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The Economic and Policy Context

The United States and Japan are the two largest national economies in the world. In the century and a half since the forcible opening of Japan by Commodore Perry's Black Ships in 1854 and the conclusion of the "unequal" Treaty of Amity and Commerce in 1858, the two countries have experienced both a dramatic increase in economic integration and intermittent conflict on a range of issues from trade to finance and macroeconomic policy. In the 1940s, these tensions were a contributing factor to the outbreak of military hostilities between the two giants.

Since the conclusion of the Second World War, policymakers in both countries have built robust economic, political, and security ties, forging what has been called "the world's most important bilateral relationship bar none." They have also experienced severe economic conflicts, however. The United States has in fact maintained, during at least the quarter-century from the early 1970s to the middle 1990s, a unique Japan-specific economic policy that was quite different from its approach toward any of its other major trading partners or the world's other large economies.

This book is about the future of economic relations between Japan and the United States. That relationship turns on three key sets of variables. One, which we will argue is decisively important, is the state of each country's economy and their relative positions in the world economy. The second is the overall status of each country in the world as a whole, including its security and broader political dimensions. Third come the specifically bilateral features, both economic and political, of the relationship between the two, which are also of great salience but must be seen within the broader economic and security contexts. All three sets of determinants have changed dramatically during the past decade.

There are four potential paths for US economic policy toward Japan in the coming period. One is to maintain the unique Japan-specific approach of the past three decades, which we believe has become more and more anomalous, and should now be explicitly jettisoned. A second, at the other extreme, is to essentially ignore Japan in the years ahead—a ''bypass-Japan'' strategy, which some US companies have in fact adopted in devising their own policies toward Asia. A third is to pursue ''deep integration'' with Japan, via a free trade agreement (FTA) or even more far-reaching effort to link the two economies, in an ambitious bid to sweep aside the problems and frustrations of the past with an expansive political initiative. The fourth is a middle course, in which Japan is still important but is treated like any other major economic power or trading partner of the United States (Canada, the European Union, or Mexico), mainly through multilateral channels and institutions.

We will outline the four alternatives later in this chapter and conclude that the last of them, the treatment of Japan as a ''normal country,'' is the best policy for the United States and for the relationship in the foreseeable future.[1] We will suggest that actual policy is already moving in this direction, but recommend that the new approach be explicitly announced as soon as possible, to clarify its adoption and to inform the myriad actors in both countries (and around the world) of the change. We will outline the four alternatives after first spelling out the context for the new policy.

A Reversal of Fortunes

As recently as the early 1990s, Japan was widely viewed as the strongest economy in the world, and there were extensive doubts about the fundamental health of the US economy. Despite the highly adverse effects of two oil shocks in the 1970s and the *endaka* (strong yen) episode of the middle 1980s, Japan had averaged almost twice as rapid growth as the United States for three decades (table 1.1). Japan's per capita income passed that of the United States in the early 1990s and was more than 40 percent higher (at market exchange rates) in 1995. Measured unemployment in Japan generally remained less than one-third the recorded US level. Japan, with less than half the population of the United States,

1. To clarify, we mean the phrase ''normal country'' in a literal, generic, or nonspecific way—not in the particular sense sometimes attached to this phrase in Japanese domestic politics. That issue—of whether, e.g., Japan should revise its Constitution to enlarge the permissible scope of military activities—will be taken up in chapter 6.

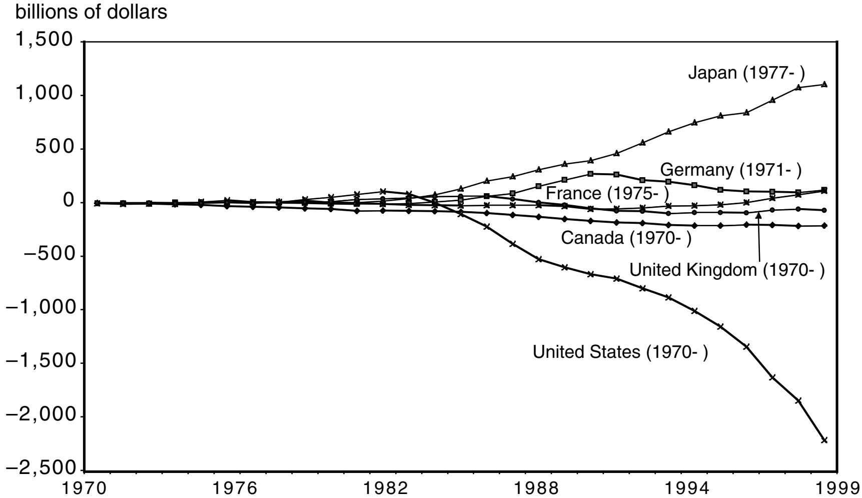
Table 1.1 GDP, per capita income, and unemployment in Japan and the United States, 1950s-2000

Measure	1950s	1960s	1970s	1980s	1990s	2000
GDP growth rate (percent)						
Japan	n.a.	9.1	4.4	3.9	1.2	1.5
United States	n.a.	4.4	3.3	2.0	3.0	4.1
GDP market exchange rate (billions of dollars)						
Japan	30	95	537	1,739	4,126	4,895
United States	395	718	1,665	4,066	7,341	9,873
Per capita income (at market exchange rate)						
Japan	324	952	4,782	14,380	30,403	38,690
United States	2,621	3,733	7,757	17,154	28,011	36,478
Per capita income (at purchasing power parity)						
Japan	n.a.	7,008	12,842	17,189	23,303	24,041
United States	n.a.	15,583	19,833	24,175	29,586	30,600
Unemployment rate (percent)						
Japan	n.a.	1.3	1.7	2.5	3.1	4.6
United States	4.5	4.8	6.2	7.3	5.8	4.0

n.a. = not available.

Sources: IMF, *International Financial Statistics*; US Department of Labor, Bureau of Labor Statistics (for unemployment data).

Figure 1.1 Cumulative net capital outflows, 1970-99



Source: IMF, *International Financial Statistics.*

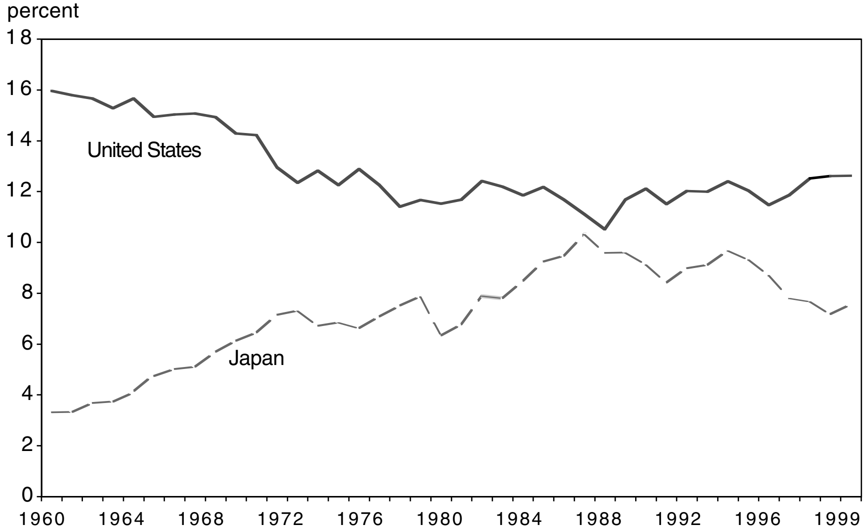
achieved a total GDP (at market exchange rates) that was only 30 percent less than the total GDP of the United States as late as 1995.[2]

International indicators painted an even starker picture. By the middle 1980s, Japan had become the world's largest net capital exporter and the world's largest creditor country by a large and growing margin over runner-up Germany (figure 1.1). The United States, which had been the world's largest creditor country as recently as the early 1980s, had become the world's largest net capital importer and debtor country by a huge margin over runner-up Canada. The US share of world exports declined steadily, while Japan's share rose sharply into the middle 1980s, almost equaling that of the United States at one point (figure 1.2).[3] Japanese firms bought sizable shares of US industry and property throughout the 1980s, while US investors remained minor players in Japan. In 1990, Japan

2. The significance of many of these statistics can be challenged. As will be discussed in chapter 4, the data on incomes converted to a common currency at market exchange rates overstate the true comparative level of income in Japan. Similarly, differences in definitions mean that similar levels of true unemployment result in lower measured unemployment in Japan. What is indisputable, however, is that according to a variety of measures, correctly interpreted, the Japanese economy substantially outperformed the US economy during this period, and that Japan's superior performance was widely perceived by both the elites and the broader publics of both countries—and viewed as a "threat to American dominance" by many in the United States.

3. This is true even when the share of US multinational firms producing from foreign locations is taken into account.

Figure 1.2 US and Japanese shares of world exports, 1960-99



Note: Figures include only exports of goods, not of services.

Source: IMF, *International Financial Statistics.*

replaced the United States as the world's largest donor of foreign assistance, and it steadily increased its margin throughout the decade.

These macroeconomic developments were replicated, and in many observers' eyes magnified, at the industry-specific level. Japanese-based firms seized large chunks of world market share from their US (and other foreign) competitors in a host of key industries. Japanese companies produced more than 50 percent of world semiconductors as late as 1989, while US companies' share hovered below 40 percent. Similar developments had already occurred in automobiles, numerous consumer electronics products, and (in an earlier period) steel. Japanese banks appeared to dominate world finance, in 1990 accounting for the top 5 banks and 6 of the top 10.

Moreover, Japan's region was clearly the most dynamic in the world. ''Asian tigers'' and ''the Asian miracle'' became household terms, partly due to the impact of Japan's own development on its neighbors, partly due to the active engagement of Japanese companies, and partly through emulation of Japan's ''economic model.''[4] Latin America, the backyard of the United States, was by contrast suffering through the debt crisis and ''lost decade'' of the 1980s.

4. See World Bank (1993).

This pattern originated in the 1960s and broadly persisted throughout the 1970s and 1980s. Hence it seemed sufficiently grounded to constitute an established trend and to justify extrapolation into the future. Ezra Vogel, a leading US expert on Asia, already proclaimed *Japan as Number One* in 1979.[5] Clyde Prestowitz, an experienced trade negotiator with Japan, posited the *Trading Places* of the two countries. The so-called revisionists—Fallows, Johnson, van Wolferen, and Prestowitz—argued that the United States could recoup only by simultaneously adopting much of the Japanese system and declaring economic war on Japan itself, without regard to the likely negative impact on the security relationship between them (see especially Johnson 1982, Fallows 1989, Prestowitz 1988, and van Wolferen 1989). By the late 1980s, surveys regularly showed that far more Americans were afraid of Japan than of the Soviet Union (James 2000).

US policy responded to these perceptions and pressures. As will be detailed below, a succession of presidential administrations from that of Richard Nixon to that of Bill Clinton, under strong pressure from the Congress and large parts of the business community, adopted Japan-specific approaches that were unique to the foreign economic policy of the United States. Despite the continued centrality of the security relationship, Japan was the target of a series of sharp economic attacks from the United States, ranging from the ''Nixon shocks'' of 1971 (which were both economic and political) to the ''managed-trade'' initiatives of the middle 1980s to middle 1990s. The United States coerced Japan into a series of bilateral ''dialogues,'' ''initiatives,'' and ''frameworks'' to pursue US concerns that stood alone in the annals of global economic relationships.

The seeming verities of less than a decade ago appear surreal at the outset of the 21st century. Economic growth in the United States has been more than double that of stagnant Japan for a decade, reversing the ratio of the previous 30 years (table 1.1). After more than a decade of steady expansion, interrupted only by the brief recession of 1990-91, US domestic demand growth accelerated to 5 percent annually in the late 1990s—relative to 1 percent for Japan throughout the decade, including two recessions and perhaps a third in 2001. Consensus estimates in the two countries suggest that the sustainable trend growth is now at least 50 percent higher in the United States—3 percent a year, versus 2 percent in Japan—because US productivity growth substantially exceeds Japanese productivity growth and is widely expected to continue to do so, absent significant reform in Japan; and because the US labor force will continue to expand, whereas Japan's is already declining owing to the aging of its population and its resistance to immigration. This resurgent US economic performance was led by many of the high-technology sectors that were widely viewed, less than a decade earlier, as under intense threat from

5. He also, however, perceptively sensed the *Comeback* of the United States (Vogel 1979, 1985).

Japan. Even measured unemployment in the United States fell below that in Japan by the end of the decade.

Government finances exhibit similarly dramatic reversals. The government of ''thrifty'' Japan has now run annual budget deficits of more than $300 billion, larger in absolute terms than have ever been incurred by the United States, and the largest as a share of GDP of any country belonging to the Organization for Economic Cooperation and Development (OECD). Japan's national debt has reached $6 trillion and is still climbing, whereas US debt peaked at about $5 trillion and is now declining rapidly. In 1999, the Government of Japan replaced the United States as the largest issuer of government debt, and the OECD projects that it will undertake more than 90 percent of net OECD debt issues in the coming years.

Sectoral data naturally mirror these aggregate shifts. In contrast to a decade earlier, when Japan accounted for the world's 5 largest banks, by 2000 Japan provided only 2 of the top 10. The profitability of Japanese banks lagged behind their European and US counterparts throughout the entire 1990s. After a series of capital injections beginning in 1998, Japanese banks are still far from being strong in their balance sheets and earning power. They are still withdrawing from foreign operations. Even in the traditional manufacturing sectors, such as automobiles, US companies have improved their positions vis-à-vis most Japanese firms. Respected authors now ask *Can Japan Compete?* (Porter, M. Sakakibara, and Takeuchi 2000) and note that Japan's performance has been slipping, even in its most successful industries.

Regional developments appear to replicate these swings in national fortunes. The Asian financial crisis of 1997-98 derailed the ''miracle economies,'' at least for a while, and exposed weaknesses in financial systems and corporate governance that undermined confidence in Japan itself and its entire ''economic model.'' Latin America continues to have its troubles, but the creation of the North American Free Trade Agreement (NAFTA) and Mercosur have imparted new bursts of dynamism to the largest countries in the region.

To be sure, a few elements remain unchanged. Some Japanese auto and electronics firms remain at the top of their world leagues. US external deficits have continued to grow sharply, and its net foreign obligations stand far above all others', now exceeding $2 trillion (about 20 percent of its GDP). Japan's external surpluses remain the largest in the world, as does its net creditor position of about $1 trillion (about 25 percent of GDP[6]).

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6. Paradoxically, Japan is running the largest domestic deficits of any OECD country while remaining the world's largest creditor in external terms; whereas the United States is still the world's largest international debtor, even after converting its domestic budget position into a substantial surplus.

Moreover, the United States confronts a series of vulnerabilities that are somewhat reminiscent of those faced by Japan in 1990. The most obvious in the short run are macroeconomic uncertainties due to possible further declines in the still richly valued stock market, a possible decline of real estate prices in some regions, and consequent reverberations in the banking sector; there are many who still believe that the United States is a ''bubble economy'' à la Japan a decade ago. The United States also faces a possible sharp change in the external value of its currency, most likely in the downward direction, whereas Japan's problems in the early 1990s were subsequently compounded by a record appreciation of the yen; a major fall in the dollar while the US economy was still near full employment could lead to a substantial rise in prices and interest rates, and hence a plunge in the financial markets, that could sharply deepen the turndown of 2000-01.

The United States also continues to face a number of more deep-seated economic problems. It is unclear whether the sharp rise in productivity growth, which fueled the dramatic rise in output in the second half of the 1990s, will turn out to be sustainable. The private savings rate is abysmally low and partly explains the country's large external deficits and dependence on foreign capital. The US primary and secondary education system, although gradually improving and clearly a high priority of national policy, remains inadequate to equip many Americans to compete effectively in a globalized, high-technology world economy. Partly as a result of these educational deficiencies, the United States has experienced a domestic backlash against globalization for almost a decade that could limit the country's ability to reap the benefits from further internationalization of its economy.

But the economic underpinnings of the Japan-United States relationship have virtually reversed during the past decade. Indeed, it is abundantly clear that Japan's economic problems of the 1990s, which continue as this book is completed, are far greater than those of the United States in the 1970s and 1980s. We leaned against the wind of ''Japanaphoria'' and ''Ameropessimism'' a decade ago (Bergsten and Noland 1993), but no one even came close to predicting either component—let alone both ends—of the turnabout of the past decade. Those who extrapolated from the past have been proven decisively wrong.

Indeed, Japan's weakness rather than its strength has become the greatest concern of the United States (and the rest of the world). Since 1998, there has been recurrent fear of a true implosion of the Japanese financial system—runs on banks, widespread failures and defaults, withdrawals of funding around the world by the world's largest creditor country, free falls of the stock market and the currency, and a renewal of financial crisis in East Asia and perhaps the entire world. This shift in the nature of ''the Japan problem,'' and perceptions of it, dramatize the reversal of the past decade.

Japan will of course eventually overcome this crisis, as it has so many others in the past, and restore at least a modicum of economic growth. But Japan also faces important long-term problems. The most notable is an aging population that, on current trends, would lead to a halving of its total population by 2050. Hence there is reason to believe, from both the US and Japanese perspectives, that an important part of the "reversal of fortunes" of the last decade will persist.

This book is about future economic policy between the United States and Japan. Hence it is essential that we attempt to assess the future course of the two economies as one important starting point for the analysis and subsequent prescriptions. This, in turn, requires us to try to explain both the performance reversal of the past decade and its implications for future developments.

Was the shift simply a temporary phenomenon based on an inevitable US recovery from its policy errors and economic woes of the 1970s and early 1980s, and on a series of Japanese mistakes that should be avoidable in the future? Even worse, did it simply reflect a US bubble à la Japan's bubble a decade earlier that could burst at any moment and throw the United States back to slow growth or even renewed stagflation? Indeed, could Japan come back strong during the next 5 to 10 years, as the United States did after *its* earlier "decade(s) of decline"?

Or does the reversal of the 1990s represent a lasting change, with the United States seizing a permanent lead in the technology revolution of the modern era and Japan continuing to decline due to its structural rigidities and aging population? Does the answer lie somewhere in between, with the United States likely to keep doing reasonably well, if not as well as in the late 1990s, and with Japan resuming at least some of its traditional dynamism and thus creating a world where the two largest national economies are moving ahead roughly in tandem? What would be the implications for the Japan-United States economic (and overall) relationship of these very different relative economic patterns?

Chapter 2 will attempt to answer these questions for the United States, assessing both the structural changes that have transpired within the US economy and the macroeconomic record. Chapter 3 will provide a similar analysis of Japan. Our emphasis in both cases will be on the likely persistence of the radical changes of the past decade, the outlook for the future, the interaction between the two economies, and the implications of all these developments for policy. Our goal is to discern the economic foundations for the relationship that are likely to prevail for the next decade or so, recognizing the huge errors that any similar effort of 10 years ago would almost surely have made and hence the inherent uncertainty of the exercise.

Before turning to the underlying economics, however, it is essential to consider the other two dimensions of the relationship. We will thus review briefly the two countries' overall global positions and the specifically bilateral interactions between them during the past three decades.

The Global Positions

These dramatic changes in the economic performance of the two countries have of course also affected their overall global positions. The strong economic resurgence of the United States has strengthened its status and prestige, and restored luster to both "the Anglo-Saxon model" and US "soft power." Conversely, Japan's decade of stagnation or worse, along with the broader Asian crisis, have dimmed the Japanese star that shone so brightly a decade ago.

In addition, the demise of the Soviet Union and the end of the Cold War resulted in a decline in the relative importance of US security alliances, including its alliance with Japan. The revisionists and other "economic hawks," who favored a much tougher stance in US trade negotiations with Japan, argued that the United States had always deferred to Japan for security reasons but could now follow their advice. The Clinton administration indeed adopted a hard line on trade matters in its first couple of years in office and then, after a short hiatus, instituted an equally tough approach on macroeconomic and monetary issues during its second term. We will evaluate those efforts in chapter 5, but it is clear that the epochal change in the global security situation was a key enabling factor.[7]

However, this tendency has been tempered by the rise of China, which presents major challenges to both the United States and Japan in both security and economic terms. In the case of the United States, China's perceived challenge had already led to a reevaluation of security matters as early as 1995-96, leading to the Nye Report on strengthening the military alliance with Japan and contributing significantly to the reduction in US economic pressures. It was demonstrated again during the George W. Bush-Junichiro Koizumi summit in June 2001, where economic issues largely took a back seat.

For Japan, China presents a challenge to its vision of its unfettered role as the regional leader of Asia and the go-between intermediating between the developing countries of the Asia-Pacific region and the rich industrial countries of the OECD. This vision has in fact been shattered by the concomitant rise of China and the stagnation of Japan itself. Japan is still

7. The only period of comparably "tough" US economic policy toward Japan was 1971-73, with President Nixon's import surcharge and threat to use the Trading with the Enemy Act to bludgeon Japan into new restraints on its textile exports to the United States. That episode occurred when Japan was just emerging as a global economic power, however, and remained totally dependent on the United States for security.

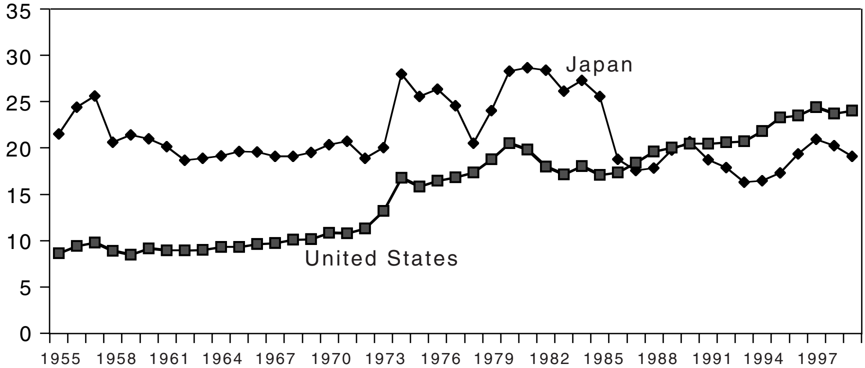
far richer and more technologically advanced than China, and its trade flows and financial markets remain much larger than those of its neighbor. However, according to some estimates of national output converted at purchasing power parity equivalents, China has now exceeded Japan in terms of total GDP (and become the world's second largest economy, trailing only the United States). Moreover, China possesses considerable military assets (including nuclear weapons) and appears to have much greater confidence in asserting its influence, regionally and even globally.

Japan's relations with the rest of Asia have of course been plagued throughout the postwar period by memories of its imperialist adventures earlier in the century and its perceived failure, by contrast with Germany, to come to terms with its past. But the rise of China has, for the first time, confronted it with a real rival for regional leadership. Hence it has had to undertake major efforts to recoup its position, sometimes stumbling badly (as with the failed proposal for an Asian Monetary Fund in 1997, torpedoed by China as well as by the United States) and sometimes more successfully (as with its efforts to help the Asian countries in crisis to recover by providing them with strong financial support in 1998-99).

Neither the United States nor Japan covered itself with glory during the Asian financial crisis. Japan's huge policy errors in 1997—primarily its sharp tax hikes when the economy was still stagnating (Posen 1998), and implosion of the financial system with failures of large financial institutions (Cargill, Hutchison, and Ito 2000)—threw its economy into recession and the yen into sharp depreciation, helping trigger and then deepen the crisis (Noland et al. 1999). The partial recovery of the most heavily affected crisis countries has occurred despite the continued stagnation of Japan, however, belying the notion that Japan was essential to regional prosperity. Conversely, Japan's provision of large credits to the recovering Asian countries has been appreciated by its recipients, in contrast to their perception of a grudging and at times opportunistic response on the part of the United States.

Emerging out of this sense of disappointment with, and even abandonment by, Washington and the international financial institutions headquartered there, appears to be a serious attempt by Asia, for the first time in history, to create regional economic arrangements that would reduce its dependence on the West and the global economic institutions—especially the International Monetary Fund (IMF), but also the World Bank and even the World Trade Organization (WTO) (Bergsten 2000). The outcome of these efforts remains unclear at this time but, as with the Asian Monetary Fund debate in 1997, they may at some point force Japan to make tough choices between its Asian neighbors (seeking greater self-determination) and its US ally (wanting to preserve dominance for the "Washington consensus").

Figure 1.3 Exports and imports, 1955-2000 (as percent of GDP)



Source: IMF, *International Financial Statistics*.

The quest for meaningful Asian regional arrangements, even if confined to the economic domain, may ultimately turn on whether Japan and China can get together, to provide joint or at least cooperative leadership for the exercise, as Germany and France did in Europe. That issue will also pose tough choices for the United States, basically similar to those it faced when Europe began to unite seriously in the early postwar period. Would a resultant Asian bloc be a force for stability in the region, and thus less likely to require yet another US military intervention in Asia? Or would it simply be a much tougher economic competitor, whose discrimination against outsiders and possible threat to the existing institutional order would be too high a cost to accept?[8]

How the United States might react to such a development would relate to the further acceleration of globalization and the backlash against it. On the one hand, the US economy has experienced dramatic globalization during the past four decades—a near tripling of the share of external transactions in its GDP, a swing of great speed for such a mature economy (figure 1.3). As a result, the United States is now more exposed to global

8. Postwar Japan has never harbored global political aspirations. It has, however, viewed itself as the world's second leading economic power (or at least tied for that position with Germany). Japan in fact periodically campaigned to promote international use of the yen to a position at least roughly equal to that of the deutsche mark as runners up to, albeit far behind, the dollar. The amalgamation of Europe into an effectively integrated economy has clearly pushed Japan into a distant third in the world output league, however. Perhaps even more important symbolically, the creation of the euro—and the view in some quarters that it could come to rival the dollar as the world's leading currency—pushed the yen to a distant third in the currency tables. With its relative decline of course accelerated by its own economic stagnation in the 1990s, Japan has clearly dropped a notch in the global economic rankings, and there is now considerable space between it and the top two. Any future trilateral leadership of the world economy could well involve some Asian regional entity, rather than Japan itself, as perhaps anticipated by the decision of the private Trilateral Commission in 2000 to replace Japan with an East Asian regional group as one of its three "poles."

economic events than either of the other two economic superpowers—and considerably more so than Japan, whose external engagement remained essentially unchanged during the same period (except for a sharp runup in the 1970s, due to the huge rise in oil prices). We will argue in chapter 2 that this is a major reason for the sharp improvement in US economic performance in the 1990s.

On the other hand, and clearly related, a substantial backlash against globalization has arisen in the United States, mainly because of concerns that further increases in the openness of the economy will cause job dislocation and significant declines in lifetime incomes for less-skilled workers (Scheve and Slaughter 2001; Kletzer 2001). Very little of that backlash has been directed against Japan, another indicator of its declining salience to US policy; most of the concerns are aimed at countries with low wages, and with allegedly low labor standards and low environmental defenses. But much of US international economic policy—most notably trade policy, with the failure to obtain any new negotiating authority since 1994, but also policy toward international investment and to some extent toward the IMF—has been stalemated. Hence the United States has been unable to exercise its traditional leadership on these issues, either globally (as in the WTO) or at the regional level (as in the Asia Pacific Economic Cooperation forum, or APEC). This backlash developed during the period of stellar US economic performance. Any prolonged slowdown, let alone recession, could intensify the domestic politics of these issues and even push the United States in an antiglobalization direction. Hence this development could have a substantial, though indirect, impact on the Japan-United States relationship.

It is clear, however, that the 1990s were a ''decade of decline'' for Japan, gauged by the welfare measures of economics but even more clearly in the relative terms of political science. The completion of European integration has created a new global economic superpower that, combined with Japan's recent economic weakness, relegates it to a sharply lessened position in international economic and financial councils. The rise of China presents Japan with a real rival for the leadership of its own region, a contest it may well lose unless China itself goes off course or Japan engineers a dramatic improvement in its economic and political positions. The Asian financial crisis, in addition to weakening both the economies of the region and the luster of the ''Japanese model,'' has triggered a push for Asian regional cooperation that will almost certainly face Japan with conflicts between the region and the United States. The further intensification of globalization strengthened the US economy, while the backlash against it raised new threats to US openness—including toward Japan.

Despite all this—or perhaps because of it?—both the United States and Japan report that their security relationship is stronger than ever. Jolted by the risks to the overall relationship engendered by the Clinton administration’s tough approach to trade issues in its early years, the foreign policy leadership of the United States initiated an extensive review of security ties with Japan in the middle 1990s and emerged with a strong reiteration, and some upgrading, of that dimension of the relationship. By all indications, the Bush administration will intensify this effort. A key question for the future, and for this book, is whether a positive overall relationship can persist if there is continued conflict or even sharp tension over economic issues. Another is whether, in light of the fundamental changes in the global and regional security situations, the overall relationship is still of cardinal importance to either of the two countries. We will analyze these issues in chapter 6.

At this point, it is enough to note simply that the 1990s brought a dramatic shift in the relative positions of the United States and Japan in both the economic and security spheres. The United States became “the only superpower” in both military and economic terms, while Japan slipped at least a notch, both globally (behind the European Union) and regionally (vis-à-vis China). The end of the Cold War fundamentally altered the global security posture. As a result, the US “need for Japan” may have declined in both the economic and security dimensions. In setting the stage for our in-depth analysis of all these issues, it remains to describe the state of the bilateral economic relationship at the outset of the 21st century and the impact that these sweeping changes appear to have had to date.

The Bilateral Relationship

Japan stands alone as the only target of a persistent country-specific economic policy in the postwar history of the United States. In 1971, President Nixon imposed an import surcharge that was directed largely at Japan and threatened to apply the Trading with the Enemy Act—an enormous affront to the closest US Pacific ally, especially in light of memories of the Second World War—to force Japan to limit its textile exports to the United States.[9] In the late 1970s, Japan was a primary focus of the Carter administration’s “locomotive theory,” which sought expanded macroeconomic stimulus in other countries to broaden the sources of global growth and help reduce the large deficit (for that time) in the US external balance. Both of these initiatives toward Japan were

9. As early as 1969, one of the authors prepared a meeting of the National Security Council (NSC) to address US economic relations with Japan (which at the time emphasized Japan’s export prowess and US import policy, Japan’s protection against US exports, the impediments to US investment in Japan, and textiles). Despite the comprehensive coverage of US foreign policy issues by the NSC under the Nixon-Kissinger regime, no other country was singled out for such attention on the economic front.

taken within a multilateral context, however, and unique Japan-centered policies were still to come.

US concerns about Japan reached their apex from the early 1980s to the mid-1990s. During this period, the United States under administrations of all types, which were in turn under enormous pressure from the Congress and large parts of the US business community, simultaneously bludgeoned Japan to restrain its own sales to the United States and launched major initiatives aimed at opening the Japanese market. President Ronald Reagan imposed a ''voluntary export restraint'' agreement on Japanese autos during his first months in office, and subsequent similar arrangements on steel and machine tools; sought a sharp appreciation of the yen with his Plaza Agreement in 1985; adopted a ''tough'' trade policy, including widespread use of Section 301, the Unfair Foreign Trade Practices component of the 1974 US Trade Act (including against Japan) the next day; negotiated the first ''managed-trade'' pact on semiconductors in 1986-87; and launched the Market-Oriented Sector Specific (MOSS) effort in 1985-87. President George H.W. Bush followed with the Structural Impediments Initiative (SII) in 1989-91. President Clinton had his Framework Talks in 1993-95, which included negotiations on autos and auto parts that were the most rancorous since the textile disputes of the early 1970s. Most recently, a US-Japan Economic Partnership for Growth was announced by President Bush and Prime Minister Koizumi in June 2001.[10] All of these initiatives embodied elaborate sets of commissions, task forces, working groups, and forums through which the United States would seek to maintain pressure on Japan to alter its policies across a wide array of specific issues and policy areas.

This Japan-specific policy on the part of the United States has been justified on three mutually reinforcing grounds. First has been Japan's size as the world's second largest national economy, largest global creditor, and rival to the United States in fields such as high-technology manufacturing and finance. Second has been Japan's distinctiveness in terms of economic institutions and organization. From these two considerations flowed the conclusion that Japan's size and distinctiveness combined in

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10. The Armitage Report on United States-Japan relations (IISS 2000), prepared and signed by a number of Japan experts, including several who subsequently became high officials in the administration of President George W. Bush—including Deputy Secretary of State Richard L. Armitage and Deputy Secretary of Defense Paul D. Wolfowitz—implied a continuation of the traditional approach. Its economic section concludes that ''bilateral trade negotiations remain an essential tool,'' emphasizes the ''mounting frustration with which successive US administrations have tried to prod Tokyo to adopt a range of invented and reinvented trade and economic policy options,'' stresses deregulation and further trade liberalization rather than macroeconomic measures as the keys to restoring Japanese growth, and is full of the usual ''Japan must . . .'' pressurizing (including on minutiae such as ''the quality of Japanese economic statistics''). It is interesting that it also raises the possibility of a Japan-United States free trade area.

a way to uniquely disadvantage US firms and workers in sectors in which they competed with Japanese producers—whether in agriculture, industry, or services—to the detriment of US national interests. Third, it was felt that, mainly for geopolitical but also for economic reasons, the United States had a unique ability to affect policymaking in Japan. Moreover, the political economy of US trade policy formation created domestic support within the United States for this relatively intrusive approach. Together, these considerations provided the basis for a Japan-specific economic policy.

The first point is largely self-evident. Japan is the second largest national economy in the world. Its weight has been viewed as sufficiently great to affect global and US economic outcomes, especially because of its dynamic performance from the 1960s through the 1980s. It has also been thought of as a major determinant of economic performance in all of Asia, a region that accounts for about a third of the world economy and has been its most rapidly growing component for the past three decades, despite its recent troubles.

Second, Japan came to be viewed by many as a truly ''different country'' with a unique economic model. To these observers, Japan's growth and competitive success could not be explained by conventional analysis. In particular, governmental intervention and industrial policy were widely thought to be key elements in its stunning economic success.

Even more important, many Americans perceived Japan as a competitor that was not only different but also ''unfair.'' The specific charges ranged from ''closed markets'' to ''government-subsidized industrial policies'' to ''competitive undervaluation of the yen.'' The overall picture was one of marked cultural and societal differences that produced clever violations of the international rules and norms by which the United States and most other countries played the international economic game. Such perceptions were fed by a steady stream of ''revisionist'' analyses of ''why Japan is different'' and ''unfair Japanese trade practices,'' such as its rejection of foreign skis that ''would not work on Japanese snow'' or of imported foods that were ''incompatible with Japanese intestines.'' The policy implication was that overt US governmental counteraction was required to ''fight fire with fire.'' Among professional economists, ''strategic trade theory'' provided a modicum of intellectual support for these views.

Taking all this together, Japan was viewed more and more throughout the 1970s and 1980s as a potential threat to US global economic supremacy and even to its own prosperity. As Japan's trade surpluses (and US deficits) mounted, and as Japanese industries achieved world leadership and even dominance in a number of key sectors, widespread fears of ''losing the competitive race'' arose in the United States. Japan was ''eating our lunch'' and even ''had won the Cold War.'' Just as the United States felt compelled to launch a concerted national response to the challenge posed by the Soviet Union to US security and global political leadership, many Americans (and many friends of the United States in other countries) concluded that the United States needed to launch a concerted national response to the challenge posed by Japan to US prosperity and global economic leadership.

Further complicating the situation, the United States had major security interests in Japan—the country that, for all the conflict on economic issues, was praised again and again as the ''linchpin of the Pacific'' (President Nixon) and ''America's unsinkable aircraft carrier'' (Prime Minister Yasuhiro Nakasone). The economic disputes, if left unresolved, could both weaken the security relationship itself and undermine US political support for continued security ties (''protecting Japan''), and hence threaten a fundamental tenet of US foreign policy in a key part of the world. Explicit efforts to resolve the economic tensions were therefore required.[11]

Moreover, in part because of this security relationship, but also because of Japan's lack of other close allies and its reliance on US markets, the United States has thought it had a unique ability to pressure Japan for policy changes much more aggressively than it could pressure other countries. Reform-seeking Japanese, including Prime Minister Kiichi Miyazawa as late as 1993, encouraged this view by *asking* the United States to apply *gaiatsu* (''foreign pressure''; see box 5.5) to affect the internal policy debate in Japan. And *gaiatsu* was often effective, at least in the 1980s, because those who applied the US pressure often had domestic allies in Japan, and Japan still wanted to accommodate to the United States. It is interesting, and somewhat ironic, that this was in turn partly because of the widespread perception, in both countries, that Japan was on the ascendancy and that the United States had fallen on hard times and needed help.

But actually achieving Japanese change has turned out to be exceedingly difficult. Moreover, the United States has never even considered pushing other countries to such an extent, with the partial exception of Germany (due to similar security ties) in the earlier postwar period. Only its unique relationship with Japan even made the efforts plausible.

This tendency was reinforced by the political economy of trade policy formation in the United States. Specific US industries and other groups have taken advantage of all these factors in their perennial effort to win protection against imports or governmental support for their exports. Steel and textiles were the most important examples in the 1970s. Autos and again steel dominated the relationship in the 1980s. Semiconductors, auto parts, and telecommunications equipment were central in the 1990s, and steel arose again in 1999. The quasi-permanence of a Japan-specific policy opened the door for industries seeking help, and numerous indus-

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11. Many believe, however, that security issues have been a ''moderating'' factor, rather than an ''aggravating'' factor, for the Japan-United States relationship. We will discuss this tension in chapter 6.

tries have been quick to push the opening wider, generating irresistible pressure (including through the Congress) even on administrations that might have been reluctant on their own to maintain the Japan-specific economic policy.

As a result of these elements, the United States has conducted a unique ''Japan economic policy'' during much of the period since about 1970. The substantive emphasis of that policy has shifted with great frequency, focusing variously (and sometimes simultaneously) on (1) increasing access to the Japanese market, (2) restricting Japanese access to the US market, (3) enhancing opportunities for US investment in Japan, (4) reducing opportunities for Japanese investment in the United States, (5) structurally reforming the Japanese economy, (6) fostering more expansionary Japanese macroeconomic policies, (7) pursuing a stronger exchange rate for the yen, and (8) seeking Japanese support for US multilateral trade and international financial initiatives. We turn next to an appraisal of the alternative strategies through which the United States might pursue these, and its other, economic objectives toward Japan in the early 21st century.

Policy Alternatives

There are at least four alternative strategies that the United States could adopt for its future economic relations with Japan. At one extreme, it could simply write off Japan as a significant global economy and adopt a ''bypass-Japan'' or ''benign neglect'' policy. At the other extreme, it could seek ''deep economic integration'' with Japan via negotiation of a bilateral free trade area or ''open marketplace'' agreement (Stokes 2000) and/or a monetary integration compact (McKinnon and Ohno 1997). In between, it could maintain the policy of the last three decades under which Japan is treated as the single most important economic counterpart of the United States and thus the frequent target of country-specific trade, structural, macroeconomic, and monetary demands (Lincoln 2001).

Or, as we will recommend, the United States could dismiss the premises that have underlain its policy for three decades and reorient its policy toward Japan within its global economic policy, treating Japan as ''a normal country.'' We will argue that US national interests would be better served in the future by such a policy, which roots its relationship with Japan in the multilateral institutions rather than in a continuation of the Japan-specific policies of the past. But before making our case for this policy and elaborating the specifics of our proposals, in chapter 7, it is worthwhile to sketch out the alternative approaches.

A ''Bypass-Japan'' Strategy

The first policy option rests on extrapolation of the dramatic changes of the 1990s: the ''decade of decline'' for Japan, the resurgence of the US economy, and a series of global developments that devalue the importance of Japan—especially with respect to China and the rest of Asia. It also rests on the view that "nothing ever changes in Japan," or changes so slowly that policy efforts to expedite the process are bound to fail. Hence a realistic appraisal of the future, according to this strategy, suggests that activist attempts to change Japan are certain to produce disappointing results and that the potential benefits are not worth much anyway. The conclusion is to neglect or bypass Japan altogether.

This approach has been adopted by some US companies. These firms, instead of entering Asia via Japan, have rejected that traditional mode in favor of launching their Asian efforts elsewhere, notably in China. In terms of economic policy, the "bypass-Japan" idea implies that the United States would pay no more attention to Japan than to any other middle-sized economic power.

We believe this approach would be counterproductive to US national interests. Japan remains the world's second largest economy and trader, and its largest surplus and creditor country. Its companies remain highly competitive in a number of key sectors. It has never exercised the international economic leadership that those attributes permit, but it nevertheless must participate actively if most international economic initiatives are to succeed.

Moreover, a bypass-Japan strategy by the United States would enable Japan to evade responsibility for the success of global economic initiatives. It could even encourage Japan to pursue regional options, or to withdraw into an inward-looking approach, without paying much attention to their consistency with broader multilateral arrangements and global objectives. Some Japanese might *like* the bypass-Japan approach for these reasons—along with a broader desire to be left alone, or at least to stop being singled out for badgering by the United States (and, to some extent, by the rest of the world).

In light of its own interests, however, the United States will need to continue working closely with Japan. The United States will need to seek Japan's support for most major multilateral projects, even if it does not pursue Japan with the bilateral zeal of the past. A stated policy of benign neglect or bypassing Japan would represent a substantively counterproductive strategy and convey the wrong message to Japan itself.

"Deep Integration"

"Deep integration" implies a substantial meshing of different national economies into a more and more united whole (Lawrence 1995). The European Union is of course the prototype. In contrast to ignoring or bypassing Japan, this second policy option would involve a concerted effort at economic integration via a gargantuan leap of political will that would sweep away the structural and sector-specific impediments to the two countries' economic exchanges.

Proposals for deep integration between the United States and Japan have taken a number of forms. The most common is for a bilateral FTA that would eliminate tariffs, and perhaps all other border barriers, between the two countries.[12] Some variants would install a special dispute-settlement mechanism between them, à la Canada-United States or NAFTA (Kuroda 1989).[13] An even more ambitious concept is for a Japan-United States ''open marketplace,'' which would also penetrate ''behind the border'' to address more subtle barriers to international exchange (especially in Japan).[14]

Somewhat similar proposals have been made for monetary and macroeconomic policy. One suggestion, based on the idea that Japan's periodic economic problems have been caused by an overvalued yen that in turn derives from US trade policy pressures, calls for a yen-dollar stabilization pact that would rest on the coordination of monetary policy between the two countries (McKinnon and Ohno 1997).

These proposals derive from the frustrations of attempting to resolve Japan-United States economic conflicts on the traditional issue-by-issue basis. They observe that major political initiatives, embodied in far-reaching commitments to economic integration, have overcome even the most intractable commercial problems between long-standing rivals—as with France and Germany in the European Union, but also Argentina and Brazil in Mercosur—and so should work between allies such as Japan and the United States. They emphasize the large potential benefits from deep integration in both economic and political terms. They cite the similar levels of economic development in Japan and the United States, at least as measured by per capita incomes, and the similarities of their economic structures as well; as noted, most US opponents of further globalization have excluded Japan from their list of major targets.

However, any initiative to create an FTA (or something deeper) between the United States and Japan would have severely adverse effects on the

12. In principle, the United States and Japan agreed to free all trade between them as part of their commitments under the Bogor Declaration of APEC in 1994 to achieve ''free and open trade and investment in the Asia Pacific by 2010.'' In practice, there has been no progress toward realizing this goal except through the several multilateral sectoral pacts (financial services, information technology, telecommunications services) negotiated since that time through the WTO.

13. It would also be possible to create a new bilateral dispute-settlement mechanism without a free trade agreement (Greenwald 1996).

14. Stokes (2000) proposes that the two countries agree to pursue such a structure by 2010, which he calls a ''more ambitious grandson of SII'' (p 3), though he acknowledges they would be highly unlikely to achieve it in practice.

global trading system and thus on the overall trade policies of the two countries. Any such proposal for free trade among high-income countries, like the proposals to create a Trans atlantic Free Trade Area between North America and Europe, would raise the specter of new discrimination against the world's poorer countries and—in addition to being a substantively bad idea for that reason—would deepen North-South tensions at a time when they are among the most vexing impediments to reaching international agreement on launching a new multilateral round in the WTO and elsewhere. In addition, US espousal of such a huge regional initiative could further jeopardize the multilateral structure of the world economy just when the United States should be reemphasizing its centrality.

In financial terms, the United States and Japan are very far from constituting an ''optimal currency area'' that could logically move toward a monetary union. They are characterized by considerable asymmetry in the impact of external shocks on their economies, so they should respond differentially, not similarly (let alone identically), to such events. There is virtually no labor mobility between them, especially into Japan, and there are no fiscal transfers between them nor any prospects thereof. The two main adjustment devices that are required to replace currency and monetary policy changes are thus totally absent, relegating the prospects for intensive monetary cooperation to the sidelines.

Most critically, the deep integration proposals fail to acknowledge both the enormous societal differences between Japan and the United States, and the absence of any compelling security motivation that could overcome these differences. All the successful integration efforts of the past and the contemporary efforts in that direction—notably the European Union, but also Mercosur and NAFTA—have had to overcome major economic and cultural differences among their members. In all these cases, however, there was an overriding security concern that enabled courageous political leadership to overcome extensive opposition to the merger: the obsession in postwar Europe of avoiding another fratricidal conflict on the continent, the decision by Argentina and Brazil to cease their potentially deadly nuclear competition, and the recognition in the United States that its southern border could become a severe threat to domestic tranquility unless Mexico were able to achieve much greater stability in the future. The only development that could conceivably generate the political momentum in Japan and the United States to justify such a project would be the rise of an ideologically objectionable and territorially expansionist China—a distinct, though unlikely, possibility.

In an earlier study of the Japan-United States economic relationship, two of the current authors stressed the prospect for partial convergence between the economic policies and institutions of the two countries (Bergsten and Noland 1993). We believe that convergence has continued, albeit slowly, during the intervening decade. In Japan, this has been driven by a combination of ideological shifts toward greater market-orientation by some policymakers and market pressures that have made the maintenance of the status quo untenable (Porter, M. Sakakibara, and Takeuchi 2000). On the US side, some convergence has occurred through corporate adoption of Japanese management techniques.

This continuing process of convergence is another reason why we conclude that the United States should now treat Japan as a "normal country" and eschew Japan-specific economic policies. At the same time, as was noted above, vast differences between the two countries are certain to remain for the foreseeable future. It would thus be economically inappropriate, as well as politically impossible, to pursue any of the deep integration options over the 5- to 10-year time horizon of this analysis.

Business as Usual

The most plausible alternative to our "Japan as a normal country" proposal is thus a continuation of the approach of the past 30 years (Lincoln 1999, 2001). As was noted above, the Japan-specific economic policy has rested on three broad principles: that Japan was more important to the US economy than any other country and that its competitive prowess represented a compelling threat to US interests, that Japan was sufficiently different (and perhaps "unfair") to require tailored approaches, and that the United States had sufficient leverage to pursue such a policy successfully. As will be demonstrated in this book, we believe that all these elements of the traditional equation have changed substantially. As a consequence, we believe that following the traditional approach in the future would lead to even greater frustrations than in the past. Hence we recommend a modest but important shift in US policy.

The changes in all three tenets of traditional US policy toward Japan are clear. As will be detailed in chapter 4, Japan is now considerably less important to US economic interests, and its weakness rather than its strength now represents the greatest threat to the United States (and the world as a whole). The process of convergence in policy and institutions between the two (as was just noted, and as will be elaborated in chapters 4-6) has reduced at least some of the "difference" between them (and thus perceptions of Japanese "unfairness"), although significant differences in economic policies and institutions persist in some areas. The prospect for successfully conducting Japan-specific policies has been sharply reduced, especially on trade issues, by fundamental changes in Japanese attitudes and by the creation of the WTO, as will be described in chapter 5; the United States simply can no longer use, and thus can no longer credibly threaten, unilateral trade retaliation against Japan.

Hence we conclude that the business-as-usual, Japan-specific approach of the past three decades has become infeasible as well as unnecessary.

A major proponent of that option, Edward Lincoln of the Brookings Institution, throws doubt on his own proposal when he concludes that "American options in encouraging a reform process that underwrites a healthy economic recovery are actually quite limited" (Lincoln 2001, 17). He also acknowledges that "the most important result is the need to lower American expectations about what can be accomplished" (Lincoln 1999, 16).

The key practical issue is how our proposed "Japan as a normal country" strategy would differ from that long-established pattern. We turn finally to a brief explanation of our proposed strategy, including an appraisal of how the United States would pursue its remaining, very real, and very important economic objectives toward Japan under such an approach. The proposal will be elaborated in more detail in chapter 7.

Treating Japan as a "Normal Country"

Our main policy conclusion is that the Japan-specific policy of the past has become an anomaly and that the time has come for the United States to start treating Japan as a "normal" nation. Japan of course remains the world's second largest national economy and third largest economic entity (behind the European Union as well as the United States). It is by far the world's largest surplus and creditor country. It remains a formidable competitor in many sectors. It is still the third largest trading partner of the United States. Hence economic relations with Japan, across a wide spectrum of macroeconomic and trade issues, will remain important and active—on a par with US economic activities with other major players, such as Canada, the European Union, and Mexico.

But there is no longer any need for a special "Japan policy." The completion of economic integration in Europe and the rise of China have reduced Japan's relative importance to the world economy and to the United States. Japan's growth is likely to approximate that of the United States itself, or even average a bit less, rather than exceed US growth by a threatening degree. Its "economic model" is sufficiently tarnished by the record of the 1990s to obviate the fears of supercompetitiveness that it had inspired a decade ago. Its "uniqueness" and "unfairness," to whatever extent they may have existed in the past, are declining as Japan slowly converges toward world norms, and especially as it joins the trend toward reduced governmental management of the economy. Past US efforts to wring concessions on reforms from Japan, even when US leverage was much greater, were disappointing. That leverage is much less than it was a decade or two ago. The time has come for the United States to start treating Japan as a normal country rather than as a unique and unfair economic superpower that requires dedicated special attention.

A normal-Japan policy by the United States would have a number of elements. First, most US foreign economic goals toward Japan would be pursued through multilateral channels. The main tool for trade issues would be the WTO (and perhaps APEC). The chief instrumentalities for macroeconomic issues would be (a hopefully revitalized) Group of Seven (G-7) and the IMF, with a subsidiary place for the Manila Framework Group (an approximate equivalent of the APEC finance ministers). The United States would encourage more regional cooperation in Asia, including Japan, as long as it is consistent with the existing multilateral processes, à la European Union and NAFTA.

Second, the United States would make a continuing effort to elicit support from other key members of these multilateral groupings to join its initiatives toward Japan. Effective use of the multilateral institutions requires active coalition diplomacy, in which the United States would seek maximum cooperation from other countries in promoting policy changes in Japan. The most important allies would be the main European countries in the G-7, IMF, and WTO, and the major Asian countries (especially the Association of Southeast Asian Nations, Australia, China, and South Korea) both in those same organizations and in APEC and the purely Asian groupings. The United States could, in at least some cases, also pursue its efforts through these Asian countries in forums where it is not a member itself, such as any Asian Monetary Fund or subregional trade agreements that might eventuate with membership limited to Asia.

Japan should of course pursue a parallel strategy of eliciting support from other key members of the multilateral institutions to support its initiatives toward the United States. Such competition within the multilateral framework would be exceedingly healthy for each of the countries, for the relationship between them, for the organizations, and for the system as a whole. The multilateral institutions should be the focal point for addressing economic issues and disputes, especially between large countries such as Japan and the United States, and our proposed strategy would accord a central role to that approach.

Third, the United States would continue to support economic reform and economic reformers in Japan. The United States clearly has a continuing interest in further deregulation and structural reform of the Japanese economy, as well as other economies, especially to strengthen Japan and to reduce the risks that its weaknesses would carry for the rest of the world. US commercial interests are not irrelevant in this context, but they are a decidedly secondary factor in the equation and should be treated as such. If a particular US company's parochial interest becomes a paramount element in the government's initiatives, it becomes quite counterproductive to the bilateral relationship. The United States should continue to play an active role in the policy debate in Japan, however, and might even have greater success by doing so in an objective, multilateral manner rather than under the threat of punitive retaliation if Japan fails to do its bidding.[15]

Fourth, the United States should generally place its emphasis on macroeconomic, monetary, and structural issues rather than sector-specific trade problems. The criterion of salience is again central: The broader macroeconomic issues are much more likely to be of importance to the United States as a whole (as opposed to specific industries or firms) than the narrower topics. They are also more likely to find allies in Japan and hence to succeed in reaching their goals.

Fifth, the United States would reserve the right to take unilateral policy initiatives in some cases where the stakes were sufficiently significant. For example, Japan's disastrous decision to bring on a recession by sharply raising taxes in 1997 appeared likely to threaten the Asians' recovery from their financial crisis and even the world economy. Hence the United States was correct to make forceful, repeated, and public demands to Japan over the issue—though it would have been much more effective to do so preemptively in 1996 and early 1997, before the decision became embedded in Japanese politics, than after the event, when it was too late to alter the outcome (Shafer 2000). Even in such instances, however, the United States should make every effort to mobilize international support for its initiatives—including through the multilateral institutions.[16]

The United States has of course always used multilateral tools to some extent in its initiatives toward Japan, especially to pursue its macroeconomic and monetary goals. But it is curious that the United States has frequently failed to mobilize other key countries to support its efforts. The Europeans, and even the other Asians that are affected most directly, have had relatively little to say in recent years about the critical need for Japan to fundamentally reform its financial system and to stimulate its economy through expansionary fiscal and monetary policies. A conspiracy seems to be at work: The United States apparently feels that its unilateral approaches will succeed or fail on their own, whatever third countries

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15. There is also a potential major role in this context for ''track two'' diplomacy, so favored in Asia in recent years, through which nongovernmental actors carry forward an issue that arouses high political sensitivities and thus counterproductive responses when conducted in official circles. Whatever tracks are followed, the United States should consistently seek allies within Japan that share its desire to promote deregulation, restructuring, and reform.

16. Such ''exceptions to the rule'' would not apply in such relatively mundane cases as continued Japanese cartelization of the flat glass industry or the interconnection charges levied on its customers by NTT. The changes in Japanese practice that have been pursued by the United States in such cases would clearly be beneficial for Japan and, to a lesser extent, to the United States and other countries. In the changed circumstances of the early 21st century, however, they do not justify treating Japan as a special case for unilateral attack. Very few trade cases would. As a result, individual US firms and industries would be discouraged from seeking new governmental jihads on their behalf, and the risk of ''political capture'' of US policy would recede substantially.

may do, and those other countries apparently believe that their involvement will not affect the outcome, so they remain largely silent and let the United States make the running, avoiding ruffling their own diplomatic relations with Japan.[17]

Emphasizing the multilateral route vis-à-vis Japan would have several positive externalities. Other countries besides Japan, notably in Europe, have structural problems, and a multilateral focus would enable the United States to address those issues simultaneously. Other countries along with Japan, of course, maintain sector-specific trade barriers, notably in agriculture, and a multilateral focus (with allies such as the Cairns Group) also would attack them. Other countries and groups along with Japan need to be actively brought into the integration of competition policy in the WTO, notably the European Union but more and more a number of developing countries as well, so multilateralism also would pay dividends there. Other countries, along with Japan, face severe problems in their financial sectors and would benefit from increased monitoring by the IMF. These issues are elaborated in chapters 4, 5, and 7. The excessive resort by the United States to bilateral approaches to Japan has inevitably shortchanged some of these other important goals, and a multilateral focus would help redress the balance.

A multilateral focus for US policy *toward* Japan would also improve the prospect for conducting at least some parts of US policy *with* Japan. Despite its weakness, Japanese agreement is essential for pursuit of key global initiatives such as a new trade round in the WTO and convincing reform of the international financial architecture. In addition, Japan's new flirtation with regionalism needs to be firmly anchored in a multilateral context (as it seems to be so far). These extremely important US goals would be served by renewed emphasis on multilateral channels in handling the economic problems between the two countries themselves.

Conclusion

The United States does not normally conduct ''economic polices'' toward specific countries. It generally pursues a set of global economic policy goals: support for economic growth and stability in the United States itself, maintenance of a prosperous and stable world economy, and promotion of broader US foreign policy and national security objectives. Those global

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17. Europeans and Asians also do not join unilateral US demands on Japan because they fear that similarly strong pressures may subsequently be applied to them. Japan, Europe, and most Asian countries are in agreement on opposition to a number of US approaches, including its use of section 301 of its trade law and antidumping duties. This outcome prevails even if US demands on Japan in a particular case may have beneficial spillover effects on Europeans and Asians. Hence the proposed shift in US policy toward Japan would also have beneficial side effects on US relations with its other major economic partners.

objectives must of course be implemented through relations with specific countries at specific times, but the resulting "country policies" are usually tactical innovations to promote the broader multilateral purposes. The United States has no economic policy toward Germany or the United Kingdom, or toward Canada (its largest trading partner), despite the existence of an FTA between the two and NAFTA, or toward the European Union (the largest economic entity in the world).

Japan has been the major exception to this pattern for the past three decades. The United States has not always pursued a Japan policy during this period, and the Japan policies that it has embraced have often differed substantially across the three decades. But the presence of a Japan-specific approach has been both frequent enough and intense enough to clearly identify the existence of such an exception to the usual US global approach (and to inspire a virtual cottage industry of studies of the topic). The Clinton administration even created a "Japan team," under its newly created National Economic Council, to deal with "the Japan problem."

The United States focused primarily on restricting Japanese sales to the United States from the early 1970s through the mid-1980s, on expanding foreign access to the Japanese market from 1985 until 1995, and on macroeconomic and monetary matters during the past 5 years. Virtually every aspect of Japanese economic policy, ranging from the broadest structural and macroeconomic issues to the most detailed sector-specific trade topics, has been addressed. The United States has employed nearly every policy instrument that is available to it: multilateral, regional, bilateral, and unilateral—often in combination and sometimes with one providing a cover for the others (as when the United States forged multilateral currency agreements in 1971-73 and 1985-87, with the Group of Ten or Group of Five countries, whose chief purpose was a sharp appreciation of the yen). Table 1.2 summarizes the intersection between the objectives pursued by the United States and the tactics it has deployed, with specific examples that illustrate the different cells in the matrix. We will assess the payoff from some of these approaches in chapter 5 before recommending a new strategy in chapter 7.

For its part, Japan has still tended in some instances to display the traditional pattern of yielding marginally and grudgingly to US *gaiatsu*, most recently in the Nippon Telegraph and Telephone Corporation (NTT) interconnection case (see box 5.5). Moreover, some of the key Japanese ministries initiated ideas for a new version of the traditional Japan-specific policy that produced the Economic Partnership for Growth in June 2001. Elsewhere, however, it was making major changes in its "America policy." It joined the European Union at Seattle in December 1999 to counter US efforts to launch a new round of multilateral negotiations in the WTO that was limited to pursuing US objectives. It rejected US proposals for a new steel agreement in 1999 and instead

Table 1.2 US economic policy toward Japan

	Goal or instrument				
Scope	**Security**	**Macroeconomic stability**	**Export expansion**	**Import protection**	**Foreign direct investment**
Multilateral	United Nations Security Council	IMF Group of Seven	World Trade Organization	World Trade Organization	World Trade Organization/OECD
Regional	ASEAN Regional Forum	MFG AMF?	APEC SRTAs?	—	APEC
Bilateral	United States-Japan Security Treaty	Reference range Currency intervention	VIEs (Clinton) SII (Bush) MOSS (Reagan)	VERs	BIT
Unilateral	Nuclear deterrent	Currency intervention	Devaluation, Section 301	ADD Import surcharge	Exon-Florio

ADD = Antidumping duties.
AMF = Asian Monetary Fund.
APEC = Asia Pacific Economic Cooperation.
ASEAN = Association of Southeast Asian Nations.
BIT = Bilateral Investment Treaty.
IMF = International Monetary Fund.
MFG = Manila Framework Group.
MOSS = Market-Oriented Sector-Specific.
OECD = Organization for Economic Cooperation and Development.
SII = Structural Impediment Initiative.
SRTAs = Subregional trade arrangements.
VIEs = Voluntary import expansion agreements.
VERs = Voluntary export restraint agreements.

fought a series of antidumping charges on a case-by-case basis, winning victories in the WTO. It rejected US entreaties to pursue a series of sectoral liberalization initiatives, especially in agriculture, in APEC in 1998, effectively bringing that institution's trade liberalization efforts to a halt. It rejected strong US entreaties to abandon its plan to raise taxes in 1997, which threw the economy into recession (as the United States had forewarned). It stiffed the US initiatives on autos and auto parts in 1995.

More broadly, Japan has begun to reverse its postwar policy of relying solely on multilateral approaches. It has launched a series of exploratory negotiations for bilateral ''free trade areas'' with Mexico, Singapore, South Korea, and perhaps others. It has reinvigorated its earlier push for regional monetary arrangements, at least partly to counter US dominance of the global financial system. It was in fact starting to sign a series of bilateral ''swap arrangements'' with neighboring countries by the middle of 2001.

Economic policy in both the United States and Japan toward the other is thus in considerable flux. The future of each is highly uncertain. The impact on the global economic system could be profound. Both countries clearly need to review the premises on which past policy have rested.

We believe that the dramatic changes in the economic positions of the two countries, and the shifts in global developments that affect both, counsel a fresh look at the relationship and at policy in both countries. Indeed, we conclude that these changes suggest a completely new approach, particularly by the United States. We turn next to an in-depth analysis of the key issues that can provide a foundation for such a new strategy for the future.