INSTITUTE FOR INTERNATIONAL ECONOMICS

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BUILDING A NEW JAPAN-UNITED STATES ECONOMIC RELATIONSHIP

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C. Fred Bergsten has been director of the Institute since its creation in 1981. He was also chairman of the Competitiveness Policy Council, which was created by Congress, throughout its existence from 1991 to 1995 and chairman of the APEC Eminent Persons Group throughout its existence from 1993 to 1995. He was Assistant Secretary for International Affairs of the US Treasury (1977-81), Assistant for International Economic Affairs to the National Security Council (1969-71), and a senior fellow at the Brookings Institution (1972-76), the Carnegie Endowment for International Peace (1981), and the Council on Foreign Relations (1967-68). He is the author, coauthor, or editor of 28 books on a wide range of international economic issues, including *Whither APEC? The Progress to Date and Agenda for the Future* (1997), *Global Economic Leadership and the Group of Seven* (1996), *The Dilemmas of the Dollar* (second edition, 1996), *Reconcilable Differences? United States-Japan Economic Conflict* with Marcus Noland (1993), *Pacific Dynamism and the International Economic System* with Marcus Noland (1993), *America in the World Economy: A Strategy for the 1990s* (1988).

Takatoshi Ito is a professor at the Institute of Economic Research at Hitotsubashi University in Japan. From 1999 to 2001, he served as Deputy Vice Minister for International Finance in the Ministry of Finance in Japan. He was senior advisor at the research department of the International Monetary Fund from 1994 to 1997. He was professor at the University of Minnesota's economics department from 1990 to 1991; visiting professor at Harvard University's Kennedy School of Government and Department of Economics from 1992 to 1994; visiting scholar at the Bank of Japan's Institute of Monetary and Economic Studies from 1990 to 1992; and national fellow at the Hoover Institution, Stanford University, from 1984 to 1985. He has received grants from the National Science Foundation and is a research associate at the National Bureau of Economic Research. He has written extensively on international finance, macroeconomic issues, and the Japanese economy. He is the author of *The Japanese Economy* (MIT Press, 1992) and coauthor of *A Vision for the World Economy* (Brookings Institution, 1996) and *Political Economy of the Bank of Japan Monetary Policy* (MIT Press, forthcoming).

Marcus Noland, senior fellow at the Institute, has been senior economist for international economics at the Council of Economic Advisers as well as a visiting professor at Johns Hopkins University, the University of Southern California, Tokyo University, Saitama University, and the University of Ghana and a visiting scholar at the Korea Development Institute. He has written many articles on international economics and is the author of *Avoiding the Apocalypse: The Future of the Two Koreas* (2000) and *Pacific Basin Developing Countries: Prospects for the Future* (1990). He is coauthor of *Global Economic Effects of the Asian Currency Devaluations* (1998), *Reconcilable Differences? United States–Japan Economic Conflict* with C. Fred Bergsten (1993), and *Japan in the World Economy* with Bela Balassa (1988), coeditor of *Pacific Dynamism and the International Economic System* (1993), and editor of *Economic Integration of the Korean Peninsula* (1998).

INSTITUTE FOR INTERNATIONAL ECONOMICS
1750 Massachusetts Avenue, NW
Washington, DC 20036-1903
(202) 328-9000 FAX: (202) 328-5432
http://www.iie.com

C. Fred Bergsten, *Director*
Brigitte Coulton, *Director of Publications and Web Development*
Brett Kitchen, *Director of Marketing*

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Preface

The United States and Japan are the world's two largest national economies, and economic relations between them have been a centerpiece of the program of the Institute for International Economics throughout its history. Virtually all of our numerous studies of the international financial and trading systems have included a substantial component on Japan, and Japan-United States relations, because of their centrality to global outcomes. We have frequently addressed the Japanese economy itself, notably in *The Yen/Dollar Agreement: Liberalizing Japanese Capital Markets* (Frankel 1984) and *Japan in the World Economy* (Balassa and Noland 1988) and most recently in *Restoring Japan's Economic Growth* (Posen 1998) and *Japan's Financial Crisis and Its Parallels to U.S. Experience* (Mikitani and Posen 2000).

About once a decade, we have also attempted to assess the rapidly evolving overall Japan-United States economic relationship and to suggest a proper policy course for it. In the wake of the buildup of unprecedented American external deficits and Japanese external surpluses in the early 1980s, and the related onset of intense trade tensions between the two countries, William R. Cline and I prepared *The United States-Japan Economic Problem* (1985, revised 1987). When Japan had come to be widely viewed as a major threat to US economic preeminence and even national prosperity, in the late 1980s and early 1990s, we commissioned and published Laura Tyson's *Who's Bashing Whom: Trade Conflict in High-Technology Industries* (1992), which ranged beyond Japan but extensively addressed that country's global competitiveness, and Marcus Noland and I wrote *Reconcilable Differences? United States-Japan Economic Conflict* (1993). Each of these studies apparently had considerable impact on subsequent thinking about the issue, and policy toward it, in both countries.

This new volume assesses the Japan-United States economic relationship in the dramatically changed circumstances of the early 21st century. The United States experienced resurgent economic growth, based on a substantial rise in productivity growth, in the second half of the 1990s. Japan has been mired in stagnation for almost a decade. Europe has completed its economic integration and created the euro. China has grown dramatically. As a result of these developments, Japan's share of both the world economy and US international transactions has declined markedly. On the security side, the end of the Cold War devalued the Japan-United States relationship for a brief period but the rise of China may have revalued it by even more.

Moreover, internal changes within Japan have clearly reduced the "uniqueness" of its economic system and whatever threat it may have posed to other countries. Our analysis suggests that the myriad past US bilateral efforts to force policy change in Japan have yielded very modest results, especially in recent years. At the same time, the formation of the World Trade Organization has increased the efficacy of addressing outstanding trade issues through *multilateral* approaches.

For all these reasons, and several more that are developed in the book, we conclude that the time has come for the United States to end the uniquely Japan-specific economic policy that it has pursued for the past three decades. It should instead start treating Japan like any other major economic power, mainly within the multilateral context of overall US foreign economic policy. The arrival of new administrations in both countries appears to offer an appropriate time for such a fundamental policy reconsideration.

To conduct this study properly, we determined at the outset that it had to be coauthored by a top Japanese economist. Dr. Noland and I were thus extremely fortunate to be joined by Professor Takatoshi Ito of Hitotsubashi University, who is one of the most eminent economists in Japan and who also has long experience in the United States, having taught at both the University of Minnesota and at Harvard and having spent three years as a senior advisor at the research department of the International Monetary Fund. Professor Ito had to disengage from the project for two years, during his assignment as Deputy Vice Minister for International Finance in the Ministry of Finance from July 1999 to July 2001, but returned in time to complete the final manuscript with us.

The Institute for International Economics is a private nonprofit institution for the study and discussion of international economic policy. Its purpose is to analyze important issues in that area and to develop and communicate practical new approaches for dealing with them. The Institute is completely nonpartisan.

The Institute is funded largely by philanthropic foundations. Major institutional grants are now being received from the William M. Keck, Jr. Foundation and the Starr Foundation. A number of other foundations and private corporations contribute to the highly diversified financial resources of the Institute. About 31 percent of the Institute's resources in our latest fiscal year were provided by contributors outside the United States, including about 18 percent from Japan.

This study was supported by The Japan Foundation-Center for Global Partnership, The Freeman Foundation, the GE Fund (which provides partial support for our work on Asian issues) and the United States-Japan Foundation. Funding was also provided under our Akio Morita Studies Program, a program of studies on topics of central interest to the United States and Japan that was created in 1997 to honor our distinguished former director and honorary director, Akio Morita, the late cofounder and former CEO of Sony. That Program is funded by the Sony Corporation, The New York Community Trust-The Peter G. Peterson Fund, and Mr. David Rockefeller.

The Board of Directors bears overall responsibilities for the Institute and gives general guidance and approval to its research program, including the identification of topics that are likely to become important over the medium run (one to three years), and which should be addressed by the Institute. The Director, working closely with the staff and outside Advisory Committee, is responsible for the development of particular projects and makes the final decision to publish an individual study.

The Institute hopes that its studies and other activities will contribute to building a stronger foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

C. Fred Bergsten
Director
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The Economic and Policy Context

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

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

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

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

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

A Reversal of Fortunes

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

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

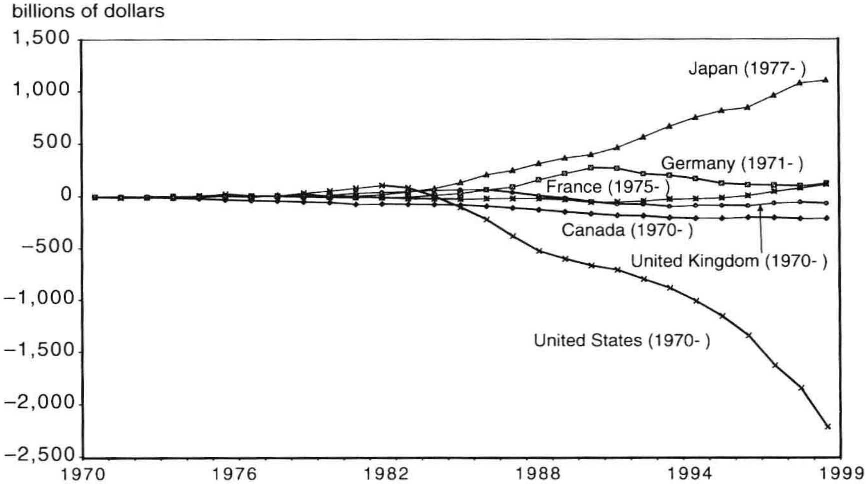
Table 1.1 GDP, per capita income, and unemployment in Japan and the United States, 1950s-2000

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

n.a. = not available.

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

Figure 1.1 Cumulative net capital outflows, 1970-99



Source: IMF, *International Financial Statistics.*

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

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

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

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