority. This was not altogether undesirable from the point of view of the regional countries if American protectionism resulting from conflict with Japan could thereby be limited without spilling over to affect their own interests. The adage that when

elephants fight, the grass gets trampled was very true here. Assuming then on the basis of discussion in earlier chapters, that U.S.-Japan relations was likely to evolve in a less conflictual way, it should also help to secure the interests of the ASEAN-ANICs. As opposed to this rather optimistic analysis, it is possible that with the likely resolution of the 'Japan problem', American attention will now be diverted to the 'Pacific Rim problem' and it is perhaps in this regard that we could interpret the remarks of Robert Wescott. Our concern with the 'Pacific Rim problem' will concentrate on Japan's role within the region. This role could be understood in terms of managing the problem of surplus industrial capacity, which as Susan Strange and Roger Tooze noted, always contained the the potential for conflicts of economic interest and protectionism [3]. In dealing with the issue of surplus capacity, we are immediately confronted with the difficulty of measurement and, to cite one example, estimation of U.S. surplus industrial capacity for 1977 ranged from 9.8 percent to 17.6 percent [4]. However, regardless of the lack of agreed estimation procedures, the appearance of surplus capacity very quickly manifests itself in a heightened level of protectionism and it is, therefore, important to provide effective mechanisms to ~~manage~~ such sectoral disturbances. In terms of causal forces, surplus capacity could result either from changes in market demand patterns, as was the case with the American automotive industry in the early 1980s, or it could be the result of deliberate government policies designed to promote

economic growth through reliance on export demand. The latter condition characterizes the situation of the market economies of East and Southeast Asia which have followed an export oriented growth strategy. This could become a source of conflict within the trading system if, as is expected, they continue their export based growth strategy and if, as Wescott obviously assumes, they continue to rely heavily on the U.S. market for the export of their industrial products. In the case of automobiles, the Japanese VFR became an instrument for managing the problem of surplus capacity in the U.S. auto industry and in the regional context, it will be argued that Japan could help to alleviate the potential for conflict by providing freer access to its market to the regional countries and thereby lower the burden on the American economy.

According to Professor Watanabe Akio, the historical development of Japanese foreign policy shows a consistent emphasis on two different themes: globalism and regionalism [5], but he went on to suggest that Japan "...never succeeded in inventing a satisfactory formula for blending the two different concepts together" [6]. For example, the Anglo-Japanese alliance of the 1920s was based on the delicate balance of collaboration with a global power (Britain) and the recognition of Japan's 'special interests' in Asia, but in the later Washington Treaty, the U.S. refused to accept Japan's regional ambitions as valid. The U.S. persisted with its foreign policy objective of assuring the independence of China under the 'Open Doors' policy and it

could be argued that it was partly this inability to combine its two national objectives that prompted Japan's decision to seek a military solution.

In the post-war period, Japan's regional ambition remained rather subdued partly because of the priority attached to achieving economic growth and establishing an identity as an industrial power but also because of the lingering pre-war and wartime legacies. The crudity of the short lived Japanese colonialism in the region made sure there was going to be no Japanese 'commonwealth' after the liberation of these countries and the vivid memories of Japanese atrocities helped to sustain a strong feeling of antagonism toward Japan. At the same time, besides reparations payments, these countries could expect little from Japan and so not only was there no desire, but also no incentive to allow Japan an active role in the region.

Furthermore, Japan's isolation from the region also owed to the deliberate policy pursued by the occupation forces, who sought to remove Japanese influence from the region. The method used was repatriation of Japanese to Japan, a task that was undertaken with thorough going and ruthless efficiency. As Reischauer wrote, in the interest of rooting out all Japanese influence from neighbouring countries, the repatriation program included not only soldiers, but all Japanese, "....regardless of humanitarian considerations and the long-range interests of the countries in which they resided. Civilians and their families who had been legitimate, permanent residents in overseas areas

gains would accrue largely to Japan. As originally intended and if brought to fruition, a PAFTA scheme could have been potentially harmful to the developing countries of Asia because of the trade diversion effects [9]. With modifications, the two concepts of PAFTA and PBEC have since become institutionalized as a series of conferences, the former in the modified form of PAFTAD - Pacific Area Free Trade and Development.

These were private level initiatives which was understandable since the Japanese government still felt insecure about how an official initiative would be received by the Southeast Asian countries. Hostility toward Japan was still high and manifested itself in a rather ugly manner when Prime Minister Tanaka's visit to the region in 1974, prompted riots and demonstrations.

Aside from the psychological gap between Japan and the regional countries, there also exists, as mentioned, an economic and trade gap. Although Japan's resource dependence ensured a persistent Japanese trade deficit vis-a-vis the raw material exporting countries, Japan is accused of keeping its domestic market closed to manufactured exports of these countries. This, however, is a common complaint of the less developed countries (LDCs) against the developed countries (DCs), which maintain relatively high tariff barriers against developing countries' exports of primary as well as manufactured products. It is not particularly unusual, therefore, that the Japanese tariff structure, for example, gave preferential treatment to lumber in

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for decades and sometimes for their whole lives were deported on essentially the same terms as soldiers and camp followers" [7]. This must have been a traumatic experience for the Japanese nation, making it more difficult for them to identify with the region. The isolation was further entrenched when Japan signed the U.S.- Japan Security Treaty in 1951, which barred relations with the communist regime on mainland China, a country with which Japan would otherwise have had a closer relationship after independence.

During this period, however, Japan's globalist vision was brought to full bloom, beginning with its admission to the OECD in the mid 1960s. It was only after Japan had finally joined ranks with the industrial countries that she began to reconsider her regional role. Although, as far back as 1957, the Diplomatic Blue Book, published yearly by the MFA, declared that Japan's foreign policy orientations ought to be determined partly in consideration of the fact that Japan was an Asian country, this essentially remained a verbal exhortation and an agenda for future consideration. Throughout the 1960s, there continued to be similar calls for Japan to establish a regional role, by Prime Minister Kishi, who emphasized the idea that 'Japan [was] a member of the Asian Community', and later by Prime Minister Sato, who forthrightly remarked that Japan would play 'a leading role' in Asia [8]. Regardless, however, Japan kept a low profile. This is not to suggest that Japan had no interests in Asia but simply that it chose to rely mainly on the U.S. presence in the

region to protect those interests. Japan's principal interest was in maintaining good relations with Indonesia because of its vast oil resources and also because Indonesia straddled the vital Malacca Straits, through which Japan's imports of Middle Eastern oil had to pass. The importance of Indonesia explains why Japan persevered in its attempts to maintain friendly relations even through the turbulent years when Indonesia swerved back and forth between pro-Washington, pro-Moscow, and pro-Peking leanings. It was in its relations with Indonesia that the U.S., at times was unable to guarantee that Japanese interests would be preserved and where Japan was forced into a relatively active role. The task, perhaps, was made easier by the influence wielded by President Sukarno's Japanese wife, Ratna Devi. Below the surface, however, hostility toward Japan remained which welled over in 1974.

The two most prominent ideas that were floated around this time were Pacific Free trade Area (PAFTA) and the Pacific Basin Economic Cooperation (PBEC), the former by a group of academics and the latter by private businesses. Professor Kojima of Hitotsubashi University, Tokyo, initiated the concept of PAFTA in 1966 but at that stage it was only peripherally regional. The membership that he envisaged was to include only the five developed economies of the region - the U.S., Japan, Canada, Australia, and New Zealand. Even with this restricted membership, he realized that the prospect of establishing a regional free trade system was not likely, considering that the

gains would accrue largely to Japan. As originally intended and if brought to fruition, a PAFTA scheme could have been potentially harmful to the developing countries of Asia because of the trade diversion effects [9]. With modifications, the two concepts of PAFTA and PBEC have since become institutionalized as a series of conferences, the former in the modified form of PAFTAD - Pacific Area Free Trade and Development.

These were private level initiatives which was understandable since the Japanese government still felt insecure about how an official initiative would be received by the Southeast Asian countries. Hostility toward Japan was still high and manifested itself in a rather ugly manner when Prime Minister Tanaka's visit to the region in 1974, prompted riots and demonstrations.

Aside from the psychological gap between Japan and the regional countries, there also exists, as mentioned, an economic and trade gap. Although Japan's resource dependence ensured a persistent Japanese trade deficit vis-a-vis the raw material exporting countries, Japan is accused of keeping its domestic market closed to manufactured exports of these countries. This, however, is a common complaint of the less developed countries (LDCs) against the developed countries (DCs), which maintain relatively high tariff barriers against developing countries' exports of primary as well as manufactured products. It is not particularly unusual, therefore, that the Japanese tariff structure, for example, gave preferential treatment to lumber in

the form of logs than to processed lumber like plywood. But what was more, Japanese tariffs also discriminated unfairly against LDC over DC exports and in the same product category. It is suggested that the differential tariff structure, in Japan, for softwood and hardwood plywood made the regional export of hardwood plywood less competitive than softwood plywood exports from North America. The GATT prohibits such overt discrimination and finally in 1985, after years of protest from the Asian countries, the tariff schedule was revised as part of the MOSS agreement with the U.S. As a result, the hardwood-softwood categorization was removed and the tariff rates too, were lowered. However, a differential tariff structure continued to remain in place with plywood exceeding a certain thickness allowed to come in at a lower tariff rate than plywood that was thinner. The consequence was, like before, discriminatory, because hardwood plywood is thinner than softwood plywood and therefore the Asian plywood exports continued to be subject to a higher tariff rate. What this illustrates is the type of problem that Japan faces in its attempts to reconcile its regional and global interests. It is almost certain that without a differential tariff, lumber trade would be diverted to the Asian countries, causing displeasure in the U.S. Thus, without keeping the differential tariff structure in place, the surplus reduction objective of the MOSS agreement would be even more difficult to achieve. And with the surplus, seemingly out of control, Japan was constrained to show some improvement even if this had to come

at the expense of regional concerns. Japan's first and foremost priority was to maintain harmonious relations with the United States, but, as will be argued below, the regional and global concerns may not necessarily be a zero-sum game.

SECTION II

DEVELOPMENT STRATEGIES OF ANICS AND ASEAN

To assess the nature of the potential future threat to the system, we have to look at the development strategy of the ASEAN and ANIC group and on the role that exports have played in this. In the process, we hope to show how some of these countries developed a strong manufacturing base and the nature of their dependence on the U.S. as a market for their export products. This, in turn, will make clear the role that Japan could play to defuse the potential for destabilization contained therein and in keeping with its evolving role as system supporter.

The countries that we will be concerned with in the main are the six members of the Association of South East Asian Nations (ASEAN) - Singapore, Thailand, Malaysia, Philippines, Indonesia, and Brunei - Hong Kong, and the newly industrializing countries (NICs), Republic of Korea and Taiwan. As a bloc, these countries displayed a robust economic growth through the 1970s, even when other countries were fighting off recession. The pace of economic growth was so rapid, especially for the ANICs, that they

were dubbed 'mini Japans', partly because their development pattern closely resembled that of Japan. Growth in the region was phenomenal and with economic growth, trade also expanded rapidly, both within and outside the region. Total U.S. trade with the Western Pacific countries (including Japan) now exceeds its trade with the European countries.

Behind the high growth rates there is a richness of diversity, not only as collectives between the ANICs and ASEAN but also amongst the six ASEAN countries. This diversity could be measured not only in terms of ethnicity or language, but also in the levels of industrialization. Within ASEAN, the two poles are represented by Singapore and Indonesia, the latter almost entirely dependent on oil exports (Brunei is in a class by itself). About 84 percent of Indonesian exports in 1983 were in the SITC categories 2 and 3, crude materials excluding fuels; and minerals and fuels, respectively. For Singapore, the ratio of manufactures to total export was 46 percent in 1984 (SITC #6,7,8), although, if we include petroleum products (SITC #3) the ratio jumps to 72 percent. Although Singapore does not have any oil resources, it developed a large refining industry, taking advantage of its strategic geographical location.

The ANICs and the ASEAN countries are heavily dependent on exports, and to give an example, whereas in 1960 the export value to GNP for South Korea and Taiwan was only 0.9 percent and 9.6 percent respectively, in 1980 this had jumped to 30 percent and 49 percent respectively. The ASEAN countries are somewhat less

dependent on exports than the ANICs and there is a wide spread from 16-54 percent (1980) [10]. For most of these countries, the export growth was due mainly to growth in manufacturing exports, which reflected the rising level of industrialization in the region. According to Hofheinz and Calder, the export drive for the four ANICs (Hong Kong, Singapore, Taiwan, and Korea) derived from motivations similar to that behind the Japanese export drive, the lack of available raw materials domestically, notably food. Of the four, only Taiwan could boast food self-sufficiency [11].

Exports became a top national priority in South Korea in the early 1960s after the earlier emphasis on industrialization by import substitution had more or less run its course. Early import substitution had been completed by the 1960s and at that time the authorities were confronted with three alternative growth promoting strategies:

1. agricultural exports.
2. advanced import substitution.
- 3. manufactured exports.

The first alternative was rejected because of poor prospects for primary commodities and the second alternative, too, had to be dismissed because of unfavourable factor endowments and the difficulties of achieving economies of scale in a small market. The size of the Korean market in the early 1960s was estimated to be only about US\$1 billion (production plus imports minus exports) compared to \$23 billion for India and \$14 billion for

Brazil [12]. This left open the third option of fostering advanced industrialization based on an outward looking, export oriented strategy.

In 1962 Korea established the Korean Organization for Trade Advancement (KOTRA) modelled after the Japan External Trade Organization (JETRO), to promote exports, conduct market surveys overseas, and provide information to domestic producers to enable them to expand into foreign markets. The Korean counterpart of MITI, the Ministry of Commerce and Industry (MCI) was also instrumental in pushing exports, even when export sales were less profitable than domestic sales. The MCI, through its control over granting of import licences, encouraged exports by setting minimum targets, \$200,000 in 1970, which had to be met for a firm to retain its import permit. Thus, even though export sales had a profitability of 2.12 percent in 1968, compared to 9.49 percent for domestic sales, there was a steady growth in export volume [13].

In 1965, President Park Chung-hee initiated the monthly sessions of the National Expanded Trade Promotion Meeting to discuss and assess progress toward meeting national export targets [14]. Trade promotion naturally took the form of promoting manufactured exports and the development of export oriented industrialization. The success of this policy was so remarkable that from a low of 14 percent in 1960, manufactured exports grew to constitute almost 90 percent in 1980 [15]. South Korea has, in recent years, moved ahead to diversify its

industrial and export base. Whereas, Taiwan, Singapore, and Hong Kong continue to focus on textiles, leather, and consumer electronics, Korea has entered the market for ship building, automobiles, steel, and high technology industries.

Taiwan, another major trading country in the region also witnessed a dramatic shift in its trade composition. As mentioned above, it was the only ANIC to have achieved a measure of food self-sufficiency, and agricultural products were its principal export commodities in the early 1950s. In 1952, rice and sugar constituted 78 percent of its total exports but by 1970 this had declined to only 3 percent, to be replaced by manufactured goods [16]. The changeover occurred as a direct shift in government policy in the late 1950s to move away from an emphasis on industrialization through import substitution to export-based industrialization. This was necessitated by increased domestic demand and consumption of rice, which consequently reduced the available surplus for export. Other factors that influenced the change in government policy were the low foreign demand elasticity for primary products, and the fact that a small domestic market constrained the viability of continuing with import substitution industrialization. Although not the first export promotion measure, the government in 1957 implemented a program of low cost export loans which could be repaid at the modest interest rate of 6 percent per annum, if repayment was in foreign currency [17]. There was thus a clear incentive for manufacturers to export and earn foreign exchange.

so that they could avail the low interest rates.

Later, in the 1960s, the government announced plans to set up special 'export processing zones' and the first one, the Kaohsiung EPZ, was established in July 1965. From a largely agriculture based economy in 1960, Taiwan has been transformed radically. In 1960, agriculture constituted 33 percent of GNP, but by 1980, this had declined to 9 percent, while in the meantime, the share of the secondary industrial sector went up from 25 to 45 percent.

The export growth of the ASEAN countries as well, followed on the heels of industrial expansion. The early impetus to industrialization came from import substitution and this received a further boost with the adoption of an outward looking policy. Industrial exports began initially with consumer goods, but from 1981 onwards both Singapore and Malaysia have increased their export of capital goods to above the levels of consumer goods. Sixty percent of these two countries' exports are in the SITC category #7 - machinery, communications equipment etc. [18]. Only Indonesia, a late starter in import substitution industrialization, has lagged behind the other ASEAN countries and this is perhaps due to the fact that Indonesia, with its vast oil resources, has not had any difficulty in earning foreign exchange. The transformation of the various economies of this region can be seen in the table, below.

TABLE 6.1
OUTPUT BY SECTOR (%)

COUNTRY	AGRICULTURE		INDUSTRY		SERVICE	
	1960	1980	1960	1980	1960	1980
KOREA	37	16	20 (14)	41 (28)	43	43
TAIWAN	33	9	25 (17)	45 (34)	42	46
HONG KONG	4	1	39 (26)	32 (24)	57	67
SINGAPORE	4	1	18 (12)	37 (28)	78	62
MALAYSIA	37	24	18 (09)	37 (23)	45	39
THAILAND	40	25	19 (13)	29 (20)	41	46
INDONESIA	54	26	14 (08)	42 (09)	32	32
PHILIPPINE	26	23	28 (20)	37 (26)	46	40

Note: Figures in parenthesis represent the share of manufacturing output.

Source: EPA, *Taiwan's Trade Policy*, 1985, p. 10.

The pace of manufacturing growth was high in all of the Asian countries except for Hong Kong which had traditionally been a service oriented economy, specializing in banking and international finance. To foster manufacturing growth, most of these countries also set tariff barriers high to protect the domestic industry from foreign competition. In the case of Taiwan, the effective tariff rate in 1985 was about 7.89 percent, considerably higher than the effective tariff rates for the U.S.

(3.6%), Canada (4.3%), and Japan (2.6%). Effective tariff rates, however, do not tell us much about the protective function of tariffs since it is possible to set tariffs at such high levels as to bar imports totally, in which case the effective tariff rate would be zero. To obtain an idea of tariff protective function, we need to consider both the effective and the average nominal tariffs. Taiwan's average nominal tariff in 1985 was 26.5 percent, more than three times the effective tariff rate. As a concession to Western criticisms, however, the government of Taiwan has recently announced its decision to lower average nominal and effective rates to 22.8 percent and 5 percent, respectively, over the next five years [19].

The success of the industrialization policies of ASEAN and the ANICs has owed much to the growth of export trade. Reliance on foreign demand to propel industrialization was a natural outcome of the low per capita GNP. Even for the middle income LDCs, in general, domestic demand and consumption levels have been kept low by government policies aimed at achieving a high savings rate, necessary to meet the investment demands. The savings rate in Korea, for example, is even higher than that of Japan. Not only Korea, but all the other ASEAN and ANIC countries were very successful in raising their gross domestic savings levels, in all cases above the level of 20 percent of GDP, in the period 1978-1980. Taiwan's gross domestic savings exceeded that of the others above, reaching almost 35 percent of its GDP. The high savings provided investment financing and made

possible the growth achievement of these countries. Maintaining a high savings rate in the developing countries is very important to economic growth since it makes possible continuous increase in the capital-labour ratio, given the high population growth rate [20].

A 1970 UNCTAD publication, The Measurement of Development Effort, comparing domestic savings rate to GNP for a group of 50 LDCs, ranked Korea 49th in 1950 but by the mid 1960s, it had risen to the top according to a separate UN study of 39 countries [21]. Much of Korean private investment is financed through domestic capital formation although in the initial stages of development, the government had anticipated considerable reliance on foreign capital sources in view of the low domestic savings. But to raise domestic capital availability, the government, following the election of President Park Chung-hee raised interest rates on deposits to encourage savings. Like Korea, Malaysia too has a high savings rate. In the late 1970s, national savings was 28% of the GNP. Salleh and Osman attribute this to the following factors:

1. An uneven income distribution which favours the very rich, who also have a very high savings rate.
2. The value system of the economically dominant Chinese community which favours low consumption/ high savings.
3. A relatively advanced social security system (public) involving long term forced savings for a large portion of wage and salary earners, and
4. High savings by the corporate sector [22].

In Taiwan, in the fifties, investment finance came mainly from overseas sources but starting in the 1960s, domestic savings ratio began to exceed 10% of GNP and "...this higher savings rate constituted the main source of domestic investment in that decade" [23]. The high savings was partly generated by a hidden rice tax to propel growth and allow low taxes in the industrial sector of the economy.

The constraints of a small domestic economy was, as mentioned, the principal instigator behind the adoption of an outward looking growth strategy. In terms of securing export markets, the focus of the ASEAN and the ANICS has been largely restricted to the Asia-Pacific region. The EC, a potentially important market for these countries, has been relatively difficult to penetrate because of protectionist European policies. Another factor restricting growth of exports to the EC has been the slow average growth rate of the Community, even compared to the U.S.

Within the Asia-Pacific region, although Australia and New Zealand are advanced developed economies, the market for imports is rather limited. The governments of both countries have pursued protectionist policies with the aim of fostering import substitution manufacturing.

In recent years, Korea and Taiwan have also established a strong services export trade, concentrated in the construction business, with the oil producing countries of the Middle East but the main export earner is still the industrial sector. In terms

of manufacturing and commodity exports, the primary destinations are the United States and Japan. The Table on the following page (Table 6.2) gives the export figures for five of the regional countries broken down for the ten (0-9) SITC categories.

As can be seen, Japan is an important market for crude and raw materials exports of Indonesia and Malaysia but with the emphasis shifting increasingly to the export of manufactures, these countries have come to rely mainly on the United States. The U.S. takes about a third of Hong Kong and Singapore's manufactured exports with Japan importing less than four percent.

SECTION III

JAPAN'S REGIONAL ROLE AND SYSTEM STABILITY

For the NICs it was exceedingly difficult to penetrate the Japanese market for manufactures although the Japanese government insisted that there was no systematic bias against the export of the regional countries. This, however, appears not to be the case as in the case of processed lumber exports to Japan. A more serious barrier, again, was the distribution network. Given the initial condition of low consumption of imports, exports from the LDCs also had to battle against the traditional practice of enveloping imported products with a brand image, certainly not an easy task to do with third world manufactures. Rightly, or wrongly, goods produced in the LDCs have acquired the image of

TABLE 6 2

TPADE BREAKDOWN FOR SELECTED ASIAN COUNTRIES

Unit: US\$1000

	SITC 0 Food and Live Animals			SITC 1 Beverage and Tobacco			SITC 2 Crude Materials Excl. Fuels			SITC 3 Minerals and Fuels			SITC 4 Animal and Vegetable Oil, Fats		
	Total	U.S.	Japan	Total	U.S.	Japan	Total	U.S.	Japan	Total	U.S.	Japan	Total	U.S.	Japan
Hong Kong (1984)	17500	58061 (33.1%)	48159 (27.4%)	83810	1606 (2%)	120 (0.1%)	245507	4361 (1.8%)	52616 (2.1%)	39942	0	0	1353	128 (9.4%)	0
Malaysia (1983)	473333	52790 (5.2%)	61885 (12.5%)	9477	0	0	3245106	133576 (4.1%)	1012004 (33.0%)	3447718	118367 (3.4%)	916880 (26.6%)	1793597	76649 (5.5%)	71813 (5.1%)
Singapore (1984)	1359616	178125 (13.1%)	83550 (6.1%)	98517	1581 (1.6%)	5096 (5.2%)	1601411	209330 (13.1%)	124347 (7.8%)	6491313	334225 (5.4%)	1344728 (22.0%)	723381	46900 (6.5%)	15270 (2.1%)
Indonesia (1983)	109133	213232	287013 (26.2%)	47837	9653 (5.3%)	0	1649580	353474 (21.4%)	518840 (31.3%)	1652952	3394831 (21.0%)	842240 (53.5%)	148647	9632 (4.6%)	4441 (3.0%)
	SITC 5 Chemicals and Related Products			SITC 6 Basic Manufactures			SITC 7 Machines and Transport Equipment			SITC 8 Misc. Manufactured Goods			SITC 9 Goods not Classified		
	Total	U.S.	Japan	Total	U.S.	Japan	Total	U.S.	Japan	Total	U.S.	Japan	Total	U.S.	Japan
Hong Kong (1984)	167835	7595 (4.5%)	33187 (19.8%)	175427	36534 (20.6%)	34398 (1.9%)	425894	218125 (51.2%)	59724 (14.9%)	10746944	5219322 (48.6%)	429281 (4.0%)	144325	16993 (11.6%)	1176 (0.81%)
Malaysia (1983)	100935	15477 (15.3%)	5334 (5.2%)	1124010	42862 (8.8%)	209051 (18.6%)	1855531	880252 (47.4%)	91684 (4.9%)	322661	83320 (25.8%)	19671 (6.1%)	38019	3576 (9.4%)	2653 (7.0%)
Singapore (1984)	1156817	22695 (2.0%)	81939 (7.1%)	1702052	141845 (8.3%)	111700 (6.6%)	7919331	3205361 (40.5%)	244961 (3.1%)	1600321	595361 (36.9%)	49231 (3.1%)	1755059	117285 (6.7%)	176268 (10.0%)
Indonesia (1983)	118718	9584 (8.0%)	5481 (4.6%)	1349724	186881 (13.8%)	208778 (15.8%)	133341	0	145 (0.1%)	213240	86416 (40.5%)	6663 (3.1%)	238423	5655 (2.4%)	4619 (1.9%)

Source: Compiled from Commodity Trade Statistics (UN), Series D, Vol. 32, No. 21, Vol. 34, No. 1, Vol. 34, No. 10, 1982, 1983, 1984.

shoddy workmanship and poor quality which made it difficult to create a brand image of exclusivity. The brand image is a major selling point for imported goods in Japan which allows the importer/ distributor to sell at a high price and unit profitability to compensate for low volume. This marketing strategy works to the disadvantage of third world products promising moderate quality at low prices. Thus, the Japanese market is substantially different from the American market which absorbs a large quantity of cheap low quality products [24]. However, exporters in some of the regional countries are increasingly optimistic and hopeful that the quality of their products had improved sufficiently to allow them to take full advantage of the opportunity presented to them by the rise of the Yen. According to S.K. Chung, deputy general manager of Daewoo Japan [the Japanese branch of a South Korean conglomerate], "We're at a point now that our product quality is good enough to sell in Japan. If the Yen had risen five or six years ago, we wouldn't have been ready, and price competitiveness wouldn't have made a difference" [25].

At the same time, the maze of government established standards and certification system has been difficult for the third world exporters to handle. As a result of the many standards, the Japanese market minimizes price competition in favour of product standardization which automatically barred the third world exporters from exploiting their cost competitiveness.

Because of these difficulties, the dependence of the

ASEAN-ANIC group of countries on the U.S. deepened with the success of industrialization and the expansion of manufactured exports. For example, until the late 1950s, two-third of Taiwanese exports were sugar and rice, and for much of that time, Japan was the principal export and import partner of Taiwan, accounting for one-half of its exports and one-third of its imports. The United States replaced Japan only after 1967 and in 1971, the share of exports to the U.S. peaked at 41.7 percent [26]. Hong Kong's traditional export markets had been the Commonwealth countries which together accounted for about 40 percent of total exports in 1955. The U.S., in 1955, accounted for only 2 percent of Hong Kong exports but later became the main destination for its exports and in the mid 1970s, West Germany also overtook U.K. to take second place [27]. The growth of the regional countries' exports to Japan was not insignificant but this growth took place mainly in primary commodities and industrial raw materials. Japan's import of manufactures, however, remained low. Thus, although over 50 per cent of all Indonesian exports went to Japan, only about 13 percent of its manufactures were exported to Japan. Kershner, in his study of Japanese trade patterns, found that during the decade of 1960s there was very little change in the composition of exports to Japan by the regional countries. He wrote that:

The principal change is that some increase in manufactures was recorded by a few countries in the region; in no sense was the export diversity widely shared throughout all the countries of Pacific Asia. Even for these countries, moreover, their manufactured goods

export to Japan simply did not account for major market shares...In view of the world export data...what results is the finding that the region's exports to Japan centered around a set of commodities that when taken together formed a pattern that differed significantly from these countries' exports to the rest of the world. In addition, the comparable world export growth rates for these commodities were on balance rising sluggishly [28].

As another indicator of the trade dependence on the United States, it is worth mentioning that the U.S. alone was responsible for about half of all OECD imports from the ANICs and ASEAN. The U.S. share in the total exports of a selected group of ASEAN-ANIC countries is given below.

TABLE 6.3

OECD IMPORTS FROM ASIAN COUNTRIES (\$BILL.)

	1979	1980	1981	1982	1983	1984(1)
SINGAPORE	5.1	7.0	6.6	6.6	6.9	9.6
KOREA	10.8	11.1	12.5	12.7	14.6	18.1
TAIWAN	11.9	13.8	15.2	15.6	18.4	23.7
HONG KONG	10.2	12.3	12.6	12.2	13.3	15.5
MALAYSIA	8.3	9.2	7.7	7.2	7.7	10.1
TOTAL	46.2	53.4	54.6	54.2	60.8	75.9
OF WHICH U.S.	17.6	20.4	23.0	24.1	29.7	39.9
ANNUAL RATE OF CHANGE IN REAL TERMS (2)						
TOTAL	-----	6.3	2.2	11.6	17.5	22.4

Notes: (1) Based on data for the first three quarters.

(2) Volume of imports: values deflated by the export price index of manufactures.

Source: OECD, *Costs and Benefits of Protection*, Paris, 1985, p. 173.

The export growth stagnation in the early 1980s was due to global recession but the strong American economic recovery starting in 1983 and weaker growth rates in other countries meant that the export drive of these countries concentrated in meeting the revived import demand in the U.S.

The threat to regime stability comes from the inability of the United States, as the result of its relative economic decline, to continue to provide easy access to foreign countries. Such easy access, as we saw, was one of the features of the LIEO which was necessary in order to entice the weaker economies into the liberal regime. The extent to which the hegemon can continue to play this role depends, in part, on the economic vitality of the hegemon and on the perceptions of an equitable distribution of the burdens. It is not much relevant, for our purposes, to determine how easy the access to the U.S. market was or the number of obstacles that had to be overcome but the important point is that not only were these smaller countries successful but, in fact, very successful. The Table below, which shows the American trading balance vis-a-vis the ASEAN-ANIC group of countries, depicts the progression with which the latter group of countries had increased their dependence on the U.S. This is measured in terms of American trade deficit against these countries which, for the seven countries listed, increased from around \$6 billion in 1980 to nearly \$28 billion in 1984. Perhaps, the reason this large trade deficit has not aroused the same sort of sentiments against the regional countries of Asia,

like those that have resulted from the U.S. trade deficits against Japan, is due to the fact that the deficit is against a group of countries. The potential for conflict, however, is clearly there because the deficit is against a specific geographic region.

TABLE 6.4

US TRADE BALANCE WITH ASEAN-ANIC (BILL)

	1980	1982	1984
KOREA	0.25	-0.48	-4.00
TAIWAN			-11.10
MALAYSIA	-1.30	-0.22	-0.97
HONG KONG	-2.30	-3.40	-5.80
SINGAPORE	1.00	0.90	-0.40
INDONESIA	-4.00	-2.50	-4.60
PHILIPPINES	0.86	-0.10	-0.85

TOTAL	-6.35	-5.80	-27.72

Source: IMF, Direction of Trade Statistics, Yearbook, 1985, pp. 399-400. The figure for Taiwan is from The Economist, London, July 13, 1986, p. 69.

The total ASEAN-ANIC exports to the U.S. in 1982 was US\$39,931 million, or about half that of Japan [29]. If, in the process of amassing their trade surplus, the ASEAN-ANIC group of countries caused severe dislocation to American industrial structure, it could, once more, destabilize the trading system. Accordingly, we could argue that Japan not only had to resolve

its trade problems with the U.S. but also had the additional responsibility of further opening its domestic market to ASEAN and ANIC's manufactured exports. To the extent that this is successful, it could ease protectionism in the U.S. by reducing the perception of ~~excessive~~ market penetration by the Asian countries. A precedence of sorts already exists.

Japan's dependence on foreign sources for raw materials is particularly critical in the case of energy needs. Like most of the other industrialized countries, Japan's tariff structure favours the import of raw materials over processed products. The developing countries, however, wish to export more processed and value-added products and in the case of oil exporting countries, many are emphasizing the petro-chemicals industry to expand their exports of refined petroleum. In July 1985, the Japanese government, for the first time, agreed in principle to import petroleum products from the countries of the Middle East, instead of just crude oil. The Economist (London) commenting on this new development noted that the action of the Japanese government should

....take some pressure off the community [EEC], which otherwise would have to import the bulk of 50m [million] tonnes of refined petroleum that the oil producing states of the Middle East and North Africa are expected to produce between now and 1990. Without extra purchases from Japan, the Ten would feel obliged to protect themselves against the quite legitimate desire of the third-world oil producers to increase their exports of refined products [30].

Japan followed up on its commitment with the first purchase

of refined petroleum from the Middle East in January 1986.

If the leading industrialized economies, particularly Japan and West Germany, achieved a degree of market liberalization comparable to that in the United States, we could also expect the barriers against Third World manufactured exports to decline because this would allow a diversification in export markets that was not possible in the past. If, on the other hand, the Pacific developing countries remained overly dependent on the American market, the protectionist threat to the system will continue to haunt its stability.

Of the ASEAN-ANIC group of countries, Malaysia, Indonesia, Singapore, Hong Kong, and Korea, together, export about 8.4 percent of their total manufactured exports to Japan (SITC 6-8) whereas Japan imports 14 per cent of its SITC 6-8 imports from these five countries. The figures are not strictly comparable because the import statistics are based on CIF prices but the percentage figures do tend to suggest that the weight of these countries for Japan is much greater than vice versa. But this has to be qualified by the low levels of Japan's manufactured imports and the high level of manufactures to the total exports of three of the above five countries, Singapore, Hong Kong, and Korea.

The long term stability of the LIEO might require a greater degree of readiness by the Japanese government to provide easier access to its market for the manufactured products of the regional countries. This will become particularly more important

if the ASEAN countries succeed in speeding up their industrialization program and become more reliant on export trade. A beginning may already have been set in motion by the currency adjustments of 1985-86. Many of the regional countries like Singapore, South Korea, Taiwan, and Hong Kong maintain currencies linked to the U.S. dollar, and with the decline of the dollar, their own competitiveness received a strong shot in the arm. While their exports to the U.S. have increased, thereby diminishing the overall trade balancing effect of the dollar devaluation, their exports to Japan have also shown hefty increases in recent months. In the April-October 1985 period, Japanese imports from the four ANICs (Singapore, Taiwan, South Korea, and Hong Kong) had declined 4.8 percent over the same period of the year before but since then imports have jumped, led by manufactured exports. South Korea and Taiwan boosted their exports of manufactures to Japan by 31.3 percent and 23.4 percent in March respectively, over the same period in 1985 [31]. Much of this improvement in the sales position came as the result of shipment of parts to Japan which, as the Eac-Eastern-Economic-Review noted, was not without problem for these countries since, "The subjugation and gearing of manufacturing capacity to Japanese needs, according to the dictates of its own and foreign markets, could result in the formation of a multi-tiered subcontracting system akin to the Japanese model where costs are kept down by keeping in line competing subcontractors" [32].

The exchange rate mechanism, however, cannot be the sole tool for promoting a horizontal division of labour in the region, which also requires, in principle, a freely accessible market. In the past, Japan's various market opening measures have been geared to promoting imports from the U.S. and the European countries. According to Watanabe and Kajiwara, "It is one of the first priorities for Japan to rectify this oversight...Most urgently required of Japan is a policy review reformulating its current stances on international trade and investment, development aid, and structural adjustments to facilitate the horizontal ties to the ANICs, ASEAN-4, and other Asian neighbours" [33].

Throughout the postwar period, Japan relied on a multilateral approach to the region. This was a convenient way of combining its regional and global interests. Thus, concepts like the Organization of Pacific Trade, Aid, and Development (OPTAD), floated by Foreign Minister Miki in 1967 and fleshed out by Peter Drysdale and Hugh Patrick in 1979, and Prime Minister Ohira's Pacific Basin Concept have all envisaged a wide membership and no special role for Japan. It might be necessary, in the future, for Japan to take a greater initiative on its own. So far, this has been lacking. In a press conference broadcast at midnight of 31 December 1984, Prime Minister Nakasone, touching on the theme of Pacific cooperation said, "As I have said all along, Japan and the United States should avoid taking the lead and becoming conspicuous." Instead, he expressed his

hope that, "...the ASEAN foreign ministers conference will take the front seat and things will be handled with ASEAN leadership" [34]. Commenting on the explanation given by Japanese leaders to justify their Pacific non-policy, the Far-Eastern-Economic-Review, stated, "Japan has taken Asean doubts over its intentions too seriously, as if the doubts were more a genuine expression of concern than the political hyperbole of Asean leaders that is an era out of date" [35].

Specific measures that could be taken by the Japanese government include the expansion of the GSP import quota for developing countries. The Japanese GSP quota for textiles is very small and covered only 11.3 percent of the total textiles export of the GSP beneficiaries countries in FY1978, a decline over FY1972 when it covered 15.2 percent of total exports, even though the absolute quota had been increased. As Yamazawa wrote, "The GSP has been of positive contribution in increasing imports from the developing countries, but leaves much room for improvement in terms of quota expansion" [36].

In April 1984, the Japanese government expanded the GSP quotas by 55 percent overall but this announcement was not very well received by either the East or the Southeast Asian countries. According to a Malaysian source, the increase was weighted in favour of products having little appeal to their exporters and a Taiwanese official suggested that the accompanying reduction in each country's maximum share of the total from half to a third was specifically designed to keep

"...out imports from [South] Korea and Taiwan" [37].

It is possible that the revaluation of the Yen will facilitate more manufactured imports by Japan not only of parts but also of finished products. One clearly discernible result of the revaluation of the Yen has been the surge of Japanese manufacturing investment in Southeast Asia. According to a report published in the Business Week in late 1986, much of this investment is geared to the promotion of 'triangular trade', under which Japanese manufacturers export to the U.S. goods manufactured in the low wage countries, thus by-passing the decline in the profitability of direct trade [38]. This might lead to a new set of problems between Japan and its Western trading partners since they could raise objections to an exclusively triangular trade on grounds that it implied a protection of the domestic Japanese market. However, we can hardly hold the Japanese government responsible for the actions of international capital. But more than that, it seems very unlikely that triangular trade would be the predominant concern of those Japanese firms engaged in manufacturing activities in the regional countries. They are, as Kitada Yoshiharu observed, unlikely to ignore the advantages of production in third countries to satisfy domestic demand in Japan, much like the strategy adopted by American television manufacturers [39].

The Pacific Economic Cooperation Conference, at its annual meeting in Bangkok in 1982 decided to set up a task force to study the question of manufactured trade in the region. The

report of the task force mentioned that a main obstacle for the developing countries trying to penetrate the Japanese market with their manufactured exports was the high degree of self sufficiency in manufactures in Japan, resulting from past protectionism and continued since then with informal barriers [40]. In so far as future prospects are concerned, it is clear that, unless Japan vacates those areas where the comparative advantage was shifting in favour of the regional developing countries, it will be difficult to achieve any meaningful restructuring of the trade patterns in the Pacific region. This leads us back to the issue of industrial structure and to the development of a horizontal division of labour. It should be noted here that in recent reports released by the Japanese government on the future of the economic structure, the term 'softization' of the economy appears to be gaining in importance. 'Softization' means not the weakening of economic resilience but rather the increasing concentration of economic activity at the upper levels of the technological spectrum. To the extent that the 'softization' of the economy proceeds as envisioned, there could be new opportunities for the regional countries to fill the vacuum created in the lower levels of industrial production and ultimately lead to the development of a genuine horizontal division of labour.

CONCLUSION.

We have, in this chapter, tried to identify a future problem area for the world trading system. At present, as documented, Japan's non-primary product imports from the regional countries of Asia is relatively low compared to the total of such exports for the ASEAN-ANIC group of countries. We suggested that Japan increase its manufactured imports from the regional countries so as to reduce the export dependence of these countries on the U.S. which might, otherwise, only shift the focus of American protectionism to these countries. The latter would, of course, reduce the pressures on Japan but would not lessen the protectionist threat to the system. As system supporters, it is postulated that Japan should not only manage its trading relations with the U.S. in a less conflictual way but also that it should help to create conditions that would contain the overall protectionist tendencies within the system.

It should be obvious from the argument presented in this chapter that the development of a horizontal division of labour would be a major contribution by Japan to the stability of the international trading system. Such an eventuality could be expected to lower the dependency levels of the ASEAN-ANIC bloc of countries upon the U.S. and this is important to prevent a repeat of the present crisis in the system with only some changes in the actors involved. It is not sufficient that Japan avoid being targeted as the system destabilizer in the U.S. but it is also

necessary that the ASEAN-ANIC group of countries are not forced into the position where they appear to be a replacement for Japan. To ensure stability and avoid protectionism in the largest market economy, Japan's positive contribution could be seen in terms of providing easier market access to the regional countries by fostering a greater degree of division of labour.

We suggest that unlike in the past, when Japan continued to be frustrated in its attempts to combine its regional and global interests, the present trading conditions in the region had created better prospects for combining the regional and global aspects of Japanese foreign policy. This requires a better understanding of the complementary nature of U.S.-Japan trade relations, on the one hand, and the triangular trade relations between the U.S.-Japan and the regional countries of Asia, on the other. While we do not deny the centrality of U.S.-Japan trade to the present crisis of the LIEO, the long term stability of the economic order cannot be divorced from the necessity of providing newer venues of trade diversification to the regional countries. Thus, it is understandable that Japanese tariff structure presently discriminate in favour of American exports to Japan over competing exports from the regional countries but it will become increasingly more important to reorder the tariff structure so as to provide better opportunities for the Asian countries. It could be argued that some structural reordering is already taking place. For example, under the present tariff structure on chicken exports, American boned chicken is allowed

entry with a tariff of only 62.7 percent of the tariff levied on boneless chicken export of Thailand. The Action Program of 1985 introduced lower tariffs that are to be introduced from April, 1987, but it also revised the tariff structure such that American chicken exports will face a tariff of 71.4 percent of that on boneless chicken exports. In concrete terms, this implies a lowering of the handicap for the Asian exporters of chicken. While this is a useful first step, we believe the crucial test will consist in the ability of the Asian countries to expand their manufactured exports to Japan, since this is the sector that is most likely to be the destabilizing force in the future.

Chapter Seven

CONCLUSION

This thesis has attempted to analyze the role of the supporter in the liberal economic system and as a modification of the hegemonic stability thesis. In the second chapter we provided the theoretical framework for this dissertation and argued that contrary to some opinion that a liberal order could be sustained on the basis of system wide cooperation, a leader is necessary for system stability in the long run. However, the relative decline of the United States had weakened its leadership function and we tried to find, in the concept of 'system supporter', a mechanism to stabilize the world trading system. We tried to apply this concept to Japanese foreign economic policies and assess the extent to which Japan was likely to adjust its policies and take on a larger burden within the system.

The role of the supporter, we argued, could be deduced from its interests in system preservation and was not necessarily predicated on cooperative behaviour, per se. We also suggested that a distinction should be made between a system supporter and a leader supporter and that congruence is neither necessary nor always possible. At the same time, we should not forget that Japan's interests in the preservation of the liberal economic order are primarily defined in terms of economic gains, given its vertical trade structure and trade dependence. American interests, in addition, also have a political dimension in that the liberal order was set up as an alternative to the Soviet system of domination. The addition of a supporter to the

leadership principle need not necessarily undermine the influence of the leader in the system, particularly as the leader of the system, the United States, was also the provider of military security for Western Europe and Japan, through NATO and the U.S.-Japan Security Treaty. Instability, however, could creep in if Japan acquired the defence potential that the U.S. is pushing for. That would reduce Japan's dependence on the U.S. and enable it to define its political interests in ways not totally coincident with those of the United States. Instability, therefore, may take the form of a greater divergence of political interests resulting in conflict. Thus far, Japan's military build-up has been kept to within narrow limits, the parameters being defined by the domestic consensus and the regional setting. However, Japan is not immune and insulated from the effects of American pressure and this may ultimately lead to a redefinition of the long term defence goals. This clearly points to a dilemma, whether recognized as such or not, for American policy makers, who must either temper their demands of Japan or be willing to accept and accommodate a more independent and assertive Japan. Although the latter is by no means a foregone conclusion, it cannot be ruled out either. A politically independent Japan might be more willing to come to some sort of agreement with the Soviet Union considering that Japan is unlikely to be able to enhance its security through military measures alone. Depending on how American and Soviet relations develop in the future, this could be an undesirable state of affairs from the American point

of view.

The system of joint leader and supporter is not visualized as having a formal institutional framework and requires only that the interests of the supporter not be totally ignored within the system. It is argued here that the supporter has a vested interest in ensuring the stability of the liberal trade system but that it also lacks the potential to take over the leadership function. This discrepancy between interest and power is postulated to be the basis of system support and this condition applies well to the case of Japan. As supporter, Japan will likely supplement the U.S. as a 'vent for surplus' within the system and undertake to shoulder some of the costs of system maintenance. Apart from this, and during periods of systemic crises, we may also witness the kind of policy coordination that was agreed upon regarding the exchange rate adjustments. However, unlike the views of Nakatani Iwao, who argued that the September 1985 agreement was a formal admission by the U.S. of its inability to lead and the onset of Pax-Consulitica, the position taken here is less radical. It may be premature to declare the end of Pax-Americana, although the relative changes that have transpired in the postwar period, necessitate a relative restructuring of the cost matrix [1].

This thesis found some evidence to support the view that Japan was actively striving to develop a role that would help to strengthen the liberal economic system. We argued that Japanese decision makers were aware of the responsibilities that

accompanied economic power but we also suggested that the ability to translate political will into action will require, as a precondition, the creation of a national consensus, a consensus of the kind Prime Minister Ikeda had achieved in the early 1960s concerning the doubling of the national income within the decade. The paralyzing effect of the lack of consensus could be discerned in our discussion of demand expansion in Japan.

As such, while we postulated that system support could be understood in terms of interest, it should be emphasized that there is no inevitability of interest-based system support. Just as the presence of a hegemon does not automatically lead to the creation of a liberal trading order, system supportive behaviour may not follow automatically from interests. It is this absence of a direct causal relationship between interest and support that makes the study of system support interesting and worthwhile. In the discussion of the specific case studies, we found that there was a clearly manifested awareness within the ranks of Japan's political leadership for a more supportive and active role in the trading system. Outside the political leadership, this awareness is also shared by certain segments of the bureaucratic structure. In this latter group, we could identify the Ministry of Foreign Affairs and the Ministry of International Trade and Industry, the former because of its functional responsibilities and the latter because of a dramatic reorientation away from protectionism and towards internationalism. The process of MITI's internationalization has been studied in considerable detail by

Chalmers Johnson and explained partly in terms of the rise of a younger and more liberal minded crop of officials and partly in terms of the changes in the international environment in the 1970s. The oil crisis of 1973 had a tremendous impact on the policy orientation of MITI officials since it highlighted the difficulties of regime maintainance in the face of hegemonic decline. As far as the trading regime was concerned, there was no reason to assume that things would work out differently which made it imperative that both the leadership function be strengthened and Japan's own position within the system be modified to ensure and enhance regime stability.

Nevertheless, it is also true that the main opposition to this line of reasoning is also likely to come from within the bureaucracy which is still relatively steeped in its conservative tradition of protecting domestic interests, as is the case of the Ministry of Health and Welfare. To simplify, therefore, it would appear that there is likely to emerge a split between the political leadership and the bureaucracy and while the former seems willing to respond to the international changes, the latter may still want to hold out. And, given the fact that, in Japan, political leaders have less effective control over the bureaucracy, progress may be, and has been, relatively slow. In Japan, the particular relationship between the political leadership and the bureaucracy pre-dates the postwar democratic reforms and suggests that the reforms themselves, instituted by the occupation authorities to establish party government, was

less than completely successful. In the interwar years, it was the relative weakness of political control over the bureaucracy that made the outbreak of hostilities inevitable and it is not difficult to discern a mood strongly suggestive of a 'Trade War' between Japan and the United States, today. As stated above, the political leadership in Japan is trying to build a more constructive consensus but consensus building is a time consuming process even in the best of times, but more problematic when economic conditions are adverse. Similarly, industrial restructuring in Japan could have been undertaken relatively smoothly if the economy had been performing well, but is exceedingly difficult now that the appreciation of the Yen has created hardships for many sectors of the economy. Still, the government is trying, even as many political analysts predict that it will lead to electoral setbacks for the ruling LDP.

We suggested that Western pressure had been useful in the past and remains a functionally useful tool but indiscriminate use of pressure can be dysfunctional, just as they were in the period leading up to the Japanese attack on Pearl Harbour. Pressure, when used injudiciously, can be used by the intransigent forces in Japan to highlight the futility of Japanese 'concessions' on grounds that the West is engaged in unfair 'Japan bashing' to divert attention away from its own internal problems. Thus, while pressure is useful, the exercise of pressure must be cautious and, in particular, crude retaliatory measures need to be avoided. In this latter

category, we can include the US\$300 million retaliatory tariff imposed by the United States on April 17, 1987 on Japanese electronic exports. This measure was taken in retaliation for the failure on the part of the Japanese government to implement an agreement reached the year before that would guarantee the U.S. manufacturers a 20 percent market share in Japan and bar Japanese manufacturers from selling in the U.S. at prices below production costs outside Japan. On top of the fact that the agreement itself was badly conceived, *Economist* magazine noted that blame was being unfairly assigned to Japan since many U.S. buyers, apparently convinced of Japanese sincerity to implement the agreement and cut production rushed to get their orders in before prices went up [2]. This retaliatory action also could not have been more ill-timed. In chapter five, we mentioned the tax reform package drawn up and approved by the LDP and part of a measure designed to reduce savings and expand levels of consumption. Prime Minister Nakasone and the LDP presently face a serious political crisis in the shape of popular and opposition parties' opposition to the tax reform package. Within the deteriorating political climate, the American retaliatory tariff has only served to further undermine the position of the Nakasone administration and strengthened the voice of those who feel that Japan has already gone too far in what is seen as Japanese 'appeasement' policies. If anything, this will make it even harder to develop the domestic consensus that the government has been trying to achieve.

To recapitulate some of the main findings of this thesis, we have argued that, in practical terms, system support implies both a broadly shared responsibility for system maintenance and a greater degree of policy coordination. A major portion of this thesis has dealt with the former issue although we did note the G-5 agreement as a clear example of policy coordination. The G-5 agreement revealed both the principle of interest aggregation as well as the centrality of the American position, since it could hardly have been achieved without American consent. In terms of Japan's role as the system supporter, we identified the auto dispute and its resolution as a prime indicator. MITI's positive attitude toward restricting Japanese car exports to the U.S. was largely motivated by its concern to help in the restructuring of the U.S. auto industry in recognition of the fact that it was a key component of the American economy and that successful revitalization of this sector was likely to dampen protectionism in the U.S. As far as the macro-level trade imbalance was concerned, specific steps recently implemented to further open the market in Japan were identified as evidence showing Japan's readiness to positively strive to control the destabilizing influences within the system. However, the macro-economic policy imbalance between the U.S. and Japan cannot be ignored either. To tackle the Investment-Savings imbalance in both countries, it is not sufficient that Japan increase its fiscal spending. There has to be a similar attempt in the U.S. to bring the federal budget deficit under control. The impact of the budget deficit

on trade imbalance was clearly stated by Bergsten and Cline, who wrote that, "The difference between the US financial balance and that of Japan rose from +1 percent of GNP in 1980 to -5 percent in 1984. The same large reversal occurred (by accounting definition) in the difference between the two countries' external balances. This growing divergence was the underlying factor driving the sharp rise in bilateral trade imbalance" [3].

In so far as Japan's market opening is concerned, it will be important for the future stability of the system, whether Japan remains, or is perceived to be, a closed economy, denying equal access to foreign manufactures. Of course, as the Japanese point out, market opening by itself cannot achieve anything unless there is a greater concomitant effort by foreign manufacturers to penetrate the market. The Japanese complain that Americans and others had made inadequate effort to respond to specific Japanese demand patterns and had therefore not been rewarded with market success.

Furthermore, while the focus of this thesis was on Japanese attempts to resolve the trade friction with the U.S. and the West, this should not be interpreted as implying an admission of guilt by Japan. Certainly, there are a large number of people in Japan and overseas who, correctly I believe, see the trade problem as involving blame on both sides. Both Shimomura Osamu, advisor to the Japan Development Bank, and Shinohara Myohei, Director of the International Development Institute, feel that the U.S. was largely responsible for the American trade deficit.

Shimomura, for example, writes that, "In 1982 the United States ran a current account deficit of only \$9 billion, but by 1985, that had swollen to \$118 billion. During this time Japan's current account surplus rose from \$7 billion to \$49 billion. Something happened to trigger this abnormal phenomenon, and the question is whether the change occurred on the Japanese side or the American side". Confident that the problem lies on the American side, he continues, "President Reagan must face up to the fact his tax-cutting and fiscal expansion policies have gone haywire" [4]. Even if we disagree that this was an accurate statement of the entire problem, it cannot be denied that there was at least some truth to this.

In recent years, the pace of liberalization of the Japanese economy has markedly quickened and we can expect this process to be continued. However, as we have emphasized, at several points in the text, total liberalization cannot be achieved overnight. The direction of change is unmistakable but it will take time, even though Japan has, on more than one occasion in the past, displayed the remarkable ability to transform itself very rapidly. One such occasion was in the mid 19th century when the Meiji Restoration ended the 250 years of isolation imposed at the start of the Tokugawa era. Although, the rest of the country bitterly opposed the opening of Japan and rallied to the popular cry of 'revere the emperor; expel the barbarian', they quickly adjusted to the new conditions. Edwin Reischauer wrote that, "The young aristocrats of Satsuma and Choshu [two outer ~~bars~~ in

southern Japan] saw how hopeless their efforts were against Western naval strength. They learnt their lesson at once, and demonstrating an amazing ability to reorient their thinking, they dropped all thought of a narrow policy of isolation and immediately began to study the techniques of warfare that had made the West so strong" [5]. Almost a century later, Japan demonstrated this same ability to reorient itself when it quickly adopted a democratic form of government after the Second World War and under American occupation. The Allied Powers, expecting strong resistance to their program of change, were pleasantly surprised at the ease with which Japan adapted itself to the new form of government. However, it would still be unreasonable to expect this same sort of transformation today. In the past two instances, the transformation followed cataclysmic events - the bombardment of Kagoshima (Satsuma) and Shimonoseki (Cho'shu) by American, British, French, and Dutch warships which demonstrated superior Western military strength, as well as the distinct threat of colonization; and in the latter instance the defeat in the Pacific War.

The Action Program for market liberalization did not constitute the third opening of Japan but it did represent both a major new initiative as well as an attempt to build a national consensus on the role and responsibilities of Japan in the international system. The culmination of the process may take time but at least the process is under way. In Chapter 6, we identified a potential future threat to the system resulting from

the excessive dependence of the ANICs and ASEAN on the U.S. as export market and suggested that Japan could help to defuse this potential threat by facilitating export diversification of the regional countries and by allowing greater access to its own market.

In this respect, a number of authors have suggested that Japan should provide ASEAN and other regional exporters special help and training to overcome their biggest obstacle to selling in Japan - the Japanese distribution system. For Narongchai Akrasanee, this could best be carried out in the private sector by the Japanese Keidanren and other business organizations [6], but the task force set up by the PEEC in October 1982 also envisaged a public sector role. According to the report of the task force:

....since positive actions are the most attractive, high priority should be given to the recommendation that governments and business provide marketing help to firms in the Pacific Basin. In reality, Japan would be called upon to be the major provider of such help since the Japanese market appears to be particularly difficult for foreigners to penetrate [7].

Although the role of supporters is likely to gain in significance in the future, it needs to be emphasized that regime stability will still require a strong and healthy economy in the leading country as well as a rebuilding of the domestic consensus on free trade. The latter point, however, will, to a large extent be determined by the objective economic indicators since it is quite obvious that protectionism becomes a rallying cry

during periods of economic decline. Below, we will discuss each of these two points.

Taking the last point first, one striking feature of the postwar developments in the U.S. has been the erosion of domestic support for liberal trade, especially within the ranks of organized labour groups. As our case study of the U.S.-Japan automobile dispute revealed, it was the UAW that triggered the dispute and continued to have a significant influence over the course of the dispute. It will be important for the future stability of the system that labour does not perceive itself to be the sacrificial lamb at the altar of liberal trade as well as to avoid conditions that, in fact, bring this about. To rebuild the domestic consensus it is imperative that acceptable mechanisms be found to make it easy for labour to make the transition from depressed industries to industries that display growth or the potential of growth.

In 1962, as part of the Trade Expansion Act, President Kennedy proposed the establishment of trade adjustment assistance (TAA) comprised of three main parts -- income maintenance (TRA); relocation benefits; and training. This was instrumental in securing the support of organized labour for the Trade Expansion Act but the actual implementation of the TAA was disappointing and succeeded only in antagonizing labour interests. As Steve Charnovitz wrote, "From 1962 to 1969, not a single TAA petition was approved....[Starting in late 1969 and]...over the next several years, only about 35,000 workers received TRA and very

few received training" [8]. Since then, the costs of TRA have continued to mount but the program has not been very effective because it has been used mainly as an additional unemployment compensation scheme rather than for job retraining and adjustment. It is not surprising, therefore, that American labour has been swiftly transformed into a vocal champion of protectionism, as a means of ensuring job security.

With respect to the other point, it should be noted that while exchange rate adjustments can restore external balance to a country's trade position, they are no substitute for flagging productivity and industrial dynamism. For the United States this is an important pending issue. Even though, under the projected new round of GATT Multilateral Trade Negotiations, the U.S. is placing particular emphasis on the liberalization of services trade, an area where the U.S. has an edge over its competitors (though not in all sectors of services trade), the future of the American economy cannot be built around the service industry alone. As R. Reich writes, "The nation's service exports depend on the vigor of its future manufacturing base. Approximately 90 percent of America's income from services consists of the investment income of its manufacturing firms...." [9]. Not only is the growth in services dependent upon the the state of the manufacturing sector, this particular sector of the economy is important for other reasons as well. Thus, even though the manufacturing sector accounts for only a fifth of the total employment in the U.S., "...it is often considered the fulcrum of

a modern economy, an important source of jobs and high wages, the major locus of productivity growth, the center of vital regional economies, and a crucial contributor to national defense" [10].

The authors of the Brookings study, however, find no evidence that the U.S. is deindustrializing or that "...structural change is accelerating, or that the country is suffering from some fundamental disadvantage in world trade" [11]. They conclude that the changes that affected the U.S. manufacturing sector over the past decade were normal and to be expected, given the global recession and a strong currency. Others, like B. Scott, find a declining ability of the United States to produce, distribute, and service goods in the international economy in competition with others. One of the factors behind this, he suggests, is the low ratio of net fixed investment to the GNP. The share of the gross GNP devoted to net fixed investment during the last decade in the U.S. was only 34 percent of the comparable share in Japan, and 56 percent of the comparable share in West Germany [12]. Scott suggests four factors that have contributed to the relative decline of the U.S.

1. an overvalued dollar.
2. mismanagement and complacency in the private sector.
3. incoherent, non-competitive government policy and the lack of an industrial policy, unlike the case of competing countries.
4. failure to learn from its competitors [13].

The problem of an overvalued dollar appears to have been

resolved through the G-5 agreement. To date, the dollar has declined by approximately 40 percent against the Yen, and there has been a similar decline against the major European currencies. The most critical weakness of the American economy is the fact that structural adjustments have tended not to keep pace with changes in the international division of labour. Instead of adjusting to global structural changes, much of the energy has been devoted to fighting the current of change and in the process the American economy has done only marginally better than stand still.

The emphasis in the private sector has been to preserve and protect an existing line of products through protecting the domestic market rather than evolve new product lines. The latter, of course, is both more risky and costly and structural adjustment, therefore, has been avoided to the extent possible. To a large degree, this has been possible because the U.S. economy is large and it is clearly understood that if it could be protected from the foreign onslaught, it could suffice to ensure profitability of the domestic industries. While acknowledging exceptions to the rule, industries in the U.S. have not been as internationalist in their outlook as their counterparts in competing countries.

In contrast, Japan provides an excellent example of adopting to international conditions. For example, when the regional countries emerged as textiles exporters, Japan gradually moved out of basic textiles manufacturing and later when the ANICs

surged ahead with steel production, "...Japan reduced its domestic steel making capacity and became a major exporter of steel technology - engineering services and equipment" [14]. Reich argued that the solution to the American malaise was not through 'paper entrepreneurship' -- diversification through corporate take-overs and acquisition but rather through the adoption of 'flexible system of production'. Standardized production should be left to the NICs and the developing countries which have a comparative advantage in the production of these goods and American firms should continuously attempt to upscale their existing product lines. Flexible system production does not require abdication from the traditional sectors - steel, automobiles etc. - which are the gateway to new products and processes but rather requires learning from the other industrialized countries which are "...seeking to restructure them toward higher value-added and technologically more sophisticated businesses...." [15]. There is no certainty, however, that this can be achieved through market forces and particularly where the government cannot help but be responsive to industry pressure for protection. This, however, is the negative function of the government and it has been argued that what is required now is a more positive governmental role in the economy. Thus, it is argued that the government should develop an industrial policy to provide a blueprint for industrial development and for industrial restructuring. Of course, most of the countries do have an industrial policy, but it is also true

that success is by no means guaranteed as in the case of the United Kingdom where industrial policy has been based on the regional concept as opposed to the sectoral concept that Japan and France adopted. America, too, has an industrial policy but it is, writes Muller and Moore, of "...the worst sort, - implicit, ad hoc, uncoordinated, and poorly administered" [16].

Thus, it is not simply a question of having an industrial policy. What is important is that the industrial policy be intended to promote international competitiveness. If anything, American industrial policy has been inward looking and protectionist, as opposed to the outward looking and export oriented model adopted by Japan and the newly industrializing countries of Asia. For protectionism in America to abate, it will be necessary to reinvigorate the industrial sector such that it can withstand foreign competition.

In the case of automobiles, as we saw, Japan's primary concern was to see the American auto industry rehabilitated. The VER was intended to facilitate this but its success can be attributed to the structure of the American auto industry and the domination of GM. At the time of the auto dispute, the call for restricting Japanese imports came mainly from Ford, Chrysler, and the UAW but not GM, which was more afraid that restrictions on Japanese car imports would cause its market share to climb which might then increase its vulnerability to anti-trust action. However, GM did take advantage of the VER to modernize its plants and facilities and in doing so, forced Ford and Chrysler to

follow suit, resulting in an overall improvement in the state of the auto industry.

However, the auto industry is just one sector of the economy and just as one swallow, does not herald the onset of spring, revitalization of the American economy, too, will require a more broadly based improvement. This demands a concerted effort by industry, labour, and the government to raise domestic productivity and international competitiveness. Only then will the threat to the liberal trading regime subside.

NOTES

NOTES TO CHAPTER TWO

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36. In this regard, this report differed quite markedly from the report presented to President Ronald Reagan in March 1981, recommending relief to auto industry. There was division within the Reagan administration as well, but the report of the Transportation Secretary, Lewis, was only presented once consensus had been reached.
37. NYI, July 9, 1980. Section IV, p. 4.
38. NYI, July 9, 1980. Section IV, p. 4.

39. Nihon-Keizai-Shimbun (NKS) (Yukan), September 19, 1980. p. 1.
40. NYI, February 28, 1980. p. 22.
41. NKS (chokan), September 20, 1980. p. 1. See also, Kusano, A., Nichi-Bei-Keizai-Masatsu-oo-Kozo, Tokyo. 1984. p. 137.
42. Ibid. The U.S. has three pieces of anti-trust legislation on the books: The Sherman Act of 1890, The Federal Trade Commission Act of 1914 (amended 1937), and the Clayton Act of 1914 (amended 1936 and 1950). Section 1 of the Sherman Act very specifically states that "every contract, combination....or conspiracy in restraint of trade or commerce among several States, or with foreign nations, is hereby declared to be illegal". The FTC Act is somewhat less clearcut but the result is still the same.
43. Patrick and Sato, Qa-gi, p. 200.
44. NKS (chokan), September 23, 1980. p. 2.
45. By law, a decision must be handed down within six months of a petition, in this case by December 12, 1980. However, the ITC had already made known its intention to submit its decision to the President in early November, in order to stay clear of election politics [check].
46. NYI, November 11, 1980. p. 1. The Chairman of the Commission voted against the petition but also criticized Japan. See, Yano, T., Isusao-Seisaku-oo-saiko-oo-Juyo-Kadai: Rooki-Masatsu-o-Chushin-to-shite, Nihon Keizai Chosa Kyogi Kai, December 1980. p. 15.
47. Obi, T., "'Nihon sha Shime Dase' was Shosu Iken Da", Shukan-Ioyo-Keizai, April 4, 1981.
48. NKS (yukan), March 18, 1981. p. 1.
49. "O Katame no Nichi-Bei Tsusho Senso- Suzuki Ho Bei mae ni Osuji Ketchaku e", Shukan-Ioyo-Keizai, April 4, 1981.
50. Ibid, p. 24. See also, NKS (yukan), March 25, 1981, and Amaya, N., Isusho-Masatsu-to-Nichi-Bei-Kankei, Nihon Keizai Chosa Kyogi Kai, Tokyo. 1984. pp. 9-10.
51. NKS (yukan), April 7, 1981. p. 1.
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53. NKS (chokan), April 10, 1981. p. 1.
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55. NKS (yukan), April 18, 1981. p. 1.
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61. *Ibid*, p. 109
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64. NKS (chokan), March 29, 1981. p. 3.
65. Hargrave, E.C., and Morley, S.A. (eds.), *The President and the Council of Economic Advisors: Interviews with CEA Chairmen*, Westview Press, Boulder, Colo. 1984. The two quotations are taken from pages 474 and 481, respectively.
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69. Amaya discusses the Chonin no Kokka ron in *Nihon Kabushiki Kaisha*, *Op. cit.*, pp. 35-44.
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71. Amaya, N., *Isushe Masatsu to Nichi-Bei Kankei*, *Op. cit.*, p. 10.
72. NKS (chokan), March 21, 1986. p. 4.
73. Miyake, Y., "Hiki Suzuki Shijo Teimei ni Nayamu Beikoku Jidosha Sangyo", *Isushe Journal*, October 1981.
74. *The U.S. Automobile Industry*, Report to the Congress from the Secretary of Commerce, December, 1984. p. 28.
75. Interview, Mr. S. Kawaharada, Nissan Motor Co. Ltd., Tokyo. Prior to the VER, it was estimated that the cost advantage

of Japanese manufacturers of sub-compacts was about US\$2000 compared to the U.S. manufacturers. See, Ihg-U.S. Automobile Industry-1981, Report to the Congress from the Secretary of Transportation; and Kawaharada, S., Jidosha-Sangyo-Ron, (unpublished), 1985. p. 30. According to the report of the Secretary of Transportation, the cost advantage of Japanese sub-compacts landed in the U.S. was about US\$1700.

NOTES TO CHAPTER FOUR

1. On top of the surplus in trade with the U.S., Japan had an overall trade surplus of about US\$ billion in 1985. A large part of this surplus was, however, due to declining commodity prices. „
2. According to one unofficial but reliable source, despite the public pronouncements, the U.S. government had informally indicated to Japan the need to restrict the total quota to under 2.2 million units.
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4. Asahi Shinbun (Sunday), January 26, 1986. p.9.
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8. Curran, T.J., "The Politics of Trade Liberalization in Japan", in Katz, J.D., and Friedman-Lightschein (eds.), Japan's New World Role, Westview Press, Boulder, Colo. 1983. p.
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10. The Japan Times, January 29, 1986. p.11. At a press conference on the 13th at the Foreign Correspondents' Club, Tokyo, Senator Danforth stated that the trade problem was no longer issue specific but one of a general nature. See, Asahi Shinbun (Chokan), January 14, 1986. p.9.
11. Kaoru, M., Op.cit., 1985. p. 8 .
12. The two sets of statistics are taken from OECD Economic Outlook, No. 38, December 1985; and World Economic Outlook, IMF, Washington, D.C., April 1985. p. 131 [check]
13. Ogura, K., Nichi-Bei Keizai Masaisu, Nihon Keizai Shinbun Sha, Tokyo, 1984. p.100.
14. Matsuda, M., "O-Bei Sho Koku to no Boeki Mondai no ichi Shiten: Seihin Yunyu hiritu Hijyo Yoso no Datosei ni tsuite", Boeki to Kanzei, Japan Tariff Association, March 1986. p.36.
15. Matsuda, M., Ibid, 1986. p.38.

16. "Foreign Barriers to U.S. Trade..." *Op. cit.*, p.5ff.
17. Speech given at the Japan Society, New York, February 6, 1984.
18. Yomiuri Shinbun, (Sunday), March 2, 1986.
19. Asahi-Shinbun (Yukan), January 11, 1986. p. 1.
20. About 40 years ago, when the Bretton-Woods system was being put together, the U.S. insisted that trade adjustment was the responsibility of the deficit, not the surplus country.
21. Ibe-Japan Times, January 29, 1986. p.11. (emphasis added).
22. Higashi, C., *Japanese Trade Policy Formulation*, Praeger Special Studies, New York, 1983. p.122. See also, Kitamura, H., Okazaki, H., and Murata R., *Nichi-Bei-Kankei-o-Ioi-tsumeru Sekai no Ugoki Sha*, Tokyo, 1983. p.163.
23. Olsen, E., "'Cheap rider' e no Fuman", *Shun-Koron*, December 1985. p.51.
24. To rectify the perception gap, the Ministry of Foreign Affairs, in February 1986, announced an Action Program to promote better understanding between Japan and the U.S. The program calls for a campaign of speeches by Japanese Embassy and Consular personnel in the United States to disseminate proper information to the general public as well as to the members of the Congress. See, Yomiuri Shinbun (Chokan), February 4, 1986. p. 2.
25. Higashi, C., *Op. cit.*, 1983. p.122.
26. Interview with JETRO official (Overseas Research Dept.), Tokyo, January 1986.
27. Kitamura, H., et. al., *Op. cit.*, 1983. p.177.
28. Foreign Barriers to U.S. Trade..." *Op. cit.*
29. Asahi-Shinbun (Chokan), September 28, 1985. p.
30. Writing in the early 1970s, the period of high economic growth, James Morley suggested that a 1% increase in defence spendings would reduce annual GNP growth by only about 0.4%. See, Morley, J.W., "Economism and Balanced Defence", in Morley, J.W. (ed.), *Forecast for Japan's Security in the 1970's*, Princeton University Press, Princeton, NJ, 1972. p. 25.
31. Kamijo, T., *Baikoku-oo-Udezi-Nihon-oo-Ie*, Nihon Keizai Shinbun Sha., Tokyo, 1985. p.181.

32. Japan Economic Research Institute., Analysis of the Degree of Openness of the Japanese Market, August 1984, p.11.
33. "Multilateral Trade Negotiations/ International Codes Agreed to in Geneva, Switzerland, April 12, 1979", House of Representatives, Committee on Ways and Means, 96th Congress, Washington, D.C., April 23, 1979. p.245.
34. "Foreign Barriers to U.S. Trade..." QDA-511A, p.18.
35. Japan Economic Research Institute, QDA-511A, p.18.
36. Maishichi-Shimbun (Yukan), January 13, 1983. p.1.
37. The Japan Times, March 31, 1983. Editorial.
38. Standards and Certification System in Japan: Measures for Improving Market Access, The Intra-Governmental Council on Standards and Certification Systems, [No Date], p.3.
39. Matsushita, K., Nichi-Bei-Isshuo Masaisu-ou Ho-Ieki-ko-Iso, Yuhikaku, Tokyo. 1983. p.280.
40. The full text of the law appears in the annual compilation of laws, Roppo-Zenshu. The original appears in pre-1983 editions and the revised text in later editions. The Japanese title of the law is 'Shohi Seikatsu yo Seihin Anzen Ho'.
41. "Progress in Implementing the Action Program for Improved Access", News from MII, NR-317 (86-2), February, 1986.
42. Matsushita, K., QDA-511A, 1983. p.278.
43. "Report of the Advisory Committee for External Economic Issues", April 9, 1985. p.2.
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