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Building a New Japan-United States Economic Relationship

The Case for Normalcy

Japan represents an anomaly for the United States: It is the only country toward which the United States, more or less consistently, has adopted a country-specific foreign economic policy. The rest of US international economic relationships—even with larger economies, such as the European Union or its larger trading partners, such as Canada and Mexico—are conducted primarily as elements of its global economic strategy.[1] But the strong US economic performance throughout the 1990s, led by sectors where Japan had been regarded as a major threat less than a decade earlier, demonstrates that it can succeed quite nicely without much accommodation from Japan. Japan's "decade of decline" makes clear that it was never the threat that some Americans perceived it to be—and, indeed, that Japanese economic weakness may be a greater risk for the United States than Japanese economic strength ever was. The revisionists were simply wrong to argue that Japan was so "different" and so important that Japan-specific policies were required for the United States to restore its economic progress.

1. Canada and Mexico are of course members of NAFTA but all of its institutional arrangements are trilateral and, even with them, the intensity of US interchange is far less than it has been with Japan.

The whole case that Japan is unique has weakened substantially in recent years. As was observed in chapter 3, internal institutions regarded as uniquely Japanese, such as lifetime employment and the *keiretsu* system, are eroding. An ongoing process of deregulation is creating a Japanese economy that looks more and more like those of other major industrial economies. Changes include complete privatization of Japan Airlines (unlike Air France, which remains under government control) and partial privatization of NTT (just as in Germany) and Japan Rail (which is de jure more private than Amtrak). Airfares have been deregulated as much as in the United States. Store hours have been lengthened, and stores are open as much as US stores (and much more than those in continental European countries). Most automakers in Japan are controlled by foreigners. Large banks, insurance companies, and securities firms are being bought up by foreigners. The unthinkable of just 15 years ago is occurring virtually every day.

Moreover, recent research by Porter and two Japanese colleagues (Porter, M. Sakakibara, and Takeuchi 2000) concludes persuasively that Japan's hypercompetitiveness in the earlier period was based primarily on management practices that could be, and were, readily emulated by non-Japanese firms rather than by government supports that demanded governmental counteraction abroad. In any event, governmental industrial policy clearly plays a much smaller role in Japan today than in the past. Deregulation and privatization are occurring at a faster pace than in some European countries. This justification for Japan-specific policies by the United States, one of the most important in the traditional lexicon, has also waned substantially.

The analysis of trade and investment relations in chapter 4 indicates that Japan's relative global economic importance is eroding as well. European unification and the creation of the euro mean that the European Union is now the largest economic unit in the world, far larger than Japan. The yen is now a distant third among global currencies, far behind the new euro as well as the dollar. The rise of China may mean that Japan will even lose its status as the key economy in the Asia-Pacific region. The anomaly of the past would be even greater in the future if the United States were to continue to pursue a unique "Japan policy."

Even in its bilateral relations with the United States, Japan's salience is falling. As was shown in chapter 4, Japan accounts for a declining share of US trade and investment (and the difference in the modalities of trade and investment with Japan—e.g., US investment in subsidiaries as distinct from joint ventures—is declining as well). Even with respect to the traditional lightning-rod issue of the US trade deficit, the share accounted for by Japan is down to about a fifth, as opposed to more than half during the 1980s, even as the total size of the US imbalance has soared. It is in fact clear that the current account deficit is a global problem for the United

States, reflecting factors that apply across all of its international economic relationships, and that it must find a global solution—as was also the case at the previous peak of the deficit, in the middle 1980s, when the United States had to engineer a steep depreciation of the dollar against all the other major currencies but when it particularly sought correction against the yen. Even the issue of macroeconomic imbalances can no longer be viewed as a ''Japan problem'' and the efforts of American industry to promote a weaker dollar in 2001 were, unlike the past, not directed primarily at the yen.

Closely related is the issue of Japan's ''unfair'' treatment of foreign competition. This charge of course continues to be heard and—because it is based so much on motivations as well as observed results—will never disappear. However, after substantial foreign takeovers of Japanese financial institutions, the sale of Nissan to Renault, and the widespread penetration of foreign brand-name retailers—such as Starbucks Coffee, Toys 'R Us, and Amazon.com—the specter of unfair treatment has become largely obsolete.

Moreover, concerns about Japan do not loom large in the backlash against globalization in the United States, the major threat to continued openness of US policy. The backlash focuses primarily on developing countries that allegedly pose threats of ''low-wage competition'' and ''races to the bottom'' with respect to the environment, labor, and other standards. Hence, Japan does not represent a threat to the maintenance of an open US trade policy, as it did in the 1970s (when it prompted the Nixon import surcharge) and the 1980s (when it, along with the massive dollar overvaluation and ''benign neglect'' of the first Reagan administration, led Congress to seriously consider sweeping protectionist legislation).

For all these reasons, the time has come for the United States to start treating Japan as a ''normal country'' and to address it henceforth primarily in the same multilateral context that largely determines the US stance toward the rest of the world. This does *not* constitute a proposal for ''benign neglect'' or for ''bypassing'' Japan. It does *not* mean ignoring continuing US economic problems with Japan nor Japan's continuing economic problems with the United States. It does not rule out bilateral, or even unilateral, initiatives that are consistent with the multilateral rules, or even that go beyond them in extreme and unusual cases. It certainly does not preclude active bilateral cooperation between Japan and the United States, especially where they can work together to provide leadership in the global institutions, as they have on occasion done in the past.

It does suggest, however, that the United States no longer needs to treat Japan separately as a special, unique target of a country-specific foreign economic policy. It is not clear, in fact, that it made sense to do so in the past. Japan's macroeconomic impact on the United States has always been rather modest. Moreover, as was demonstrated in chapter 5, the tangible results of the frequently intense US pressures on Japan during the past 30 years have been exceedingly modest, despite an enormous variety of approaches and huge expenditures of political capital. Some of the wide array of Japan-specific policies pursued by the United States during this extended period—such as the campaign to achieve abolition of the Large-Scale Retail Store Law—were met largely by accommodation, whereas some others did not produce any tangible results, at least from the viewpoint of the "results-oriented" camp. Changes and reforms have tended to happen in Japan when US demands have made economic sense and have won allies within Japan itself, but results have not been delivered when US demands have lacked a coherent rationale and domestic supporters.

The final element in the equation is the reduction in the US ability to prompt changes in economic policy in Japan, as revealed so clearly by the failure of the last major US trade initiatives in the middle 1990s and of the equally aggressive US efforts to change Japanese macroeconomic and financial policies in the late 1990s. This is partly the natural result of the maturation of Japan to a point where it no longer feels such an acute need for US patronage and approval. It is partly due to the idiosyncratic twists and turns in the policy of the United States itself, which have left Japan successively feeling betrayed (as in the Asian financial crisis) and beleaguered (as in so many of the trade disputes). It is partly due to the end of the Cold War, with the consequent sharp reduction in Japan's need for protection by an external superpower. It is partly due to Japan's persisting economic weakness and the new found strength of the United States, which suggests to many Japanese both that the United States no longer needs their help and that they can no longer afford to give it. And it is particularly due to the creation of the World Trade Organization, with its dispute-settlement mechanism that protects Japan against US unilateralism.

There is considerable evidence that Japanese resistance to *gaiatsu* has risen substantially and that future efforts to deploy it will be more likely to jeopardize the overall relationship than to win Japanese acceptance of US objectives. As was discussed in chapter 6, this effect could be compounded by the inevitable fiscal pressures of Japan's huge budget deficit and national debt, and the subsequent rapid aging of the population. These pressures have already led to modest cuts in Japan's aid budget and calls to reduce "support costs" for the US military, and they could pose an increasing threat to the security relationship, especially if the overall ties between the countries were to sour. One traditional element in the security debate, emanating from the foreign policy and national security community, has always been that the economic tensions should be ignored or at least downplayed to avoid jeopardizing the broader relationship. As the relative importance of security issues has again risen in the US calculus, with the ascent of China replacing the decline and demise of the Soviet Union, that concept clearly takes on added weight.

For the future, the prospects of US "success" for any Japan-specific policy are thus even slimmer. Indeed, one should be careful in measuring "success" in Japan-United States negotiations. If it is measured in terms of a "level playing field," by harmonizing regulation, there is a chance that further negotiations can succeed. However, if it is measured by limiting the amount of Japanese exports to the United States or artificially increasing the amount of US exports to Japan, then its chances are slim.

In his extensive analysis of the prospects for change in Japan, Lincoln concludes that "actual job loss and bankruptcy have not been sufficiently widespread to produce a strong political movement in favor of more radical or thorough reform" (2001, 203). Moreover, the tight interlocking of the various parts of the Japanese economic system means that even successful reforms of individual elements do not produce much actual change. Lincoln estimates that the sum of Japan's "vested interests" in portions of the status quo add up to a majority of the population (2001, 8), confirming a remark once made to one of the authors by reform advocate Ichiro Ozawa that the Japanese public *likes* its web of extensive governmental regulation and that it would take a very strong government in Japan to carry out an extensive restructuring program.[2]

Perhaps the Koizumi cabinet will turn out to be such a government. But even if it does, Japan is unlikely to respond quickly in the future to even aggressive US reform urgings. Indeed, such forcefulness is more likely to lead to US frustration (and perhaps Japanese backlash) than to Japanese action. This combination of probable outcomes adds further to the case for a much more measured US policy approach toward Japan. This outlook suggests that future US administrations and Congresses would be well advised to eschew Japan-specific economic policies, even if one believes that their predecessors were correct to pursue them.

The most important factor underlying this prescription is the revival of the US economy in the 1990s, as was traced in chapter 2. Indeed, in a previous work, two of the present authors argued that the "restoration of satisfactory economic growth and international competitiveness in the United States itself would go far to defuse tension with Japan, as much of the hostility toward that country reflects America's own performance and the resulting tendency to look for scapegoats abroad" (Bergsten and Noland 1993, 4). We added that a successful implementation of US economic reforms would "noticeably reduce the intensity of US-Japan economic conflict" (18). In particular, we advocated a sharp reduction in the

2. Two other leading foreign observers of Japan, Abegglen (2001) and Dore (2001), agree with Lincoln's conclusions—though they approve of the outcome, whereas Lincoln deplores it.

public-sector deficit; adoption by the private sector of competitiveness-enhancing Japanese practices, where applicable; and a willingness to share leadership with Japan in managing the world economy.

The record in the intervening years has been largely positive. In the private sector, US firms have indeed raised their productivity sharply, in part by adopting innovative management techniques developed by their Japanese rivals. In the public sector, the United States has made enormous progress in improving its finances. It has made less progress in other areas (e.g., public education) that we identified in our earlier work, and which remain sources of significant concern. Nevertheless, the future for the US economy looks considerably brighter than it did a decade ago. A confident United States should be well positioned to engage Japan cooperatively in resolving bilateral issues and managing the world economy more generally.

Indeed, it now appears that the quarter-century of acute US economic hostility toward Japan, from the early 1970s through the middle 1990s, was the result of a unique historical coincidence. The United States encountered substantial economic difficulties in the early 1970s—just as Japan was emerging into global economic prominence. The United States restored satisfactory levels of economic expansion and stability, with sound underlying government policies, only in the middle 1990s—just as Japan was slipping into its ''decade of decline.'' In retrospect, it seems clear that this coincidental juxtaposition of Japanese rise and US (temporary, if prolonged) fall goes far to explain the decisions by successive US administrations to adopt the unique Japan-specific policy that prevailed for about 25 years.

As viewed from the middle of 2001, the next half-decade or so looks most likely to witness a continuation of the late 1990s: a reverse combination of US economic strength and Japanese weakness. We must be careful, however, not to assume that this state of affairs will last indefinitely, any more than did the opposite juxtaposition of 1970-95. Indeed, the weaknesses revealed in the US economy in 2000-01 could turn out to be lasting. And Japan, under the Koizumi government, could adopt far-reaching reforms and even enjoy a period of catch-up growth that would recoup some of the huge output gap that opened up during its decade of stagnation. Our proposals for Japan-United States economic relations in the period ahead must nevertheless rest on the best judgments we can reach about the outlook for the two economies, tempered of course by the history and realities of the direct relationship between them.

Restoring Japanese Economic Vitality

Unfortunately, in contrast to the United States, Japan's macroeconomic performance for the past decade has been disappointing. Following the bubble period of the late 1980s and early 1990s, officials made a series of macroeconomic policy mistakes that left the economy limping for a decade. Monetary policy remained tight for too long after the bubble burst. Fiscal policy was opaque, and the imposition of a tax increase in 1997—though understandable in terms of Japan's long-term health—was premature and pushed a weak economy into first recession and then a liquidity trap.

Unwise lending by the banks and reckless commitments by the insurance sector—along with poor prudential regulation on the part of the authorities, in the context of the excesses of the bubble period and the weakness of the economy in its aftermath—have left the financial sector burdened with huge nonperforming loans and Japan as a country with vastly underfunded public and private liabilities. The weakness of the banks impairs their ability to act as efficient financial intermediaries, undermining the confidence of both consumers and investors, and thereby weakening the economy at its core. Public concern about the future boosts precautionary savings, reducing both consumption and investment. The result is a vicious circle, in which slow growth creates more NPLs, which further undermine confidence and impair the ability of the banks to finance recovery.

The government has made progress in financial-sector reform (''the Big Bang'' and the establishment of the independent Financial Services Agency, to name two), but the political consensus necessary to resolve the problems of the banking sector has been absent. The weakness of the MOF-led regulatory system, and the historically clubby relationship between MOF officials and the financiers that they regulate, has meant that there has been no serious accounting of the incompetence (and at times outright corruption) that allowed the system to deteriorate. Without accountability, voters have been understandably unwilling to countenance using the large sums of public money that are necessary to recapitalize the banking system. And the politicians—caught between their own unwillingness to act decisively with respect to the financial establishment, and the public's unwillingness to fund a massive bailout—have temporized.

This delay has been extremely costly. It has plunged the economy into a vicious circle of slow growth and financial distress. Most importantly, the authorities must address the NPL issue far more aggressively. The stance thus far has been to recognize and write down NPLs at a rate that was consistent with bank profitability (i.e., banks have only classified loans as nonperforming and written them down as they had profits to do so). In addition, the financiers who have been subject to legal proceedings have all come from failed institutions. The lesson that the government has inadvertently conveyed, that one can avoid investigation by keeping one's institution afloat, has reinforced the private sector's incentive to evergreen NPLs.

This approach was consistent with the interests of the banks, which did not want to admit to an erosion of their capital bases and voluntarily apply for an injection of funds. It was in the interest of their NPL borrowers that wanted to avoid foreclosure. It was in the interest of the FSA, which did not want to admit that it had made a mistake in 1999 when it erroneously indicated that the capital injection at that time had fixed the problem. It was in the interest of incumbent politicians who did not want to go back to the public for more money to fix the banking system. Given this coincidence of interests, it is perhaps not surprising that the policy has amounted to a stable equilibrium in both economic and political terms—but one that has permitted the continued deterioration of the economy and, even more important, has made the ultimate resolution of the problem ever more costly and ever more disruptive.

The crucial issue is that, as the costs mount, deferring the resolution of the problem is not in the interest of the country as a whole. The formation of the Koizumi government gives the FSA the political support it needs to address the problems more forcefully. First, it can broaden the definition of problem loans to encompass all financial institution loans—not just those of the major banks.[3] Second, it can encourage weak banks to ''voluntarily'' accept a capital injection. (The preferable alternative would be new legislation that would permit the direct nationalization of the banks and their closure or recapitalization under new managements.) Third, the government needs to clearly signal that malfeasance at existing institutions will be dealt with firmly to discourage the socially harmful evergreening of NPLs.

Aggressive action toward the banks would act as a further drag on growth in the short run. It has been estimated that the Yanagisawa Plan to force the major banks to clear their NPLs in 3 years could lead to 20,000 corporate bankruptcies and the elimination of 200,000 jobs. Resolution of the extensive problems beyond the major banks could ultimately lead to more than 1 million people losing their jobs.

Although repairing the banks might slow the economy in the short run, however, it is necessary to restore long-run growth. In addition, decisive action by the government should actually restore public confidence. Forward-looking equity markets would rise, strengthening bank balance sheets. Decisive action would also encourage capital inflow, further reinforcing the rise in asset prices (and the exchange rate). Most important, decisive action by the government and increases in equity prices would help both to reduce precautionary savings and to generate a positive wealth effect to encourage private consumption. The result

3. The FSA has defined the problem in an excessively narrow way. Such a strategy has a certain bureaucratic logic—the ''problem'' is sufficiently small that it can be dealt with largely using resources already allocated for financial-sector cleanup—but it does not begin to address the totality of the *real* problem.

would be a virtuous circle that could help offset some of the short-run frictional slowdown due to financial-sector disruption.

The most critical reason for forceful action, however, is the unpalatable alternative faced by Japan. At best, it could experience another decade of lost growth. At worst, it could face a major crisis at almost any time as the increased transparency of the accounting system reveals the depth of the problems facing the financial and corporate sectors: a renewed Japan premium in world financial markets, bank runs as in late 1997, and capital flight from the yen. The case for definitive action is overwhelming.

In addition, the short-run depressive effect of decisive action to deal with financial-sector troubles could be partly offset by macroeconomic policy. The case for more aggressive monetary policy is straightforward: Japan is in a liquidity trap, and the Bank of Japan should adopt an inflation-targeting approach to extricate the economy. More expansionary monetary policy can be supported by more expansionary fiscal policy—although, in the case of fiscal policy, greater nuance is required because of legitimate long-term concerns regarding the high level of existing budget deficits and national debt, and the society's prospective aging and thus early need for substantial increases in welfare spending.

In the long run, Japan needs to address the problem of its fiscal health with respect to both the accumulation of excessive government debt in recent years and the likely needs of an aging population in the near future. Prime Minister Koizumi has announced his intention to limit the issuance of bonds in fiscal 2002 to ¥30 trillion. Such fiscal consolidation should be pursued, but in a flexible manner.

In particular, the termination of substantial wasteful expenditures on public investments of dubious merit will free up resources in the budget. Some of these resources should be redirected to expanded safety-net and worker-retraining programs to address the problems of those left unemployed by the reduction of public investments and the essential restructuring of the financial system.[4] Some can be used to fund tax breaks targeted at residential housing; housing construction is 30 percent below its 1991 peak, and it would be far better to use the construction industry to build suitable housing (as recommended in chapter 3) than to build roads to nowhere. This would offset some of the loss of aggregate demand and help cushion the blow for the construction sector.

The remainder of the budget savings can be devoted to financial-sector cleanup (although loans to the financial sector do not technically count as current budgetary expenditures under existing Japanese accounting conventions). This would help square the circle of the desire to consolidate fiscal policy while recognizing that public money will be required to

4. These new programs might usefully include a component for wage insurance as proposed for the United States in Kletzer (2001).

finance recapitalization of the financial system. At the same time, it should be recognized that tax revenues expected at the time the bond-issuance pledge was made by Koizumi are unlikely to be realized, given the weakness of the economy. The government should not be dogmatic on the timing of its adherence to the bond-issuance ceiling; indeed, it needs to interpret the pledge as relating to the budget on a full-employment basis.

More aggressive financial-sector cleanup policies, undertaken in the context of supportive monetary and fiscal policies, should help return Japan to a stable growth path in the medium run. Indeed, in light of the huge output gap that has developed during the past decade, Japan might even experience several years of supernormal ''catch-up growth.'' The restoration of sustainable domestic demand-led economic growth in Japan would be not only in Japanese interests, but in the interests of the United States and the entire world as well. A growing Japan would contribute to the world economy rather than threaten it. It would be far more likely to act in concert with the United States to address global issues, such as development and security. Moreover, it would be a more attractive destination for US exports and investment.

Nevertheless, no matter how desirable such outcomes might be from a US as well as Japanese perspective, the United States can do little to ensure their realization, beyond providing hortatory encouragement and peer pressure through groups such as the G-7, the IMF, and the OECD. Although the United States may have expertise for Japan to draw upon, it has little leverage through which to encourage Japan to adopt the desired prescriptions. In contrast, the United States has a greater capacity to influence outcomes in the areas of trade and investment, where the linkages between the two economies are much more direct. It is to these bilateral trade and investment links that we now turn.

Reorienting the Trade Relationship

Japan and the United States should continue to shift the resolution of their trade and investment conflicts away from bilateral channels and toward multilateral forums, such as the WTO and the OECD. As was noted above, as Japan becomes less distinct, the ''less'' is the justification for addressing these issues bilaterally. Moreover, to the extent that Japanese political institutions remain weak, and Japan continues to rely on external pressures to stimulate its own reform process, it is better that this pressure come from multilateral organizations (e.g., the WTO) or agreements that Japan has entered into voluntarily (e.g., the Japan-Singapore FTA) than ad hoc from the United States. Better yet, of course, would be a domestic political force capable of self-initiating reform without foreign pressure; the Koizumi government, which has publicly put structural reform at the center of its domestic agenda, would appear to be the best bet to achieve this since the Hosokawa cabinet collapsed in 1994.

The Role of the WTO

The changes in global trading rules, embodied in the creation of the World Trade Organization, bear emphasis, as was described in chapter 5. The new Dispute Settlement Mechanism (DSM) essentially precludes the United States from using unilateral devices, such as Section 301, either against alleged violations in sectors covered by the WTO or as a basis for retaliation in those sectors—which amount to the vast bulk of world trade.[5] Japan would simply threaten to take the United States to the WTO, where it would almost surely be granted authority to retaliate against such US practices. Indeed, the United States retreated quickly when Japan threatened WTO action if the United States acted on its threat to retaliate in the auto parts dispute in 1995. (By contrast, Japan was unable to get the GATT even to convene a panel when it sought to counter the US retaliation in the semiconductor case in 1987.) In this sense, the establishment of the WTO forces the Japan-United States trade relationship into a more ''normal'' pattern, which we regard as desirable.

At the same time, the new DSM presents a powerful new tool for the United States to pursue its trade objectives toward Japan. The United States won 23 of the first 25 cases it brought under the new arrangements, achieving liberalization of the target country's trade regime in each instance. Japan has a good record of adhering to judgments against it in the GATT and now the WTO. Indeed, an important reason for the United States to emphasize normal multilateral channels in its trade efforts with Japan is its need to win Japanese agreement to bring competition policy and other important but uncovered issues into the WTO so that the DSM also may apply to them. Even when the United States loses, as in the Kodak-Fuji case, the WTO can resolve a complaint brought by the United States that would have been much messier if the WTO had not had the power of the DSM.

The antidumping issue is a difficult one. From a pure economics standpoint, it would be better to abandon antidumping cases altogether and adopt a competition-policy standard, but this would be difficult from a political or negotiating standpoint. Given these realities, the WTO is also extremely useful, because it both legitimates and constrains the United

5. Technically, the United States could still use Section 301 (or simply apply unilateral increases in its import barriers) if it were willing to pay compensation to other countries or accept retaliation from them. There would be little point in doing so, however, and the domestic politics of such a sequence of steps would almost surely be damaging for any presidential administration that took them—as is intended to be the case.

States and its partners in the application of the few remaining tools in their unilateral arsenals.

Both antidumping duties, and countervailing duties against government subsidies, are permitted under current WTO codes. Japan (and many other countries) will clearly try to negotiate changes in these rules in future multilateral trade negotiations, and the United States may decide to accept some modifications in their implementation to constrain their use by its partners and to obtain concessions by Japan (and other countries) on other issues. Again, the WTO provides major benefits for US trade policy.

It is difficult to imagine the two countries making much bilateral progress on the two outstanding issues of border protection that now confront them: agriculture in Japan, and antidumping in the United States. These issues must be addressed multilaterally, to reach solutions that are both coherent economically and sustainable politically. Japan is not going to undertake discriminatory agricultural liberalization with the United States, and the United States is not going to create a Japan-specific waiver in its antidumping laws. To secure its goals, the United States needs METI and Japanese manufacturing interests on its side to overcome opposition by the Ministry of Agriculture, Forestry, and Fisheries and rural interest groups. Conversely, Japan needs to offer the United States something big to induce change in antidumping practices, because Congress regards the antidumping law as the last line of defense against hidden protection in Japan (and "low-wage" imports from poor countries).

For any government, exploiting these cross-issue trade-offs and creating the internal political clout to overcome entrenched domestic issues is less difficult in "big-package" multilateral negotiations (Bergsten 2001). Japan and the United States are no exceptions. In particular, the built-in agenda of agriculture and services coming out of the Uruguay Round offers Japan little in the mercantilist terms of domestic politics. The US position in Seattle—of simultaneously trying to limit the conventional trade agenda to these topics while adding the new "social clause" issues of trade and the environment and trade and labor—encouraged Japan (and the European Union) to play an obstructionist role. If progress is to be made, the agenda must be broad enough to allow all participants to point to "victories" or "achievements" when selling it at home.

Extending the Agenda: Competition Policy

So what should Japan and the United States be pushing in the WTO (and APEC) to realize their respective interests in a more constructive way? One can imagine three significant additions to the built-in WTO agenda on which the two countries could usefully cooperate, and that would increase the likelihood of the United States achieving its goals in agriculture and services: a multilateral accord on competition policy that would embrace antidumping measures, stronger WTO rules to govern bilateral or plurilateral free trade agreements, and new procedures for selecting the future leaders of the key multilateral economic institutions.

The first and most important would be a multilateral accord on competition policy. This would have to involve the European Union and could most naturally be done in the WTO. As a fallback, one could possibly imagine an Asia-specific initiative in APEC or, more likely, a plurilateral agreement in the OECD (which would exclude the developing countries, which might act in an obstructionist manner in the WTO).[6]

The issues of competition policy and antidumping are related. Antidumping laws were originally an attempt by national authorities to deter predatory behavior by foreign firms with respect to domestic producers for which the ''reach'' of national competition policies was inadequate. Today in practice, however, the application of antidumping laws has little to do with deterring predation and instead serves largely as a mechanism for shielding inefficient local producers from foreign competition, in effect transferring rents from domestic consumers to domestic and foreign producers. As the practice has proliferated around the globe, the United States has emerged as the second leading *target* of new antidumping actions in recent years, following China, as well as a leading initiator of antidumping cases.

In the United States, there is an understandable wariness about ''surrendering'' antidumping policy for an international accord on competition policy. To start, there is no single international competition-policy standard, and what constitutes unacceptable or illegal behavior varies enormously across countries.[7] Even where laws do exist, there may be significant differences in content, sectoral scope, and entities covered.[8] Many, though not all, countries, for example, prohibit horizontal cartels but not vertical exclusive dealerships. These differences even extend to core competition-policy rules in major industrial countries, including Japan.[9]

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6. The competition-policy issues are not of great relevance for most developing countries, which would probably be wary of taking on new obligations in an area of policy in which their own domestic competence remains rudimentary in most cases and nonexistent in others. Another approach would be to have a plurilateral competition-policy code in the WTO from which developing countries could opt out, as proposed by the European Union.

7. See OECD (1996) and Graham and Richardson (1997) for excellent overviews of industrial-country competition policies.

8. See OECD (1996) for an elaboration of these issues.

9. For example, under the Japanese Anti-Monopoly Law (AML), a private monopolization or cartel is illegal only if it restricts competition ''contrary to the public interest,'' a phrase that is subject to multiple (and contradictory) interpretations (Matsushita 1997). However, at least one former US official intimately familiar with the issue regards enforcement, not the law itself, as the problem.

These cross-national differences in legal standards are compounded by differences in enforcement procedures and the severity of penalties for illegal behavior. In Japan, for instance, alleged lax enforcement of competition policies has been a source of trade and investment friction with both the United States and the European Union. Many observers in the United States, with reason, are quite skeptical about Japan's (or China's, or South Korea's) seriousness about competition policy, as least as generally understood in the European Union or United States.[10]

Japan and the United States have been in continual negotiation over competition-policy issues since the Carter administration, and the key bureaucratic actor in this regard is the Japan Fair Trade Commission. In part because of US pressure, in the past decade the JFTC received a bigger budget, bigger staff, and more statutory independence. Although the JFTC has historically been regarded as the lapdog of the interventionist MITI, the incompatibility between the goals of the two organizations seems to have declined as METI (as it has now become) has reinvented itself as the champion of deregulation.

In recent years, the JFTC's scrapes have been with other ministries (e.g., construction and transportation) over JFTC actions toward their client industries. Indeed, from an international perspective, the JFTC appears to be fairly large and active, at least as measured by budget or staff. In addition, Japan and the United States have signed a positive comity agreement, so that if one competition-policy authority suspects anticompetitive behavior in the other's market it can request an investigation by its counterpart agency. US courts and the Department of Justice have no way to compel foreign firms to produce evidence for their own investigations, however.[11]

The issue (beyond some possible inadequacies in Japanese law) is the JFTC's willingness to vigorously pursue and prosecute potential violations. Outside Japan, there is considerable skepticism about the JFTC as a watchdog. A survey done by the International Institute for Management

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10. See Bergsten and Noland (1993) and MITI (1996) for examples of such friction with Japan involving the European Union and United States. In an attempt to address this issue, the European Union and the United States have spearheaded the establishment of a Global Competition Forum, which is intended to be a think tank that brings together competition-policy professionals from public, business, academic, and consumer bodies (Monti 2001). See Morici (2000) for a comparison of EU, Japanese, and US approaches to competition policy.

11. During the presidential primaries in 1992, when incumbent President George Bush was taking a drubbing from both his Republican challenger and Democratic opponents for being soft on trade in general, and soft on Japan in particular, the Justice Department revived the notion of the extraterritorial application of US antitrust laws, which had been abandoned during the Reagan administration. This was immediately denounced in Japan, which threatened to enact blocking statutes prohibiting its firms from complying with US court rulings (as other countries had done in similar episodes of this type). Internal opposition within the Bush administration and foreign blocking threats effectively killed this initiative.

Development found that the United States had the 5th best competition policies in the world (following Australia, Germany, Canada, and the Netherlands), whereas Japan ranked 17th (following Mexico, India, and Brazil).[12] Stokes (2000) notes that only one survey by the economics section of the JFTC has ever led to an investigation. Despite enhanced legal penalties, no one has ever gone to jail in a Japanese antitrust case. In cases in which offending executives were subject to criminal sanctions, they received suspended sentences. Instead, most cases end up in formal injunctions (corrective actions) but with consent (*kankoku shinketsu*) rather than going through a court procedure to a verdict (*shinketsu*) with a penalty.[13] Ariga, Ohkusa, and Nishimura (1999) find that monitoring activities by the JFTC appear to be more effective in disciplining market power than formal actions.[14] Although chapter 4 documented a number of specific actions undertaken by the JFTC, one gets the impression that the behavior exposed represents little more than the tip of the iceberg.

No one would claim that the JFTC is as effective as it could be, and one can easily identify areas in which it needs to articulate coherent competition policies. For example, with new entrants and the complete deregulation of airfares, competition policy must be applied to questions such as whether incumbent airlines have pursued anticompetitive pricing policies to discourage new entrants on particular routes; how landing slots should be allocated between established carriers and new entrants; and what rights should be accorded to passengers bumped from overbooked flights. After more than 20 years of air travel deregulation, the United States has considerable experience in dealing with these sorts of issues.

Another example is telecommunications. What is the appropriate policy toward the dominant NTT group, when Internet access can also be achieved through a cable television provider, and the Internet may permit the long-distance telephone communication to bypass the long-distance telephone service provider? A third area is the impact of foreign mergers on Japanese consumers, as in the proposed merger of General Electric

12. *The Economist*, 16 May 1998.

13. Penalties are imposed, however. For example, in 2000, the JFTC imposed $62 million in fines on firms for violating the AML. See Morici (2000) for a description of the JFTC's enforcement options and procedures.

14. Using an econometric model, they find that the JFTC can influence profit margins by listing firms on a suspicious-pricing and anticompetitive-behavior "watch list" (involving monitoring and compulsory reporting). Industries on the list tend to have higher concentration ratios, as measured by the market shares of the top three firms. In contrast, industries subject to formal injunctions do not have higher than average concentration ratios, and the injunctions do not affect profit margins. Of course, as the authors admit, their result merely establishes the relative effectiveness of monitoring—not the optimality or desirability of the underlying profit margins.

and Honeywell, where the JFTC has issued regulations, though it remains to be seen how these will be applied and to what end.

Beyond the issue of its legal mandate, the JFTC seems to suffer from a lack of intellectual vitality. To the extent that it embodies any particular concept of competition policy, it is the traditional antitrust mantra: A large market share is bad, collusion is bad, and price fixing is bad. It does not appear to have incorporated modern concepts from industrial organization (e.g., the theory of contestable markets or notions of dynamic pricing) into its policy framework, despite their obvious relevance to a raft of issues that Japan confronts (Graham and Lawrence 1996). It would be desirable for the JFTC to increase its analytical capability; this could be accomplished by creating a chief economist position with significant staff resources and hiring a highly regarded applied microeconomist from outside the government to fill it.

From a US perspective, despite the JFTC's uneven record of accomplishment, there are reasons not to dismiss the competition-policy approach out of hand. Ultimately, this is where the action is, and the United States eventually will have to reach mutually acceptable accommodations on competition-policy issues, not only with Japan but with China and South Korea as well. The question is one of tactics. The United States is more likely to reach agreements that it regards as satisfactory, and that would be politically sustainable in these countries, if it worked multilaterally in concert with Australia, the European Union, New Zealand, and other countries with similar competition-policy traditions, than if it were to try to do so bilaterally.[15] Japan would seem to be the obvious first "non-Western" candidate for possible integration into a multilateral competition-policy scheme.[16]

The appointment of a strong independent chief economist to modernize the JFTC's economic analysis and serve as an improved basis for policymaking would be a start. But in the end, to achieve results, improved analysis will need to be combined with effective enforcement. This could be particularly important with respect to public works and construction, where the problems are large and the government's responsibility direct. Only when the JFTC is revamped will Japanese competition policy be credible, and cooperative competition policy be in a position to replace antidumping.

Likewise, it may prove advantageous to reemphasize the process of strengthening international norms with respect to regulation and corporate governance through the OECD. Skeptics will counter that agreements

15. This is not to say that bilateral international cooperation agreements with like-minded countries might not be steppingstones to multilateral accords. See Graham (2000).

16. See Graham (2000), Morici (2000), and Monti (2001) for alternative conceptions of what such a regime might entail.

reached in the OECD lack an enforcement mechanism. This is true but, although the formal dispute-settlement process of the GATT was ineffective, the establishment of international norms in the context of a consensual process was useful in achieving trade liberalization in Japan, despite the absence of credible sanctions. If an external anchor is needed to spur Japanese reform, it would be both more effective and less damaging to bilateral relations if it were to come through a multilateral consensual process in which Japan was a voluntary participant.[17]

Moreover, even accepting the mercantilist logic of trade negotiations, the value of the negotiating concession that the United States would have to make—acquiescence in tightening disciplines on the use of antidumping laws—is falling. Although the United States is by far the major user of this form of protection, US firms are increasingly the targets of antidumping actions as more and more countries adopt this trade-policy instrument. And, as maddening as the US government's application of its antidumping law is to others, the degree of transparency and economic rationality in other countries' application of their own antidumping laws is even lower. The United States should quit while it is still ahead.[18]

The acceptance of tightened disciplines on antidumping laws, in return for a strengthened international standard on competition policy, would be a hard sell from the domestic political perspective of the United States. However, US trade negotiators have faced similar "sacred cows" before: The absence of an injury test in the US countervailing duty statute was viewed as sacrosanct by Congress before the Tokyo Round in the 1970s, and the quotas on textile and apparel imports enjoyed similar status in the 1980s and 1990s before the Uruguay Round. In both cases, however, US negotiators were ultimately able to win approval to liberalize the objectionable practices by combining two elements: concessions by the other major countries on both the key issue itself (respectively, commitments to limit export and other subsidies, and liberalization of their own imports of textiles and apparel) and on other issues of compelling national interest to the United States (including, respectively, bringing services trade into the GATT and a strong agreement to protect intellectual property rights).

In addition to an agreement on competition policy itself, the United States is thus likely to need significant concessions from its major trading partners to win domestic political support for the deal. The main areas

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17. Some argue that market pressure alone, mainly in the form of increased foreign investment and the increased role of foreign financial intermediaries in the economy, will be sufficient to achieve improvements in Japanese corporate governance. Although foreigners may play a constructive role in this regard, we remain skeptical that market forces alone will generate a fundamental transformation of Japanese corporate governance.

18. Messerlin (2000) recommends a number of changes in WTO rules to impede the abuse of antidumping laws.

where such concessions could convince Congress to accept some tightening of international disciplines for the use of antidumping measures are the modern perennials of US export interest: agriculture and services. Japan, in particular, will have to agree to substantial reductions in its agricultural and services protection to enable US negotiators to win domestic support for any eventual WTO package. (The European Union also will have to liberalize substantially on agriculture but in mercantilist terms, like the United States, it will generally *benefit* from liberalization in the services sector.)

Shaping the New Free Trade Agreements

Another potential element of a new WTO negotiation that could help ''sell'' the eventual package in the United States, as well as make sense on its merits, could be a strengthening of the WTO rules that cover bilateral and plurilateral free trade agreements. As was discussed above, Japan is in the process of exploring FTAs with a variety of countries. It alone among the major industrial countries does not now participate in regional preference schemes, and can rightly argue that it has been adversely affected by trade diversion stemming from the formation of the European Union and NAFTA. That said, both Japan and the United States (and indeed the whole world) stand to lose if the locus of international trade policy shifts from the WTO to a crazy quilt of preference schemes. Indeed, the United States could be disadvantaged by trade diversion arising from Japan's FTAs—just as Japan can argue that it may be further harmed by the Free Trade Area of the Americas (FTAA).

Since about 1998, Japan has begun cautiously exploring—and also receiving approaches from other countries concerning—the possibility of a series of bilateral free trade agreements. A high-profile discussion was launched with South Korea by the countries' heads of government. Bilateral talks were initiated with both Mexico and Singapore—the latter reportedly intended as an initial sally into ASEAN that Japan would hope to extend eventually into similar bilateral talks with Malaysia, the Philippines, Thailand, and ultimately Indonesia (although many in those countries would prefer that any such discussions with Japan be conducted by ASEAN as a group rather than bilaterally, and Japan in fact proposed a Japan-ASEAN FTA in early 2001).

At the time of this writing, the Japan-Singapore agreement seems likely to be concluded in 2001, but it is unclear whether any of the numerous other regional and subregional initiatives in East Asia, including those launched by Japan, will succeed (Scollay and Gilbert 2001). It is clear, however, that there has been a debate for some time in Tokyo over whether Japan should continue to place priority on its relationship with the United States or whether it should shift to an ''Asia-first'' strategy. The new regional initiatives (which are taking place in the monetary area as well, initially via the Network of Bilateral Swap Arrangements under the so-called Chiang Mai Initiative) that were described in chapter 6 represent an initial, perhaps tentative and experimental, step in the latter direction.

These initiatives clearly represent a possible new course for Japanese foreign economic policy, with which the United States must reckon as it considers its own policy for the future. Knee-jerk US opposition to such groupings in Asia, including Japan, could of course invite considerable resentment; if the European Union, NAFTA, Mercosur, and other regional agreements are viewed as building blocks for multilateral economic integration, so should regional agreements in Asia (Lawrence, Bressand, and Ito 1996). Construction of a free trade agreement or two by Japan is nothing but a move toward more normal-country status.

We believe that this new Japanese gambit strengthens the case for the United States to move beyond a Japan-specific economic policy in favor of treating Japan as a very important but normal part of US foreign economic policy—including a heavy reliance on multilateralism to pursue most US priority objectives. Strengthening the existing multilateral institutions in both trade and finance, and their ''democratization'' to include an increased role for Japan and other Asian countries, would lessen the desire (or excuse) for Japan (or other countries in East Asia) to opt for regionalism as an alternative strategy. The Asians, including Japan, could of course still develop regional arrangements—just as the United States has done with NAFTA and the Europeans have done much more extensively. But their doing so *within* the framework of an effective, appealing multilateral system would obviate most of the risks that might otherwise result for global economic cooperation, and in particular the risks for Japan-United States relations that could evolve from a Japanese movement away from the global institutions.[19]

As a consequence, a strengthening of GATT Article 24 concerning preferential schemes, and the WTO process of reviewing preferential agreements for compliance, could be another new item of mutual cooperation. Japan and the United States could do several things to ensure that their own preferential agreements do not undermine the global system. First, they could push for reform on this issue within the WTO. One change would be to clearly define the key term ''substantially all sectors,'' which is required to make FTAs legal under the WTO, to eliminate the possibility of sectoral carve-outs. A second change would be to rule out the use of grey-area measures, such as VERs in preferential arrangements, *without* grandfathering the existing soft FTAs.[20] Third, rules of origin are some-

19. In their report to the G-7 heads of government in July 2000, the G-7 finance ministers endorsed the pursuit of Asian regional financial arrangements that are ''supportive of the IMF's objectives and responsibilities in the global economy'' (G-7 Finance Ministers 2000).

20. In theory, the Uruguay Round agreement foreclosed the use of VERs in the context of preferential arrangements. However, this practice has yet to be challenged. Similarly, there

times written to frustrate liberalization in particular sectors, effectively undermining the "substantially all sectors" requirement; this problem could be addressed through strengthened "rules on rules," such as requiring that rules of origin be the same for all sectors (Lawrence 1995).

Other reforms could seek to limit the likelihood of injury to third parties through trade diversion. Conceptually, the most straightforward approach would be to require FTA participants to reduce their external tariffs to compensate disadvantaged outsiders. The problem, of course, is that this requires economic, not legal, analysis, and it is difficult to imagine WTO signatories ever agreeing to submit their trade policy to this kind of constraint. A plausible alternative would be to adopt a rule that external tariffs must be reduced to the tariff of the lowest member (in effect converting FTAs into relatively liberal customs unions) or, less daunting, that external tariffs be reduced to the average of the FTA participants' tariffs.[21] Although such schemes would not eliminate the possibility of trade-diverting FTAs, they would in effect raise the "reservation price" of entering an FTA and thus reduce the likelihood of a proliferation of welfare-reducing agreements.

Last, WTO members also could be required to submit their preferential arrangements to annual WTO reviews. The objective would be to generate peer pressure and moral suasion to ensure that FTAs expand world trade by producing more trade creation than diversion. The existing Trade Policy Review Mechanism could be used for this purpose (Keesing 1998). Having staked out such a position in the WTO, Japan and the United States could voluntarily submit their own FTAs for review before the procedure was even formally adopted by the organization.

Some will object that what is good for the goose is good for the gander, and that it would be hypocritical for the United States—having entered into NAFTA and proposed an FTAA (along with possible bilateral FTAs with Chile, Jordan, and Singapore)—to try to deny others the joys of regionalism. But this line of argument fails on three grounds. First, NAFTA is largely, if not completely, consistent with Article 24, and innovative aspects of NAFTA (e.g., liberalization of investment and services) in fact became a model for the Uruguay Round. Second, all countries stand to lose if regional agreements proliferate unchecked. Third, Japan, given its problems in agriculture and services, cannot realistically expect to achieve major benefits through WTO-consistent FTAs.

Japan may of course counter that the rush to conclude preferential arrangements has been led by the European Union and United States, and that Asian schemes are reactive and defensive. But the real issue is whether the prospective Asian agreements will be WTO-consistent. Rather

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was some attempt to strengthen Article 24 in the Uruguay Round, but this effort foundered on how to treat existing EU deals.

21. See Frankel (1997) for further discussion along these lines.

than criticizing such explorations a priori, the United States should emphasize the need for any such agreements to be consistent with Article 24. For Japan, it may be desirable to give the United States something on Article 24 (as part of a bigger package) in return for something much more important—strengthened disciplines on antidumping.

Another potential area of Japan-United States cooperation in the WTO, indeed in this case in the multilateral economic organizations more broadly, is leadership selection. Japan and the United States backed opposing candidates in the struggle to succeed Renato Ruggiero as director general of the WTO in 1999. This, in and of itself, is unremarkable and should not be subject for concern. However, what the struggle itself signaled (as was reaffirmed in a similar fight soon thereafter over the managing directorship of the IMF) is that the "national reservation" system of filling the top spots at international institutions is fundamentally bankrupt. Reform of the leadership-appointment process is another area of potential mutual cooperation—in this case spanning trade, finance, and development (Kahler 2001).

Recalibrating US Trade Policy

What would be the tactical implications for the United States of this proposed new approach to Japan? It is traditional for area specialists to complain that the United States does not "do enough" with respect to their area of concern and to recommend an increase of resources—whether that area be Japan, Africa, or anywhere else. But advocates of "doing more" with respect to Japan must face the reality that exports to Japan account for less than 1 percent of US national income. Even if one accepts the high-end estimates of the potential mercantilist gains from enhanced access to Japan, the experiences of the Bush administration (SII negotiations undertaken at the undersecretary level) and the Clinton administration (undersecretary-level negotiations, plus semiannual meetings of heads of government) do not support the view that the United States has not devoted enough high-level attention to the problem. The reality is just the opposite: Those resources would surely have been better spent addressing other problems that confront the United States internally or strengthening the multilateral system externally.[22]

22. One exception to this notion would be in the area of compliance, where the United States is notoriously weak. According to Stokes (2000, 73), "the Commerce Department's Market Access and Compliance Unit, which monitors the implementation of US trade agreements, had seventeen people working on Japan issues in 1992. It 2000, it had nine." See also Lincoln (1999). But even with respect to monitoring, it should be recognized that the relative amount of resources devoted to Japan-specific activities should probably decline as Japan's relative importance in US economic life lessens.

Rather, the United States needs to strengthen some skill-specific areas in its dealings with Japan. The first area for improvement would be Japanese language skills. At times, the USTR has had only one person on the Japan desk who actually spoke Japanese. A second area of improvement would be competition policy. Trade negotiators and antitrust lawyers do not see the world in exactly the same terms. If competition policy is going to become more and more central to the bilateral agenda, then it behooves the US government to strengthen the degree of cooperation between the USTR and the Department of Justice (DOJ). One possibility would be to begin a permanent program of cross-secondments between the two organizations.[23] Another would be to initiate a cross-recognition policy that DOJ has the right to participate in any discussion of competition-policy issues with Japan, and the USTR has the right to participate in antitrust activities that DOJ pursues in conjunction with the JFTC.

The issue of competition policy, the need to strengthen the skill set embodied in the bureaucracy, and the need to better integrate activities across the bureaucracy are simply leading indicators of a more general phenomenon that the United States will face more and more in the future. As the Japan-United States trade agenda shifts away from traditional border measures and toward domestic regulatory issues, the necessary professional backgrounds and skills of US negotiators will have to change as well. Again, this may require improving the human capital of the bureaucracy (e.g., improving expertise in technical issues relating to information technology), while at the same time improving the coordination and integration of activities between the USTR and a growing number of agencies within the US government. This is particularly important in the context of the US system of complainant-driven trade-policy formation. Without the capacity to evaluate competing industry and firm claims on attention and resources, the US system can easily degenerate into an orgy of rent seeking in which the squeaky wheel gets the grease.

These personnel and organizational improvements will not be easy, either in terms of recruitment or coordination. The skills that will be needed to conduct Japan policy will more and more correspond to skills in demand outside the government. Compensation will have to be adjusted accordingly to recruit and retain staff.[24] Bureaucratically, coordination will have to be genuine. Today, the US government maintains an extensive

23. Along with cross-agency secondments, the two governments could usefully consider expanding cross-government secondments, e.g., those currently carried out through the Mansfield Center for Pacific Affairs.

24. Political realities mean that it will be very difficult to pay civil servants with marketable skills salaries comparable to what they can earn in the private sector. Intangible compensation is not limited by the Constitution, however. High government officials could make a start by forswearing the practice of scoring cheap political points by bad-mouthing the federal bureaucracy, as has been the case for well over two decades.

network of interagency groups, including several devoted to Japan policy. In large part, these serve as mechanisms for defining turf. In the future, no single agency will embody the skill set necessary to successfully and effectively integrate the skills and perspectives needed to achieve US national interests.

These staffing and coordination issues are genuine challenges for the successful implementation of public policy. They will be difficult to surmount for global issues. They will be even more difficult to overcome for a series of country-specific or regional policies. These considerations underscore the notion that the United States would be better served if it were to deemphasize Japan-specific policies, and to root its dealings with Japan more firmly in multilateral forums. Indeed, given the increasing informational complexity of the issues that the multilateral forums will be called upon to resolve, Japan and the United States would do well to increase expenditures on the WTO, strengthen its secretariat, and professionalize the treatment of its dispute panel members.[25]

Rebasing the Monetary Relationship

The international monetary system carries no deterrents to unilateral action similar to those for the trading system that are now imbedded in the WTO. The United States can unilaterally stimulate (sometimes with jawboning alone) appreciation of the yen, as it arguably did in 1993-95 in pursuit of its trade-policy (as well as trade-balance) goals, without running afoul of any rules that would authorize Japanese ''retaliation.'' The current regime of unilaterally managed floats leaves each major country with enormous discretion. Moreover, Japan's huge trade surpluses and massive foreign exchange reserves enable it to deflect virtually any conceivable external financial pressure.

In an earlier book on this topic, two of the authors proposed the restoration of the yen-dollar target zone that had been implemented for a year or so in the middle 1980s as a ''reference range'' under the Baker-Miyazawa initiative (Bergsten and Noland 1993, especially 208-10). That bilateral accord preceded the Louvre Agreement that broadened the agreement to adopt reference ranges for the full G-7. Our third author has endorsed similar proposals in his own writings on the topic (Takatoshi Ito 1989).

We continue to believe that the sharp gyrations in the yen-dollar rate, which have been the most marked of the fluctuations among any of the major currencies throughout the three decades of generalized floating of exchange rates, have significantly exacerbated Japan-United States trade and broader economic tensions. They have done so by producing prolonged misalignments, generally dollar overvaluations, that have

25. See Schott (1998) for further discussion.

increased the external imbalance between the two countries and intensified protectionist pressure in the United States. They have also produced significant financial disruptions and risks, including for Japan, when the yen also has become misaligned—in both directions, as with its excessive appreciation to 80:1 against the dollar in 1995 and its subsequent excessive depreciation to 150:1 in 1998.

Both countries would thus benefit from the installation of a more stable monetary regime, either bilaterally or more broadly among the G-7. We recognize, however, that the present positions of these countries reject such a system as either undesirable or infeasible, or both.[26] Hence, there is no practical prospect for the adoption of such reforms in the near future, and we will not make a major point of recommending them in this volume.

There is another potential area for multilateralizing the monetary relationship that offers more immediate prospects, however. As stressed in chapter 3, and earlier in this chapter, the weaknesses of Japan's banking system lie at the heart of its economic difficulties over the past decade and continue to cast a dark shadow over its outlook. Hence the United States has increasingly emphasized the need for fundamental banking reform in its entreaties toward Japan over the past couple of years.

The opportunity for multilateralization lies with the decision of the International Monetary Fund in early 1999, largely in the wake of the Asian monetary crisis (and similar earlier crises), to launch a Financial Sector Assessment Program. That program monitors financial sectors in member countries, developed and emerging alike, in an effort to promote preventive actions and thereby head off future disruptions. In August 2001, the IMF asked Japan to agree to an assessment of the country's financial system, including the state of nonperforming loans at the banks, under the new program. Japan's initial reaction was hesitant but the program offers an excellent opportunity to replace traditional American *gaiatsu* with a multilateral approach in a critical policy area that should be much more acceptable to Japan.

In the meanwhile, and partly because of US unwillingness to consider substantial changes in the global financial architecture, Japan appears to be actively considering a new policy alternative that could be important for its relationship with the United States: the creation of regional financial arrangements in East Asia that could reduce Japan's dependence on US markets and the fluctuations of the dollar. We have already noted that Japan is promoting these arrangements in the trade area, but it is doing so in the monetary area as well.

On finance, Japan has bounced back from the rebuff (mainly by China and the United States) of its proposal for an Asian Monetary Fund in

26. The reasons for those views are explained and countered to in Bergsten and Henning (1996).

1997. As was described in chapter 6, the ASEAN + 3 group (in which the "3" consists of China and South Korea, along with Japan) announced in May 2000 their agreement to create a regionwide network of currency swaps (really medium-run credits) to help them respond to future crises without relying so heavily on Washington. The group announced the first bilateral credit lines under this so-called Chiang Mai Initiative in May 2001. More broadly, the ASEAN + 3 group has held annual summit meetings since 1997, and its finance ministers now meet when opportunities arise.

This process can be compared with the initial series of regional agreements among European countries in the early 1950s and the first steps toward the creation of the worldwide G-10 swap network and General Arrangements to Borrow in the early 1960s. The embryonic Asian initiatives could evolve over time into a true Asian Monetary Fund and even—as was already proposed by the respected head of the Hong Kong Monetary Authority, Joseph Yam—into an Asian currency unit à la euro (though the Japanese Ministry of Finance quickly indicated that such a development could only be realized in the distant future, if at all). A central motive for all these monetary initiatives is greater regional autonomy and self-determination, more and more independent of the United States and the Washington-based international financial institutions (Bergsten 2001a).

Although some Americans may reflexively see such efforts as threatening US interests, this need not be the case. The integration of China into the institutions and norms of the liberal global order is likely to be one of the greatest strategic challenges of the next generation. Indeed, an ideologically hostile and territorially expansionist China is probably the only threat sufficiently large to fuel the kind of "deep integration" between Japan and the United States that some advocate. Rather than be forced down this difficult and dangerous road, it would be far better to integrate China into the international system in a way that would not only facilitate more harmonious relations between it and the rest of the world but would avoid the need for the United States and Japan to pursue the dubious chimera of deep integration. To the extent that regional institutions act as another thread in the web drawing China into the international system, the United States should be supportive of Japanese efforts to construct regional arrangements in Asia—as long as those institutions do not detract from the global institutions.

In the same way, 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 has been indicated 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.

On the central issue of macroeconomic and monetary policy, the United States has at least three significant institutional levers vis-à-vis Japan: the ''finance G-7'' of finance ministers and central bank governors of the seven leading industrial democracies (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States), the IMF, and the Manila Framework Group (MFG). A further institution, an Asian Monetary Fund, may be developing albeit without US membership.

The MFG was created by virtually all the APEC countries in late 1997, partly as an alternative to the AMF proposal. Its chief goal was to institute a process of multilateral surveillance over the (mainly emerging) Asian economies, and it has met annually since that time. It has not produced tangible results beyond what the IMF would do in any case. But it might be useful for multilateralizing constructive pressure on Japanese economic policy, because it brings together all of Japan's Asian neighbors—the countries that are both most dependent on Japan's economic health and most important to it politically—along with the United States.

With skillful multilateral diplomacy, the United States could mobilize considerable international pressure in support of policy reforms in Japan. It could use the G-7 to coordinate the efforts of the largest industrial countries, and the regional organizations to involve Japan's neighbors. This would undoubtedly require greater effort and more creativity than simply pursuing Japan bilaterally, as in the past. It would almost certainly be both more effective and more appropriate for the circumstances of the period ahead, however, and thus clearly worth the effort. Similarly, with skillful multilateral efforts, Japan could counter-argue its case to the United States.

Reconfiguring Japan's Foreign Economic Policy

Japan may well be the prime beneficiary of the liberal postwar order, yet its ability to influence that order has been constrained by US dominance, lingering suspicion of Japan in the rest of Asia, and Japan's own internal politics.

Japan's external environment began to change radically with the collapse of the Soviet Union, and with it the comfortable verities of the Yoshida Doctrine. Paradoxically, the period following the end of the Cold War has seen increased tensions in Northeast Asia and reaffirmed the importance to Japan of the Japan-United States security alliance. At the same time, Japan has groped for a strategic framework that would reflect its increasing attention toward Asia as a region, and its desire to differentiate its foreign policy from that of the United States.

In this respect, the Asian financial crisis was a critical event for Japan. Asia has been shaken by its experience during the financial crisis, and this has led to a reappraisal of its relationship with the United States and the Washington-based multilateral economic institutions. There is a sense of disappointment with both aspects of ''Washington,'' and this—together with US initiatives that are likely to encounter opposition in Asia—has created an unprecedented opportunity for Japanese diplomacy. This opening could be widened by an economic slowdown and any accompanying rise in US protectionism (Noland 2000b).

In such an environment, it would be understandable if the Asians intensified their efforts at regional cooperation, either as a complement to or a substitute for multilateral cooperation. Yet Japan's ability to lead such an effort is uncertain. Ironically, one of the reasons that the United States is so influential in setting the agenda in Asia is that the Asian economies remain dependent on the US market as the ultimate destination of a significant part of their output (even if this dependence has lessened over time; Noland 1994). If Japan wants to wield more influence in the region, it must develop a strategic approach to the panoply of international issues it faces. It will have to import more, and establish better political and economic relations throughout the region, especially with China, the region's second largest economy (Ikenberry 2000).

Reform of Japan's internal policymaking process is essential to permit such changes to occur. To start, strong leadership on the part of the prime minister's office, to coordinate the actions of ministries that are used to pursuing their own narrow bureaucratic interests, is necessary to effectively pursue the national interest. To date, Japan has been too defensive in trade negotiations, allowing internationally uncompetitive sectors to determine its stance. There has been no high-level political commitment to overcome domestic lobbies that, for example, effectively vetoed the Early Voluntary Sectoral Liberalization program in APEC in 1998 and support perpetuation of the extraordinarily tight import regime in rice.[27] A more assertive and responsible policy, emphasizing the importance of open markets for Japan's internationally competitive sectors, is highly desirable and in fact necessary if Japan is to become an active player, including an active partner with the United States, in pursuing an effective multilateral economic strategy.

If narrow sectoral interests continue to exert a disproportionate impact on policy, Japan will put its economic standing and international influence

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27. As one long-time foreign observer put it, ''APEC will fail without effective leadership from Japan. Japan placed at risk major national interests by granting excessive influence to sectors now of minor importance to its national performance. Effective leadership requires the Japanese polity to assert national over minor sectoral interests'' (Garnaut 1999, 2).

at risk. It could find itself isolated in a sea of regionalism—surrounded by the FTAA, the European Union, and a new China-ASEAN Free Trade Area linkage—sinking under the weight of its highly protected rice farmers and construction workers.

A far preferable alternative would be for Japan to assert constructive leadership in world forums such as the IMF, the World Bank, and the WTO, and regional ones such as APEC, ASEAN + 3, and the bilateral FTAs. For this to happen, Japan must make an internal decision to reorganize its agriculture and construction industries while acting on a strategic vision at the international level. In this regard, *gaiatsu* is no guide. Leadership is necessary.

The most important challenge for Japan is to find a political mechanism to make decisions without *gaiatsu*. Otherwise, it will be under constant pressure from the United States, the WTO, the IMF, and other international organizations to reform and change. But simply responding to the demands of others is hardly a recipe for advancing national interests. Regional organizations, such as the prospective FTAs and a nascent Asian Monetary Fund, could be a good training ground for the Japanese bureaucracy in forming its own policy without *gaiatsu*. Peer pressure in these groups may operate in a quite different way from the past frustrating experience of the Japan-United States bilateral relationship or Japan's seemingly reluctant participation in the multilateral trade negotiation process.

Other countries, especially the United States, tend to be skeptical of the will and skill of Japan's politicians and bureaucracy to reform themselves. Japan therefore must show the world that, for example, its competition policy can be strengthened and its protectionism can be curtailed without *gaiatsu*. In this regard, there are encouraging signs: the initial directions of the Bush administration in toning down public criticism of Japan, and of the Koizumi government in declaring its intention to pursue structural reform without respect for sacred cows.

Suppose that Japan were to reform its internal policymaking process successfully and seek a greater role in international affairs? Such an effort would still be impeded by lingering distrust of Japan in the region, especially in China. For example, despite South Korean President Kim Dae-jung's proactive policy of improving relations with Japan, bilateral relations have deteriorated due to such emotive issues as Japanese sexual enslavement of foreign women during the Second World War and the approval of public school textbooks that appear to whitewash Japan's behavior. Kim went so far as to cancel joint military exercises, cancel a scheduled opening of the South Korean market to some Japanese cultural products, recall Seoul's ambassador to Tokyo, and refuse to meet with a visiting Japanese political delegation in protest of the textbook issue. And South Korean reaction has been mild compared with that in China, where the Chinese Communist Party has made Japan bashing a staple. Both countries reacted angrily to Prime Minister Koizumi's August 2001 visit to the Yasukuni Shrine. Australia, which has called for Japan to play a more active role in regional military affairs (e.g., the peacekeeping mission in East Timor), and Singapore, which signed a base agreement with Japan, would appear to be exceptions to this trend.

For its part, Japan remains understandably wary of China, particularly in light of its authoritarian political system. The kind of political exigencies that fueled the rapprochement between France and Germany in Europe after the Second World War appear to be missing in Asia, and will continue to hamper regional cooperation, at least in the medium run.

Surmounting these obstacles is a hard task. From a Japanese perspective, the path of less resistance is to remain under the US security umbrella, continue to export to the United States, and maintain a focus on the WTO-centered global trade system. But there is no guarantee that Japan will continue in this manner, because such a policy would require a continual rebalancing of Japanese interests. Japanese economic performance would determine the resources available for such an economics-centered foreign policy, whereas its relative performance would condition both Japanese demands for influence in global and regional policymaking bodies, and the receptiveness to those demands by the United States and other participants.

The balancing act on the security side is just as delicate. Although there is widespread support for the Japan-United States security alliance in both countries, within Japan there is also considerable unease about the US military presence and the prospective missions of Okinawa-based US forces. The Government of Japan's low-profile stance in the wake of the April 2001 emergency landing on the Chinese island of Hainan by an Okinawa-based US surveillance plane, and its reaction in July 2001 to another sexual assault involving a US serviceman on Okinawa, are illustrative of Tokyo's ambivalence.

The alternative—a significant rupture in the Japan-United States alliance, perhaps as the culmination of a conflict between growing Japanese desires for policy autonomy and increasing US unilateralism—would pose very difficult issues for Japan and the region. No such rupture is conceivable from the US side, though some observers continue to believe that the United States has leverage in its economic relationship with Japan due to its contribution to the military protection of Japan. This is simply not credible now—if it ever was. As a practical matter, the United States cannot reconfigure its security relationships around the world in response to trade disputes that occur on a fairly regular basis, or in response to the even less frequent disagreements over macroeconomic or financial policy. Moreover, even if there were some viable way of operationalizing the linkage between US security and economic interests, it is hard to imagine economic disputes of such a magnitude that the United States, after 50 years of the security alliance, would reduce its security support for Japan in response to economic tensions—especially in light of the declining salience of those tensions as emphasized throughout this book.

In Japan, such a break, were it to occur, could be traumatic, forcing the country to confront heretofore unresolved issues of its politics and history that it has avoided thus far. A rupture in security relations with the United States could prompt Japan to remilitarize, possibly calling into question its renunciation of nuclear weapons and destabilizing Asia. Alternatively, such a rupture could encourage a Japanese accommodation with China—both nightmare scenarios for the United States.[28]

For Japan and the United States, this implies two options. The first is the status quo policy of trying to make the alliance between the two countries work against some ill-defined security threat. Rather than attempting to use the presence of its troops as leverage over Japan on economic issues, the United States would need to address issues of mutual interest between the two countries that cut across the economic and security spheres. Politically, this means that both governments must proactively build domestic constituencies for bilateral engagement. On the economics side, this is done naturally through private-sector contacts—especially if there is a continued surge in foreign direct investment by US-based companies in Japan—though there is always room for improvement.

On the security side, it means greatly expanding participation in dialogue beyond the mid-level bureaucrats who primarily manage bilateral security matters. This requires a much more intensive effort to bring high-level officials, legislators, and private-sector opinion leaders into the mix. Such a process would be greatly facilitated by improved relations between Seoul and Tokyo, because any US presence for an explicitly regional role would require a reconfiguration of US forces in Northeast Asia, as well as new political understandings about their potential missions.[29] It is important that policymakers not become captive to shibboleths, such as the commitment of 100,000 US troops to Asia, which may well be unrelated to actual expected missions—especially because the presence of US troops is not costless in terms of political relationships. For example, the United

28. See McNaugher (1994) and Halperin (1999).

29. For example, bureaucratically, US forces in Japan and South Korea are under separate commands that report to the Commander in Chief, Pacific Area Command in Hawaii, and the forces based in South Korea are not configured for missions off the peninsula. The structure of the Combined Forces Command, under the UN mandate in Korea, integrates US and Korean troops and officers. If US forces in Northeast Asia were to be reoriented toward a regional role, it would require reconfiguration of the forces, reorganization of the command structure, and political agreements with Japan and Korea about their potential activities—in the Taiwan Strait, for example.

States may be able to fulfill its regional missions without the US Marine contingent on Okinawa.[30]

Programmatically, making the alliance work is less a matter of bold new initiatives that of achieving improved consultation between Tokyo and Washington on the whole panoply of international issues that they face. This includes both economic and security issues, as well as each country's positions in the international institutions. The Armitage Report (IISS 2000) contains numerous specific recommendations along these lines. For example, Washington must accept a greater political role for Japan and understand that there is a difference between genuine consultation and mere forewarning.[31] At the same time, Tokyo should be reminded that global and regional policy initiatives undertaken without prior consultation with Washington—such as the AMF proposal in 1997, and the FTAs that it has launched unilaterally in recent years—are unlikely to succeed.

The alternative to making the alliance work would be for Japan to become an autonomous great power. Under current circumstances, without significant regional organizations to mediate festering historical animosities, this would run the risk of destabilizing Asia. Its huge costs, to Japan itself and to the United States as well as to regional and global stability, add strongly to the case for making every effort to restore the Japan-United States relationship—including in the economics sphere—in a modern and normal direction.

Toward Normalcy and Partnership

The United States and Japan are the world's two largest and richest national economies. Their policies and performance have significant implications not only for their bilateral relationship but for the world as a whole. Continuing Japanese economic weakness poses a far greater threat to the United States than Japan's previous strength ever was. As we have argued, Japan can recover in the coming years and resume expanding at a sufficient pace to avoid a "worst-case" scenario—albeit perhaps after

30. There are two sorts of operations in Northeast Asia in which US forces could be expected to participate. First would be the defense of South Korea. The key roles for Japan-based US forces would be naval and air combat support, and transportation. The lightly equipped Marines on Okinawa would not be particularly useful in a Korean invasion scenario. More heavily equipped US ground forces could be airlifted from bases in the United States. A second sort of operation would be in the Taiwan Strait. Again, the Japan-based forces that would be most relevant would be the naval and air units—not the Marines on Okinawa.

31. For example, there is no evidence that President Bush gave the Japanese forewarning before announcing in April 2001 that the United States would do "whatever it took" (presumably involving US military assets stationed in Japan) to defend Taiwan.

a further period of difficulty that could accompany the additional reforms that are needed to provide a foundation for sustained future growth.

The most likely prospect for the initial decade or so of the 21st century is in fact relatively optimistic for both Japan and the United States. In the 1970s and much of the 1980s, Japan was the most dynamic economy in the world, while the United States lagged behind badly. In the 1990s, these roles were dramatically reversed; the United States was clearly up, and Japan was clearly down. But an important source of the recent US resurgence was its earlier troubles and the catalyst for reform they represented; Japan is quite likely now going through a similar challenge-and-response cycle, though perhaps it will last for a longer period, in light of the lesser flexibility of both its economic and political systems.

This outcome will be of critical, probably decisive, importance for the economic relationship *between* Japan and the United States. Their prolonged economic conflict correlates almost perfectly with the quarter-century, from the early 1970s through the middle 1990s, when US economic performance lagged and Japan was achieving global prominence. The reversal of these conditions in the latter half of the 1990s has already led to a dramatic change in the relationship, in the direction of ending the unique Japan-specific policy that the United States had maintained for so long.

As has been noted, we hope and believe that Japan will recover and again become a positive contributor to the world economy. We also believe that the United States will resume most, if not necessarily all, of the dynamism that it exhibited in the second half of the 1990s and thus eschew any return to the Japan bashing of the previous generation. Indeed, steady and stable growth in the two largest national economies would be optimal for the world as a whole, as well as for their bilateral relationship.

Beyond these likely paths of national economic performance, we conclude that a large number of structural conditions argue strongly for a restoration of normalcy in that relationship. Japan, in the wake of recent global developments—the completion of the European Union, the creation of the euro, and the rapid rise of China to prominence in East Asia—has simply become a smaller factor in the world economy, world trade, and international finance. Japan's share of US trade and investment have fallen sharply, and Japan's share of the US external imbalance has dropped from half to less than a quarter.

Even more important, many of the factors that seemed unique about Japan's dramatic economic ascendancy in the earlier period, and seemed to justify a unique US policy in response, turn out not to have been so unique after all (e.g., lean manufacturing techniques) or are rapidly eroding (e.g., lifetime employment). In particular, government industrial policy, the basis for the so-called strategic trade theory rationale for special US approaches to Japan, has virtually disappeared (and the infamous MITI has even become reform-minded METI).

Perhaps most important, US ability to influence policy in Japan has dropped precipitously. Our analysis in fact suggests that the results of past US efforts, even when US leverage was considerably greater, were exceedingly modest in terms of the expenditure of US effort and political capital. More recently, more US efforts have wound up in utter failure: the auto talks in 1995 on the trade side, the pleas to head off the disastrous tax increases in 1997 on the macroeconomic side, and the repeated calls to act decisively to resolve the problem of the nonperforming bank loans on the financial front.

In theory, there remain the traditional three sources of US leverage on Japan: closing the domestic market, stimulating appreciation of the yen, and withdrawing US security protection—or, much more likely, threats of all three. But all three are even less credible now than in the past. The ''new WTO'' precludes virtually any unilateral market closure by the United States. Sharp yen appreciation can significantly hurt a US economy at or near full employment, by generating inflation and higher interest rates. The rise of China requires maintenance of the security alliance with Japan at least as much as the Cold War did. More broadly, the sharp increase in US economic openness and the decline in Japan's openness tilt the impact of any distortions in the economic relationship—whether new trade barriers in the United States or sharp currency swings—against the United States much more than against Japan.

We return, at the end of this volume, to the theme that has permeated its pages. Japan and the United States experienced a number of years of economic conflict during a historical period when, for reasons unrelated to their relationship, the United States suffered substantial, sustained economic travail while Japan performed exceedingly well. It is now clear that this juxtaposition, although prolonged, was temporary—indeed, a historical accident that turned out to have had far-reaching implications for both countries (and for the world as a whole). At a minimum, we can project with some degree of confidence that such a juxtaposition is highly unlikely in the years ahead—for it would require a re-reversal of the pattern of the past decade.

In the years immediately ahead, the most plausible scenario is in fact that both countries will do reasonably well. The United States is likely to do better in some years, and Japan may do better in others. Such a return to ''economic normalcy'' counsels an adoption of ''policy normalcy'' along the lines proposed here. This normalcy will lay the foundation for a relationship of true partnership rather than the patron-client norms that, for all the rhetoric to the contrary, have largely prevailed to date.

Such a partnership could not come at a better time for the world economy as a whole, as well as for the national interests of both Japan and the United States. The global economic system is clearly at risk, less from the demonstrations of antiglobalization protesters than from the erosion of the perceived effectiveness of the traditional multilateral institutions. Both the International Monetary Fund and the World Trade Organization are viewed with suspicion if not downright hostility in a growing number of quarters, and are blamed by normally responsible people (and even governments) for such alleged failures as ‘‘worsening the Asian financial crisis’’ and ‘‘exposing the world to Frankenfoods.’’ The new regional initiatives, on both the trade and financial fronts, represent both reactions to these developments and potentially an accelerated erosion of the global system—and could decisively cripple this system if they were to evolve into such far-ranging ventures as the East Asia Free Trade Area and Asian Monetary Fund that are already on some drawing boards, including in Tokyo.

There is thus an urgent need for Japan and the United States, along with the European Union, to start cooperating to restore the legitimacy and effectiveness of the multilateral order. They have clearly failed to do so in recent years: Japan-United States (as well as European Union-United States) conflicts were at the heart of the failure in Seattle to launch a new trade round that would revive the WTO, Japan’s rejection of the EVSL program in APEC effectively scuttled the entire trade program of an initiative that had been launched to bolster transpacific security as well as economic ties, and Japan’s initiative to create a new Asian Monetary Fund in the teeth of the financial crisis of 1997 represented a frontal attack on the United States and ‘‘its’’ Washington-based international institutions. Japan-United States cooperation to repair all this damage, and to initiate a new period of constructive cooperation in the multilateral context, is imperative.

Hence, a termination of the unique Japan policy maintained by the United States for almost three decades could have extremely positive effects. It would eliminate a major irritant, and the high degree of uncertainty, in the relationship between the two countries. US policy has already been moving in this direction, as has been shown throughout the book. The time has come for the United States to clearly enunciate this new approach. By doing so, it could herald a new era in Japan-United States relations, along with far better prospects for the world economy in the period ahead.