U.S.-Japan Economic Relations

A Symposium on Critical Issues

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Walter E. Hoadley
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Foreword

In November, 1979, a conference on Japanese-American economic relations was held at the Claremont Hotel in Berkeley, California, under the auspices of the Institute of East Asian Studies at the University of California. Attending the conference were approximately two hundred representatives of business, journalism, and education in the Bay Area. Each paper read at the conference was followed by a period of questions and discussion. The authors of the papers, all with long practical experience in Japanese-American economic relations, are identified on the preceding page. The papers are printed here in the hope that they will contribute to a better understanding of issues of great importance to both countries.

The first paper in the volume, by James Abegglen, describes the radical nature of these problems. The author states that the present tension between Japan and the United States over trade is likely to be a long-term condition because it has deep structural causes in the relative decline in the productivity of American industry. Thus, the deficits are likely to continue, and they are likely to be accompanied in the future by intensified competition from Japan in high-value-added industries. U.S. imports of such products cannot be offset by increased exports of semi-finished or labor-intensive products to Japan; in these sectors the United States cannot expect to compete with Asian exporters to Japan. Nor will Japanese investment in this country provide a significant offset. The disadvantages of Japanese investment in high-technology industries abroad are considerable. They include the loss of economies of scale, uncertainties of supply of reliable parts, and Japanese inexperience and sense of inadequacy in managing a foreign work force.

It is a grim prospect, but Abegglen is not entirely without hope. The Japanese market is now as open to industrial imports as any in the world; the rise in Japan of large-scale retailers like Daiei and Seiyu has eased the marketing problem for the foreign company in Japan; and in some industries U.S. companies have advantages of size and technology over Japanese competitors. Chemicals, pharmaceuticals, food-processing, and computers are industries in which individual U.S. companies already are doing or may in the future do exceedingly well in Japan. Abegglen

believes that, if General Motors is not too badly hurt by government subsidies to competitors and anti-trust actions, the company in the 1980's may "have both the product and the resource capacity to make a serious impact in the Japanese domestic auto market." Yet, over-all, he expects U.S. industry to do poorly in competition with Japanese companies, even in the U.S. domestic market. And he fears that—as in the past in textiles, color television, and steel—solution to noncompetitiveness will be protectionism in one form or another. The results of an increasingly general resort to protectionism, he warns, will be "simply appalling."

Ambassador Tadao Kato's paper concerns trade issues between the United States and Japan, but he begins by asserting that the two countries are "today bound by ties of global significance" that transcend economic relations. This belief is shared by most authors in this volume, and it is the grounds for much of their alarm over the tension that massive U.S. trade deficits with Japan have generated. Kato joins Abegglen and Mulkern in rejecting the widespread American belief that the deficits result from market restrictions in Japan. Japan's markets are today as open as any in the world, Kato says, and U.S. deficits are largely the cumulative result of differential productivity gains in Japan and the United States during the past two decades. He fears a protectionist reaction in the United States, stating that it will require an extraordinary amount of mutual understanding to preserve and expand the free-trading system in the face of continuing trade imbalances.

The article, "U.S. Trade Relations: Economic and Strategic Implications," by Louis Mulkern, will give no cheer to readers dispirited by the Abegglen paper noted above. Japan is rapidly replacing the United States as the world's foremost industrial power, a movement that Mulkern thinks is likely to continue. The trend is based in part on Japan's rapid development but equally on the erosion of the basic industrial competitiveness of the United States. The magnitude of the resulting shift, which is already well underway, has not yet been grasped by Americans, who comfort themselves with the belief that chronic trade deficits with Japan are the product of unfair trade practices and have responded with protectionist measures. These have only made matters worse, Mulkern asserts, by protecting noncompetitive industries and raising the costs of producers using their products.

Mulkern believes that the most critical reason for the loss of U.S. industrial competitiveness is lack of an intelligent national economic policy. By economic policy he means "an integrated program of national economic priorities, to be debated, modified, and implemented through our established political process." Presumably such a program would permit Americans, in much the same way as the Japanese do, to "reallocate human and capital resources into industries of high growth, high technology, and capital intensive productivity." Mulkern insists that such a program is practicable. But when he also states that a necessary condi-

tion of success is a new sense of collaboration and mutual understanding among government, business, and labor, the reader may wonder at his optimism.

Keiske Yawata's paper, "Japanese Quality: How it was Built up and Maintained," discusses one of the major reasons for Japan's export success. The relative slackness of quality control in the United States is the other side of that coin, though the author does not say so. He points out, however, that quality-control methods in the two countries are fundamentally different. In Japan they depend on a combination of design and control during production; whereas in the United States they depend mainly on screening for defective products after production. Not only is the former method more effective, Yawata states, it is also considerably cheaper. Why, then, one wonders, is it not adopted in the United States? The author suggests a possible answer, indirectly, when he notes that the Japanese method requires a high degree of quality-consciousness among workers, made possible by Japanese workers' identifying with their company and its product. Conceivably Yawata's method is less suited to American workers, whose company identification is notably weaker.

Walter Hoadley, executive vice-president and chief economist of the Bank of America, emphasizes that *both* the United States and Japan face difficult economic problems, and that the method by which each addresses or fails to address these problems will have economic consequences for the other country. Government expenditures in Japan, for example, have since 1974 been running 20 to 40 percent ahead of revenues, and the resulting deficit has been financed by the sale of government bonds. This practice cannot be indefinitely sustained, Hoadley argues; either government spending must be reduced or additional taxes levied. Lower government spending would impact unfavorably on U.S. interests by reducing Japanese imports; higher taxes, on the other hand, would lower business profits in Japan and might reduce Japan's competitiveness in world trade with at least short-term benefits to some American companies. Hoadley believes, however, that the solution to one country's economic problems will be generally favorable to another, and that some problems can best be solved cooperatively. He lists as examples energy development and conservation, dollar-yen capital market linkages, and assistance to developing countries.

Whatever the reasons, Japan's export success and the United States's lack of it led to severe problems in 1978 when the accumulated trade surplus of Japan and the accumulated deficits of the United States reached mammoth proportions. The United States demanded that Japan take measures to solve the imbalance, and the demand was backed from many other countries with large trade deficits with Japan. Koei Narusawa, managing director of the Bank of Tokyo, describes in his paper how in 1979 this dangerous situation was turned around. The turnaround was aided somewhat by the appreciation of the yen, which encouraged imports

and dampened export demand; but government policies—public works, emergency imports, voluntary restraint of exports among others—were largely responsible for moving Japan abruptly from an over-all surplus to an over-all trade deficit. Significantly the U.S. trade deficit with Japan, though reduced by these measures, was not eliminated, suggesting the underlying U.S. weakness in world trade. That weakness, clearly, cannot be remedied exclusively by the cooperation of trading partners; measures of self-help are also needed.

Few Americans would quarrel with the goals aimed at in these papers. It is on the details of implementation that interests and opinions diverge, making effective action difficult. The necessary step to a consensus enabling action would seem to be a general and realistic appreciation of the rapid loss of competitiveness of the American economy and the reasons for it. The Institute of East Asian Studies hopes these papers will contribute to such understanding.

Thomas C. Smith
April 9, 1980

U.S.–Japanese Trade Competition in the 1980s: Changing Context and New Issues

James C. Abegglen

The 1970s have been difficult years for the U.S.–Japanese relationship. As the Japanese economy moved to U.S. levels of per capita output, Japan maintained a large surplus in trade with the United States, and expanded its share of the U.S. market. As the U.S. economy grew more slowly, the U.S. lost a share of the Japanese market, with the national problem of a major trade deficit and a series of industry-specific problems of competing with Japanese producers. The result has been two major trade crises, one at the beginning and the other at the end of the decade, and continuing tension around the trade issue.

The importance to the two countries and to the world of Japan and the United States maintaining mutually supporting relations must surely be clear. It must also be clear that this relationship has been damaged and is likely to be further damaged by a continuation of conflict and confrontation over trade competition. Yet the nature of the two economies is such that trade conflict will inevitably continue and will quite likely reach crisis levels periodically during the next few years. Perhaps the best that can be achieved is to attempt to foresee the course of trade interaction, and anticipate and try to handle critical problem areas in an orderly and timely fashion. There seems little excuse for surprise, crisis, and confrontation as in the recent past, and the cost of a failure to anticipate problems may prove to be very great.

Trade Between the Two Economies

In a sense, Japan is the "cause" of the problem. That is, it is the dynamism of the Japanese economy compared with the more static U.S.

economy that destabilizes previous trade patterns. Looking to the 1980s, some effort to try to understand the probable pattern of Japanese development seems required as a basis for identifying new issues that may arise in the trade relationship.

A basic change in the context of trade interaction in the 1980s is likely to be the long-discussed shift by Japan from being an importer of basic materials to being an importer of semifinished goods. The shift is historic, and poses real problems for Japan in terms of supply strategy.

Japan is notoriously dependent on imports of food, raw materials, and energy. The need for these imports is immutable. Throughout Japan's industrialization, the capacity to process those imported materials was entirely sited in Japan. That is, virtually all of Japan's needs for petroleum products have been met by on-shore refiners of imported crude oil. A similar pattern applies to bauxite, copper ore, wood products, and the whole range of essential materials, imported in basic-raw-material form and processed in Japan.

This pattern of importing raw materials and processing on-shore was the inevitable result of Japan's basic raw material vulnerability. However, from the late 1960s on, it began to be clear that the pattern needed to change. The requirements of pollution control, the cost and difficulties in obtaining sites, and the relatively high cost of energy in Japan, meant that these pollution-intensive, energy-intensive, and land-extensive processing facilities were becoming uneconomic in Japan itself. Through the 1970s, not least owing to increases in energy costs, the forces driving the shift to processing off-shore increased in strength.

Parallel to this Japanese requirement, the countries supplying the raw materials became steadily more aggressive through the 1970s in their demands that value be added to the materials before their export. In this sense Japan is well-positioned regarding the north-south problems of the 1980s, because her needs and the needs of "the South" are complementary. Japan will, in fact, seek to supply capital and technology to the countries with raw materials. The process allows Japan to sell more sophisticated goods (including the plants for material processing), while allowing the host countries to achieve higher incomes from the value added to the materials.

There has been widespread agreement in Japan that this change should take place, and that it is in Japan's interest that it take place rapidly. Investments have been made in a number of industries, notably aluminum, petrochemicals, and wood products, and in a number of countries, notably Indonesia, Australia, Canada, and Brazil. The effects will become apparent in the 1980s, as Japan's incremental demand in those industries is increasingly met from off-shore sites. (The Middle East, Siberia, and mainland China will be additional investment/source points.)

For Japan, the process poses two difficult trade problems. The first is strategic. What level of domestic processing capacity is the minimum acceptable in strategic terms? All of these products are basic and critical to the economy. To reduce Japanese processing capacity to the level sufficient only to meet domestic demand is a simple decision; it means only that Japan will no longer export these products. However, to go further in reducing on-shore processing capacity is to raise the question of security of supply. Is Japan secure against supply interruption with domestic capacity sufficient to meet 75 percent of domestic demand? Fifty percent? Even less? Processing in Japan is not economic. How much processing is required strategically?

This strategic issue is difficult in its own right. It serves, too, to highlight a further question, more tactical than strategic, concerning supply security. The host countries for this type of investment tend to be less stable economically and politically than developed countries. Security of supply off-shore therefore requires a diversification of sources, so that a failure of supply from one source can be balanced by another source. Thus aluminum, wood products, and petrochemical projects are underway or being planned in several countries, rather than being concentrated in a single supplier country.

Japan is a huge importer of materials, taking a good portion of total world trade in many items. She is not, however, a favored customer, either from a geographic standpoint or, often, for political reasons. At the end of the supply pipeline, and totally dependent, Japan must have as much assurance of steady supply at reasonable prices as circumstances allow. Thus Japan needs large-scale supply sources with some geographic diversity.

It is in this context of a broad shift in the economy and in the strategic and tactical questions posed for Japan that we can look at the U.S. position. First, the United States is unlikely to be a site for any substantial part of these raw-material sourcing and processing investments. As a mature economy, the United States offers few raw-material investment sites of a scale and attractiveness sufficient to compete with other investment sites. An example is the precipitate decline during the past ten to fifteen years in the U.S. share of Japan's coal imports; the United States is not the most attractive source for coal in terms of quality, logistic efficiencies, and scale compared with Australia (and perhaps the People's Republic of China next). Thus, in trade terms, the United States is unlikely to be the beneficiary of the trade consequences, or investment consequences, of this shift in the Japanese processing pattern.

Further, the United States—oddly, perhaps—has proven to be not an entirely reliable supplier. The infamous cancellation of soybean supply contracts in the early 1970s is the most emotionally charged example of the problem, but U.S. quotas on wood product exports to Japan and the U.S.

ban on export to Japan of North Slope crude are no less cogent reminders to Japan that, for the United States, domestic political needs have a clear and considerable priority over trade needs or trade rationality. Again, the conclusion must be that the changes in pattern of supply to Japan are not likely to greatly benefit the U.S. trade balance.

The second broad shift in the trade context, the shift off-shore of the Japanese supply of labor-intensive goods, similarly seems unlikely to benefit the United States as supplier. Japanese wage rates have been rising rapidly. At recent exchange rates they are 50 percent higher than British wage levels, nearing parity with manufacturing wage levels in the United States. Given that Japanese productivity has been increasing by about 8 percent annually for the past five years, while U.S. productivity has increased little, we can expect Japanese wage rates soon to be at and above U.S. levels.

This shift in labor rates is the counterpart to the pressures that are shifting raw material processing off-shore. Asian economies with Sinic cultural bases, literate work forces, and rapid growth rates—the economies of South Korea, Taiwan, Hong Kong, and Singapore—are increasingly suppliers of labor-intensive manufactured goods to Japan. In textbook fashion, the Japanese imports are now largely textiles and footwear, along with the kinds of sundry light manufactures that Japan, many years ago, exported in large amounts (e.g., toys, household goods). This off-shore sourcing is to some unknown extent the result of smaller Japanese manufacturers moving their production off-shore, especially to the Korean and Taiwan free-trade zones. The shift of light manufacture off-shore seems likely to continue, as Japan provides the capital, technology, and market in this sector, as well as in the raw-material processing sector.

Again, these seem not to be product areas in which the United States is well-positioned to compete. The U.S. share of Japanese manufactured imports has declined from 38 percent in 1968 to 23 percent in 1978. Asia's newly industrializing countries have increased their share of Japanese manufactured imports from 2 percent in 1968 to 15 percent in 1978.

It is possible that by the end of the 1980s some parts of the United States will have sufficiently low wage levels, compared with other economies, as to compete in the Japanese market against other low-wage producers. Britain is nearing that position now. But for most of the decade, at least, United States wages will not be low enough to attract Japanese investment, and the United States will not be competitive in supplying Japan with those goods at the low end of the value-added technology scale that Japan will be purchasing from abroad.

The question arises whether the trade problem with the United States will be mitigated by Japanese investment in production facilities in the United States. Thus U.S. production by Japanese companies would take the place of exports from Japan. There has been some increase in

Japanese investment in the United States, but the level of investment remains low. The advantages offered by the United States as an investment site are limited, as noted. The disadvantages of production investment abroad are considerable—for example, fragmentation of production sites and resulting loss of scale economies, the difficulties of securing supplies of reliable parts in the United States, and Japanese inexperience and sense of inadequacy with respect to managing a foreign work force.

Investment to date has largely been the result of U.S. protectionism, as with color-television receiver assembly and production. This response to closed or closing U.S. borders can be expected to continue. Total Japanese production investment in the United States, compared with the incidence and amount of production investment elsewhere, is likely to remain small, and to have little impact on the trade balance.

The two broad changes in the context of Japanese trade—Japan importing semifinished materials that are energy-intensive in their processing, and importing manufactured goods that are labor-intensive in their manufacture—are simply the next phase of the long process of economic growth and increase in per capita output and income that Japan has been experiencing for nearly a century. To further raise national levels of income, Japanese resources of capital and labor need to be focused on areas of higher cost efficiency and higher value added.

The implication of this projection is that the Japanese economy will continue on trend to perform well, and to grow faster than other major economies. Japan's high level of savings makes possible high levels of capital investment. This investment makes possible continued growth. The relatively high growth itself contributes to continuation of the cycle, because under conditions of rapid growth, the shift of labor resources, in particular, is politically possible at a rate not possible in a slow-growing economy. The high level of education of the labor force, and its high mobility from job to job within a company (in part because of the absence of skill-based unions) means that the resources are available and able to move to more sophisticated product levels in manufacture.

We can think of U.S.–Japanese trade competition, therefore, as a situation in which Japan continues to exert a destabilizing effect from the fact that she will continue to grow relatively faster, continue to experience relatively more rapid increases in productivity and therefore in cost effectiveness, and continue to shift her product mix downstream to higher value-added manufacture. If this general projection is at all accurate, the only expectation can be for continued and considerable trade friction. This process puts Japan on collision course with the United States in such product areas as electronics, where the United States has thus far held the advantage.

The sequence is visible. It was only a decade or so ago that the focus of U.S.–Japanese trade tension was on textiles. The next crisis sector was

steel. The most recent was color television. Each succeeding area of problem was in a higher value-added product sector. (And be it noted for later discussion, in each case the United States solved the trade problem by protectionism, using the device of Orderly Marketing Agreements, all of which are still operative.) The current problem sector appears to be automobiles. And considerable agitation has begun around the issue of semiconductors. The United States still enjoys a favorable balance on semiconductor trade with Japan, but the U.S. industry, observing the situation with color television and preparing for the worst, has begun a ferocious campaign against Japanese semiconductor exports to the United States.

This is perhaps an appropriate point at which to take a step back, and instead of inquiring into future trends, review some basics of the Japanese trade position. These form the framework against which the newer trends appear.

First, Japan will run a surplus on its trade in manufactured goods. Japan must import all food, material, and energy necessary to power a modern economy. To pay for those imports, Japan will export manufactures. By definition, then, Japan will run a surplus on manufactured-goods trade. Further, Japan has a large deficit on its invisibles account—with Britain and the United States in particular—and can cover that deficit only by a manufactured-goods trade surplus. And again, Japan will invest abroad; to do so requires foreign-exchange funding, and the manufactured-goods export surplus will provide those funds as well.

Second, the United States is the largest market for manufactured goods in the world and the most important for Japan. The U.S. share of Japan's exports is declining, but the importance of the market has no substitute. Therefore, any discussion on the future of trade must be based on these home truths: Japan will run a surplus in manufactured-goods trade, and a considerable part of that surplus will be from its trade with the United States. The yen will move to make that surplus possible (and decline against the dollar as that surplus may from time to time diminish). The political and strategic consequences of the United States' failing to understand and accept this fact are simply appalling.

(It is perhaps sufficient to note here a few of the advantages to the United States of this situation. Viewed multilaterally, Japan's deficit with other traders who, in turn, are in deficit to the United States is much to the United States' advantage. Japanese goods provide good value to an inflation-racked U.S. economy. The trade of U.S. farmers and farm products profits from Japan's large purchases from the United States. And the strategic costs to the United States of an alienated Japan would be great. But this aspect of the trade issue is to the side of the present discussion.)

The problem, then, is a structural imbalance in U.S.–Japanese trade in manufactured goods, not related to tariffs, quotas, or other formal as-

pects of trade relations. This structural imbalance is much exacerbated by the relative decline in U.S. trade competitiveness, not only with respect to Japan but to other suppliers to the Japanese market. The problem is aggravated because of Japan's own economic success, which causes Japanese growth and competitiveness to increase most rapidly in those product areas where the United States has hitherto enjoyed some advantage. Given all this, it can only be concluded that U.S.–Japanese trade relations will remain troubled.

Competition between Japanese and U.S. Companies

Curiously, when we consider future trends and issues in competition between Japanese and U.S. companies, it is possible to see more change, and somewhat better prospects from a U.S. point of view, than when we look at relations between the economies as a whole. The macroeconomic pattern seems bleak for the United States, but the microeconomic pattern in terms of prospects for particular companies or industries seems more promising.

Let us consider the question of specialization, or segmentation. It is all very well to speak of economies shifting broadly to higher value added; they do, albeit slowly, but individual companies deal in specific products and deal with the issue of building a dominant position in a particular area. This may not at any time be congruent with the broad changes in the economy as a whole. Thus Britain's United Biscuits or Imperial Chemical Industries may flourish internationally quite against the current of their parent economy's over-all performance.

Japanese companies will undoubtedly confront competitors in the next decade from which, until now, they have been sheltered. A principal change is the degree of openness of the Japanese economy to imported goods. Japan will shortly have the lowest tariff levels in the world, and already has relatively few quotas. These are both substantive and symbolic indications of the degree to which the economy has been opened. In many cases, U.S. companies will not be able or willing to take advantage of this opening, but the opportunity for U.S. firms is there.

Further, Japan is unlikely, during the decade, to be able to reverse this process of opening. Trade is essential for Japan. Exports are necessary to pay the import and invisibles bill. Japan can hardly take protectionist initiatives when under challenge and protectionist threat around the world. Japan is open, and will become more so, just as Britain and the United States during their heydays of economic power pursued free-trade policies.

Besides, the exchange-rate advantage enjoyed by the Japanese competitor is largely gone. An undervalued yen was a mighty sword in the hands of the Japanese exporter. With floating exchange rates, that price

advantage is lost. Indeed, for some U.S. companies, the probable improvement in value of the yen against the U.S. dollar will bring considerable benefits.

The exchange rate reflects the average of the performance of the two economies, and the average of the performance of companies in the economies. At any time, some U.S. companies, who dominate their fields of business, will have cost positions more favorable than the average U.S. firm. One thinks of such well-managed U.S. firms as Dow Chemical, Eastman Kodak, IBM, Caterpillar, Du Pont, and Weyerhaueser. These companies, and companies like them that have not sold their technology, that have made the necessary marketing investments in Japan, that are determined competitors for a market share, and that take a long view of their business, will be the beneficiaries of an open Japanese market and a weakened U.S. currency relative to the yen.

The well-managed U.S. firm has one great advantage over its Japanese competitor. The U.S. firm operates within the largest single market in the world. If its production is essentially concentrated in the United States, and if it is the largest producer in the United States, it is then almost automatically the low-cost producer in the world. That advantage can be dissipated by lack of export effort, or canceled by protectionism and exchange-rate disadvantage. But in relatively free trade, with a favorable exchange rate and determined management, these companies should be able to make a great impact on the Japanese market. Indeed, some of them already have, with annual export sales to Japan in the hundreds of millions of dollars.

There are other changes that work to the disadvantage of the Japanese producer. The erosion of wage-rate differences has already been noted. Lower wages have provided an advantage to the Japanese company in many industries. The importance of wage rates can be—indeed often is—exaggerated. Wage costs are the real issue, and productivity is the key. Still, lower wage rates help, and for the Japanese company that help is now gone. Indeed, wage-rate advantage may reverse in favor of the U.S. producer.

Still another change that may work to the advantage of the U.S. competitor in trade with Japan is the rise in Japan of large-scale mass retailers. Companies like Daiei, Ito-Yokado, Nichii, and Seiyu are multibillion dollar retail firms now, and growing rapidly. The Japanese exporter to the United States has frequently chosen to take advantage of the giant retail chain to achieve market penetration with low marketing costs. Until recently, there was no balancing opportunity in Japan, because the retail system was made up almost entirely of small-scale operations. A Daiei with sales of $5 billion, more than half in nonfood items, offers U.S. companies a similar opportunity of low-cost entry to the Japanese market as the Sears, Penneys, and Kresses of the United States have offered to the

Japanese. With increasing disposable incomes making luxury purchases by the consumer possible, and increasing concentration of distribution providing increased access to the consumer, the foreign supplier of a range of consumer goods has in the years to come an opportunity in Japan not hitherto available.

With this market increasingly accessible in the 1980s, it becomes more apparent, too, that for all the over-all strength of the Japanese economy, there are industrial areas in which the Japanese position is relatively weak. Japan's chemical industry is an example. In this industry, scale of production is critical for many products. Yet the Japanese chemical industry is fragmented, with far too many producers. At the same time, German, British, and U.S. firms in this industry are large companies. There is no Japanese chemical company even near the size of Hoechst, Bayer, BASF, Imperial Chemical Industries, Dow Chemical, Union Carbide, or Du Pont.

Production of caustic soda is one example of Japan's problems. Japan has the enormous number of thirty-eight caustic-soda producers. Two might be sufficient and effective; three might well be too many. The world market is led by Dow, with ICI an important rival. The problems of supply of caustic are substantial, breaking into an established pattern of supplier-customer relations is difficult, and setting up distribution facilities is costly. But it seems inconceivable that Japan can maintain its present caustic-soda industry in the face of opening markets, rising production costs, and a litter of small-scale producers. Caustic soda is only one of a large number of chemical products and intermediates in which the Japanese industry is fragmented and high-cost. PVC, with twenty-odd producers, is still another example.

The solution for Japan, in order to maintain competitiveness against world suppliers of these chemicals, would seem to be a series of mergers and acquisitions designed to consolidate and concentrate the industry into the hands of a few efficient producers of sufficient scale to compete with the large Western firms. Here, however, Japan is victim of its own strength. The very pattern of employment relations and company identification that serves Japan so well in raising productivity levels and ensuring high quality of output makes it nearly impossible in Japan to buy, sell, and merge companies.

Again, the conclusion must be that the Japanese economy over-all is indeed very strong and will continue to be so, but there are sectors in which Japanese companies will come under severe competitive pressure. The result can only be beneficial to the Japanese economy, but may be hard on many individual Japanese companies. The chemical industry was used as an example, but the pharmaceutical industry and the processed-foods industry also have too many producers, undistinguished technology, and disadvantages in access to raw materials.

Another major difference between the 1980s and previous decades in terms of competition between Japanese and U.S. companies arises from the fact that, in many of the product sectors in which competition will be most severe, the U.S. competitor has an established position in Japan from which to compete. The contrast with the earlier period is almost total. There were then no foreign companies producing steel in Japan, no foreign companies producing and marketing radio and television receivers in Japan, no foreign companies producing and selling passenger cars in Japan.

The pattern of competition until recently has been drearily similar. The Japanese entry to a product area begins with a large number of companies attempting initial production. The Japanese market, totally protected from both imports and foreign investment, then grows rapidly. This growth, enjoyed entirely by domestic producers, allows them to bring their costs down to world levels rapidly and without foreign intervention. After fierce domestic competition, a few winners emerge in a strong position. From this protected and substantial domestic base—a fortress as it were—the Japanese competitor has moved his troops out into the world market.

This pattern will not obtain for the battles of the 1980s. The largest producer of computers in Japan is not a Japanese-owned company, but IBM. Its wholly owned Japanese subsidiary, with sales of more than $2 billion, is the industry leader. It is seen by technical graduates of Japan's top universities as one of the nation's half-dozen most attractive employers. It is a formidable organization, wholly Japanese except in its ownership. In semiconductors, America's Texas Instruments is a major factor in the market, with a wholly owned company producing and marketing in Japan. Burroughs and National Cash Register have well-established positions in the Japanese electronics industry, as have Honeywell and Hewlett-Packard. The list need not be made exhaustive; the point is clear. In this industry, clearly a major competitive battlefield of the 1980s, there is a difference. Farsighted and aggressive U.S. managements did what was necessary to build up a position in Japan. They have staff and facilities in place. However the industry develops, and however comparative advantage may develop in terms of particular products, the earlier pattern of Japanese industry development and export success will not apply to this sector. The competitive interaction will be more balanced, and the prospect is for mutual specialization rather than for an overwhelming position achieved by one side.

Pharmaceuticals is another industry where the foreign-investment presence is substantial. Chemicals is still another, where foreign firms, appropriately, have focused efforts more on building an import and sales capability than on building production facilities. Off-shore sourcing for specialty chemicals is proving an effective basis for competition within Japan.

Looking at corporate competitive interaction, then, a number of critical changes are in process or in prospect. The Japanese market is more open. Distribution problems are lessening. Some sectors of Japanese industry are weak by international standards, and are now exposed to world competition. In some sectors of special importance to trade competition in the 1980s, foreign companies (and especially U.S. companies) have built strong positions in the Japanese market.

The picture that emerges, therefore, is that trade problems over-all will continue, with Japanese trade remaining in surplus against the United States and Japanese economic performance continuing to surpass that of the United States by a considerable margin. However, this over-all pattern can be applied to individual company performance only with care. There are real changes taking place at this level, largely to the advantage of the U.S firm.

In one sense, the presented situation describes a classic movement toward trade specialization. There will be sectors in which Japan will import in large amounts. In some of these, leading U.S. firms are likely to have a strong position. This pattern of specialization, with U.S. successes as well as problems at the corporate level, may well help to mitigate some of the potential political problems of the over-all trade imbalance and conflict. To the extent that Japan is exporting unique products (the video tape recorder is the current example) that do not affect individual U.S. firms, this, too, will make for an over-all trade imbalance, but less political friction, inasmuch as no particular U.S. firm is being damaged.

This view supposes, of course, that major U.S. firms are in fact allowed to compete aggressively, in Japan and elsewhere. It is romantic nonsense and political demagoguery to speak of small-business exports as a solution to trade problems. Some small businesses will do well in Japan and elsewhere. But substantial solutions to trade problems, and substantial contributions to the U.S. trade balance, will be provided only by a small number of large companies. It is entirely possible that U.S. government efforts to limit the competitiveness of IBM, and of Kodak, and of General Motors will be successful—to the considerable disadvantage of U.S. competitiveness in the Japanese market.

The General Motors case is interesting. We are treated to the spectacle of Mr. Douglas Fraser, president of the United Auto Workers and a director of the Chrysler Corporation, stating, "I am getting increasingly weary about the Japanese government always being willing to take and take and take and very rarely giving anything." Mr. Fraser continues, as reported by the Associated Press, "The government has got to get tough with the Japanese auto companies." Such remarks are destructive, serving to increase misunderstanding and prejudice. In fact, provided U.S. subsidies to high-cost competitors do not greatly harm General Motors, and, provided the Justice Department allows the marketplace to determine the economics, the 1980s hold the promise that General Motors will have both

the product and the resource capacity to make a serious impact in the Japanese domestic auto market. Only with a competitive product and cost position can the cost to the United States of the American auto industry's past mistakes be remedied. Mr. Fraser's attack on Japan, and efforts to salvage a weak U.S. competitor, are not helpful.

The area of attitudes and feelings, and their political consequences, may be the real issue of the 1980s. The United States has for decades been spending beyond its resources, consuming rather than saving and investing, hence the long relative decline in the U.S. economic position, the decline in value of the dollar, loss of trade share, and general realization of a slippage of power.

It is hardly surprising that the U.S. response is one of resentment toward the rapidly growing economies, and toward Japan in particular because of the long history of patronizing Japan. Certainly, protectionism was on the steady increase in the United States even before the attrition of the U.S. position was so visible or widely realized.

With increasing U.S. irritation over trade problems, and responses of the sort that Mr. Fraser indulged in, a counter tendency is discernible in Japan. The view is widespread in Japan that the Japanese work hard and others do not; that they produce high-quality goods and the goods of others are shoddy. There is rising self-confidence, and an increasing impatience that Japan is being blamed for what is seen in Japan as the incompetence of those doing the blaming. The increase in Japanese willingness to react rather than passively accept criticism was exemplified by the Japanese Foreign Ministry report, published in August 1979, detailing the causes of the poor export performance of the United States. The report was the first official publication of the sort, and seems to signal a different Japanese attitude in future trade discussions, an attitude that Japan has done what it must and can, and that the trade problem must find remedy in an improvement in U.S. economic performance.

This attitude has in it the potential for greatly increased tensions, as confrontation may become more the mode and the Japanese may become less accommodating toward ill-informed criticism. It is a dangerous business for both countries, this trade issue. It is not being handled well, as confrontation recurs, and threatens to intensify. The issues are not going to disappear in the 1980s. It will take considerable conscious, deliberate, and continuous effort on both sides to contain the potential damage to relations of the trade competition. That effort was not made in the 1970s to a sufficient degree. The 1980s will be more difficult because of this history, and the effort required to maintain constructive relations even greater.

Japanese–U.S. Economic Relations: Issues and Prospects

Tadao Kato

Geographically separated though they are by an ocean, Japan and the United States are today bound together by ties of global significance, transcending purely economic relations. In addition to being natural trading partners across the Pacific–with a two-way trade larger than that of any other overseas trading partners–both are leading industrial nations and exponents of market economics. The number of visitors across the Pacific reached nearly 1.4 million last year. The two nations are allies with shared democratic values and a common interest in peace and prosperity in the Pacific basin and in the world.

A study of Japanese–U.S. relations released by the prestigious Potomac Associates reveals that, asked what countries are important to the United States, 88 percent of the American people cite next-door neighbor Canada, 86 percent Japan, 85 percent West Germany, and lesser percentages other countries.

Similar opinion polls in Japan showed that 84 percent of the Japanese people felt the same way toward the United States. American programs proliferate on Japanese television. We have Hollywood movies, disco music, and, yes, even jogging.

For Japan, relations with the United States have been, and will continue to be, the cornerstone of our foreign policy. Likewise, the Carter Administration has consistently made relations with Japan central to its Asian foreign policy.

Yet, to point out how very close the relations between Japan and the United States are is not to imply that this relationship has been trouble-free.

The disequilibrium in our trade balances is perhaps the single most glaring example of our economic and trade friction. The United States ran up massive trade deficits with Japan in 1977 and 1978, and 1978 ended with a deficit of $11.6 billion, 50 percent more than even the 1977 deficit.

Those figures were viewed with alarm not only in the United States but also in Japan, where the private and public sectors moved for a quick resolution to this threat to the development of sound economic and trade relations between our two countries.

Of course, no quick remedy was available, for economies are a bit like the bucking broncos in a rodeo—it takes a long time to bring them under control, and meanwhile you just have to hold on and break your butt trying.

The record trade deficit in 1978 was certainly not for lack of Japanese efforts to balance her trade. The Japanese government and private industry did everything possible. For example, the government unilaterally lowered its tariff duties, simplified import procedures, dispatched a special import-promotion mission to the United States, and took a number of other special measures to promote imports. At the same time, Japan also moved to stimulate domestic demand—and hence to create a larger market for imports.

The Japanese government's special efforts to stimulate domestic demand for the sake of international equilibrium have to a large extent been based upon heavy deficit spending. National bond issues reached a record high 39 percent of all treasury revenues in fiscal 1979. As a result, Japan will find it difficult further to increase government spending in the budget for fiscal 1980 (from April 1980 through March 1981). Large-scale deficit financing has already reached such a level that the problem of restoring budgetary soundness is becoming more serious, and the possibility of instituting additional indirect taxation has been under discussion for some time. In fact, the hint of such an unpopular cure for the problem is thought to be one of the reasons the government party failed to gain a comfortable majority in the recent election for the Lower House.

Despite these difficulties, Japan's economic policies have been oriented toward the goal of a better external balance, and it is no accident that Japan's global current account in the first eight months of 1979 registered a $2.9 billion deficit. Together with the improvement of Japan's global external balance, her trade surplus with the United States fell from $7.7 billion in the first nine months of 1978 to $4.2 billion in the same period of 1979.

Even clearer evidence of this trend is provided by the OECD *Economic Survey of Japan* issued on August 13, 1979. In this report on 1978 and the early months of 1979, the OECD noted several "remarkable developments" in Japan's efforts to coordinate its economic policies internationally, among them the fact that economic recovery was sustained by the growth of domestic demand rather than by exports. As far as the adjustment in the balance of payments is concerned, the report pointed out that the large current account surplus in the first half of 1978 had virtually disappeared by the spring of 1979, mainly because of the growth of domestic demand and the impact of currency appreciation. Looking at

Japan's trade trends on a global basis, the OECD report said exports are expected to be down 3 percent by volume in 1979, while imports may be up about 10 percent.

Let me next touch on the so-called "closed Japanese market." With past mounting deficits in U.S. trade with Japan, many Americans came to echo—and even to believe!—the litany that this deficit was primarily attributable to what was termed the closed nature of the Japanese market. This is simply not true. Japanese markets are today at least as open as are the markets of any other industrialized nation—the United States included.

Japan has made a major effort to internationalize and open its economy. And Japan's leadership role in guiding the Multilateral Trade Negotiations (MTN) to a successful conclusion has been only part of that effort. These negotiations were recently agreed upon among Japan, the United States, and the European Community nations, in order to lay the basic rules for world trade in the 1980s and to promote mutual tariff cuts and equitable trade practices. Japan has agreed in the MTN to cut its tariffs by approximately 50 percent on a global basis. By comparison, the equivalent figures are approximately 30 percent for the United States and about 25 percent for the European Community.

After these MTN tariff cuts have taken place, the Japanese average tariff will be only 3 percent globally, the lowest figure in the world and even lower than the 4.3 percent of the United States. On a Japanese–U.S. bilateral basis, the average tariffs under the MTN arrangements will be 3.1 percent on U.S. exports to Japan and 4.4 percent on Japanese exports to the United States. Yet myths die hard, and the low percentage of industrial goods in Japan's total imports is also occasionally cited to substantiate the charge that Japan's markets are closed.

Although the absence of industrialized neighbors until recently, and the inherent need for resource-poor Japan to earn its way by importing commodities and exporting finished goods, make it unlikely that Japanese industrial imports will ever equal our resource imports, there has been major improvement in this area as well. Industrial products accounted for nearly 30 percent of Japan's import total in the second quarter of 1979. In dollars, manufactured-product imports jumped from $4.4 billion in the first quarter of 1978 to $7.3 billion in the second quarter of 1979. In Japanese–U.S. trade, Japanese 1978 imports of U.S. manufactured products were 48 percent more than in 1977, and the figure for the January-September period of 1979 was 45 percent more again than in the same period of 1978.

There are several issues which require urgent attention from the global economic community.

The first major issue confronting us is the energy problem, which has had serious repercussions for the world economy, both in that higher oil prices have exacerbated inflation across the board and in that anxiety

about future oil supplies has cast a pall over economic growth rates. Moreover, this problem has undoubtedly had the gravest ramifications for those developing countries that lack oil resources.

At the Tokyo Summit last June, the participants, themselves accounting for 70 percent of the world's total oil consumption, agreed upon specific import curtailment targets from 1979 through 1985. In addition, the energy ministers from the leading industrialized nations met in Paris in September to formulate a still more explicit follow-up to this Tokyo Summit agreement. Those efforts are most significant in providing a definite outlook for oil supply and demand among the industrial nations.

The Japanese record gives some idea of what can be done in conserving energy. Between 1973 and 1978, Japan's real GNP increased by 22 percent, but our imports of crude oil, which for all intents and purposes means our total consumption of crude oil, *decreased* by 6 percent. In other words, Japan produced *more* with *less*. This remarkable feat resulted largely from private-sector initiative. After the oil crisis, industry moved ambitiously to develop and install new energy-frugal technologies, such as consolidated blast furnaces for steel, and improved smelting furnaces for aluminum. In addition, a broad-based public campaign was launched to conserve energy, and more energy-efficient products were developed. Such electrical appliances as refrigerators, television sets, and air conditioners now consume less energy than they did before the oil crisis. The fuel efficiency of Japanese cars has improved 30 percent in the past three years.

The per-capita energy consumption in the United States is 2.6 times Japan's, making it all the more essential that the United States step up its efforts to conserve energy. The constructive energy policies now being implemented in the United States are welcome evidence that the United States realizes the urgency of this issue.

Development of alternative energy sources is another important aspect of this issue, and Japan and the United States have been cooperating in this area for a long time now. As one recent example, the bilateral agreement on scientific and technological cooperation signed during Prime Minister Ohira's visit to Washington in May 1979 provides for close cooperation between the two countries.

As a part of such cooperation, an agreement on joint research for nuclear fusion was signed in August 1979 by the Department of Energy and the Japan Atomic Energy Research Institute, with each side putting up half of the $135 million needed for this five-year project. Several Japanese scientists are already working side-by-side with their American counterparts at the General Electric Company in La Jolla.

The second problem confronting both Japan and the United States is inflation. The OECD countries' average price increase was 6.9 percent in 1978, and is expected to be approximately 9 percent in 1979. Yet together

with this, we have also been plagued with recession in the wake of repeated oil crises. Consequently, efforts to contain inflation must necessarily be coupled with simultaneous efforts to minimize the decline in economic growth rates. Along with formulating effective fiscal and financial policies, we must also marshal policies to improve productivity, as was appropriately agreed upon at the Tokyo Summit.

Japan has already had some success with this approach. Moving decisively in the wake of the oil crisis, Japanese industry invested heavily in productivity. Processes were modernized, automated, and consolidated to improve production efficiency. The results speak for themselves. While the U.S. automobile industry's productivity increased 29 percent from 1970 to 1977, the Japanese auto industry's productivity rose 44 percent during the same period. Productivity improvement figures for other industries are similar: in steel, 10 percent for the United States and 27 percent for Japan; in electrical machinery, 21 percent for the United States and 90 percent for Japan.

As a report by your own comptroller general, the so-called Bentsen Report, has recently noted, the United States' productivity increases in the eighteen years 1960–77 were less than one-third of Japan's. It is my contention that this productivity differential is also largely responsible for the trade differential.

The third major subject before us is the maintenance of the free trade system. I hope you will not think the battle has been won simply because the MTN were successfully concluded. This *was* a most historic and most heartening agreement, and I am confident that it will help us to conduct our future trade under sound rules and equitable codes, leading to the steady development of the free-world economy. Nevertheless, this does not mean that the threat of protectionism has been eliminated. I know only too well that, in the real world, trade does not obey only the law of comparative advantage.

Each of us is prone to protectionism. "Just this once," we say. Yet it is never "just this once" when the poison of protectionism infects world trade. That is why we must do everything possible to contain protectionism through continuous international consultation and cooperation, even after the gratifying success achieved in the MTN. Protectionism is the antithesis of productivity—the bane of sound growth—and we must continue to open our markets to ensure that protectionism never again appears preferable to free trade.

Looking again at Japanese–U.S. economic relations in the context of this international economic situation, it is clear that positive coordination of our trade, anti-inflation, and energy development must be high on our common agenda.

There is growing recognition in Japan, for example, that we should shift the emphasis of our economic policy to give greater priority to

enhancing the quality of life, improving the social infrastructure, including housing, sewerage, and social-welfare facilities, and encouraging consumer demand—including the demand for imports of manufactured goods.

The United States is also reexamining her basic economic management policies to dampen inflation, to improve the competitiveness of American industry in domestic and world markets, and to improve U.S. trade and payments balances with the world.

Because these economic policy efforts are related to structural changes in the economy, it takes time for them to show up in the statistics. However, they are already having an impact, and I am confident that they will continue to make the two economies even more compatible.

In addition to these economic concerns, there are also cultural and perceptional differences between Japan and the United States. The Japanese distribution system, relations between big manufacturing enterprises and their subcontractors, various health and safety regulations, and other distinctively Japanese factors, are derived in part from social and cultural traditions. While we must continue to make every effort to ensure a smooth flow of trade, we must remember that many of our policy differences are rooted in basic cultural differences.

Yet many of Japan's most vocal recent critics in the United States and Europe have not bothered to differentiate between problems that can be dealt with in the short term and those that require long-range solutions. When Japan fails to produce an immediate response to a long-term issue, they charge foot-dragging, and argue with more emotion than reason. This emotionalism is regrettable, for it complicates the situation and further delays a solution. Only an understanding of each other's circumstances can defuse emotional antagonism.

Next, let me share with you some thoughts on the prospects for our bilateral and global relations in the 1980s. Dire predictions abound. We are running out of oil. We are heading into a recession. And there are many places where armed conflict could erupt and escalate. Yet I believe that we can ensure that these grim prophecies do not come true. Cooperation is the key.

First, it is important to extend the scope of our international economic activity beyond trade into international investment. Columbia University recently published a survey, "Economic Impact of the Japanese Business Community in the United States." Let me briefly summarize some highlights.

The growing economic interdependence of the United States and Japan, as evidenced by the $36 billion trade between them, has led to the emergence of a large Japanese business community in the United States. By 1978, more than a thousand business entities had been established in the United States by Japanese interests, directly providing jobs for an

estimated 81,300 local residents. Japanese investments in these U.S. operations exceed $3.4 billion. The 210 U.S. manufacturing subsidiaries of Japanese firms produce $4.8 billion worth of goods. About $3.9 billion in American goods, or 3 percent of all U.S. exports, were exported to third countries by Japanese trading companies. This is a very considerable involvement in the U.S. economy.

Moreover, this is reciprocated by an equivalent U.S. involvement in the Japanese economy. In 1978, there were 460 U.S. manufacturing firms in Japan (by which I mean firms having a U.S. capital investment of at least 50 percent). Despite Japan's relatively high wage levels, U.S. direct manufacturing investment in Japan has consistently hovered around 3 percent of all U.S. direct manufacturing investment overseas since 1971. Moreover, as a study commissioned by the American Chamber of Commerce in Japan in July 1979 pointed out, "U.S. manufacturing investment in Japan . . . has been very profitable." Japan welcomes this manufacturing investment, and America's even heavier participation in the Japanese service sector.

As a result of this growing mutual involvement, the two economies are becoming increasingly complementary. At the same time, this pooling of personnel, capital, and technological resources will make it possible to move into still more sophisticated and knowledge-intensive areas. This is important, because not only does progress by the advanced industrialized countries enhance standards of living worldwide, it also makes room for the developing countries to move into the traditional manufacturing sectors, and thus to become contributing participants in international economic growth.

Nevertheless, the transition will not be without its trials, as people instinctively resist the building of a broader, stronger international economy. Thus it is significant that the OECD countries have reached general agreement on the Positive Adjustment Policy in an effort to thwart protectionist measures and actively to promote the readjustment of their industrial structures.

Second, I visualize the 1980s as a decade of intensified scientific and technological cooperation among the advanced industrialized countries. Trade will be only one aspect of much more complex economic relations, inevitably including closer industry-to-industry and business-to-business contacts and cooperation. Direct investment in manufacturing will open up new routes for the exchange of capital goods, components, and raw materials among nations. Production of new technology and technical agreements on research and development for new products and equipment will have a similar effect.

Paramount among the research and development areas demanding a concerted approach in the 1980s is energy. Unless we develop and commercialize technology such as alternative energy production, nuclear

fusion, and solar energy, we will never be free of energy shortages. Nowhere can international cooperation be more productive. In addition to the nuclear-fusion project mentioned earlier, the United States and Japan have also agreed to develop coal-liquefaction technology that could tap the United States' immense coal deposits and enable the United States to export liquefied coal gas, as well as coal itself, to Japan. Solar technology also offers outstanding opportunities for joint development to mutual benefit.

Nor are science and technology as a means to world economic activity limited to the energy field. Food production, health, communication—these are just some of the many other imperatives we face. There is no lack of areas for scientific and technological cooperation between the United States and Japan. And, as we incur the increased costs of this scientific and technological research for developing new energy and other technologies, for protecting and improving the global environment, and for realizing the Third World's potential, there will be more sharing of risks and burdens among the advanced countries. This will, in turn, create a climate still more conducive to the cooperative approach.

In scientific research and development, in overseas economic activity, and in domestic economic policies, it is imperative that we coordinate our orientations and adjust our structures to accommodate each other. As in Japan, so also in the United States, adjustments can be costly and painful. Yet the reasons for making these adjustments are compelling in both cases, provided business, labor, and the consuming public recognize the long-term benefits to be gained. We need more business leaders to speak out. We need more government leaders to speak out. And we need more academic people to speak out on the importance—indeed the imperative—of integrating our nations within the world community. Isolation is not a viable alternative. We must get to know each other better, and this must include both broad exposure to a wider audience and depth of understanding among our opinion leaders. That is one of the reasons I am so appreciative of the work of the Institute of East Asian Studies in Berkeley. We must shake off out-dated stereotypes and cooperate with each other in recognition of the reality as it exists today and as we would like it to exist tomorrow. I am appreciative of the honest economic research being done by Boston Consulting, American banks, and other impartial organizations. Academic and business leaders—in the United States as in Japan—have it within their power to nudge the public toward that enhanced awareness and enhanced understanding so necessary to international cooperation. And upon that cooperation hangs the fate of mankind.

In conclusion, in free-enterprise economies, there are limits to what governments can accomplish by adjustments in national policy. The creative decisions, the decisions which make the real difference in national

economic performance, are made in the marketplace by producers and customers. To that extent, the thoughtful and successful negotiations between our two governments over the past two years, and the long-range policy decisions our respective governments are now considering or actually implementing, will be fruitful only if business leaders seize the opportunities provided and make the most of them.

I am confident that they will do so, for in the United States, as in Japan, the creativity, imagination, and enterprise of the private sector have always been the wellspring of national vigor and strength. Thus I am optimistic about the prospects for the future—optimistic not because I think everything is going well, but because I believe we know what needs to be done, and because I believe we can do it—all of us—together.

U.S.–Japan Trade Relations: Economic and Strategic Implications

Louis J. Mulkern

The purpose of these comments is to focus attention on the economic relationship between the United States and Japan, and where it might be heading in the next ten years. Japan and the United States are the leading democracies of Asia and the West, and the two largest economies in the world. Their economic performances in the decade ahead will largely determine the tone and quality of the global economic environment for the remainder of this century.

At the turn of the decade, we are well into fundamental changes, not only in our bilateral relationship, but in the international economic order, in which Japan is challenging the United States as the foremost industrial power. The implications of this development for the United States, for Japan, and for the rest of the world, are far-reaching.

This shifting is not in the interest of either country, first, because it is not based solely on Japan's rapidly developing industrial strength, but includes a steady erosion in the basic industrial competitiveness of the United States; and second, because the effects of declining American industrial power extend well beyond the economic sphere and into some areas where Japan may be less inclined to expand its role.

Further, the decline in American industrial competitiveness is largely the result of our failure to understand the competitive dynamics of international trade, and to respond with national policies and programs. Nothing less than a fresh and comprehensive structuring of basic economic policy, with strong leadership in government, industry, and labor will reverse the downward trend. The private sector on its own cannot effect the necessary changes.

Given such an effort, however, the changes necessary to restore America's industrial leadership can be accommodated within her free-

enterprise system and her existing governmental structure. With a restoration of U.S. competitiveness and economic vitality, the potential for economic cooperation and balanced trade between the United States and Japan, to the benefit of both countries and the world should be evident. It is not a question of U.S. potential—the potential is clearly there. Ultimately, it is a question of leadership, will—and a realization that our economy requires the cooperative efforts of industry, government, and labor.

I would like to elaborate on the comparison of Japan and the United States as industrial powers, because I believe that few Americans have yet realized the depth and magnitude of our economic problems or how formidable is the Japanese challenge. First, bearing in mind that Japan is a nation of a hundred million people, let me note that the Japanese per capita GNP—the measure of how much the average citizen produces, and, ultimately, of how well he will live—is now essentially equivalent to that in the United States, but growing faster and with much greater momentum. In historical terms Japan's productivity has overtaken the American with breathtaking speed and force. As recently as the 1950s, Japan's GNP per head was about 6½ percent of the U.S. GNP. At the current exchange rate, it is around 90 percent, and given the trends in GNP growth and currency-exchange rates, it seems most probable that Japan will pull ahead permanently some time during the next year or so.

Perhaps the most compelling evidence of Japan's industrial superiority, however, is the comparative performance of the two economies in world trade. Last year, the United States ran a $4.8 billion deficit in its industrial trade—Japan's surplus was $77 billion. On a bilateral basis, U.S. over-all trade result with Japan was an $11 billion deficit, but in manufactured goods alone (that is, without the effect of American agricultural exports) the deficit was $19.2 billion. Japan's share of the world market for manufactured goods is now equivalent to that of the United States ($96 billion versus $100 billion for the United States in 1978), but is still rising, while the American share continues to decline.

It is, of course, comforting (and, therefore, popular) to believe that the chronic U.S. trade deficit with Japan is the product of unfair Japanese trade practices, such as dumping, and of artificial protectionist barriers in the Japanese marketplace. But this ignores the sheer magnitude and manifest strength of Japan's industrial base. Yes, the Japanese have at times engaged in both dumping and protectionism, but the idea that Japan achieved a $77 billion trade surplus, solid profits, and steadily rising levels of real wages and living standards during a period of thirty years by selling dear in a protected home market, while pouring massive volumes of high-quality goods into foreign markets at or below cost is not merely self-deceptive—as the underlying premise of a national economic policy —it is dangerous.

Likewise, a trade deficit as large as ours is with Japan, built up over so long a time and sustained through a massive currency adjustment, cannot be explained away in terms of questionable trade practices. It can be based only in a serious and fundamental disparity in industrial competitiveness. I would, in fact, contend that the current trade imbalance actually understates the competitive disparity, having been influenced much more in recent years by American protectionism than by Japanese. In the absence of U.S. political pressures, Japanese inroads into U.S. markets would be even deeper.

Perhaps the following figures will add further perspective to the comparison:

In 1978, Japanese investment in new plant and equipment was $144 billion versus $148 billion for the United States. This means that, with half as many people, Japan in 1978 was building new industrial capacity at the same absolute rate as the U.S. The 1979 figure for Japan is projected at an increase of 21 percent over 1978. Of the world's largest 30 banks in 1978, 4 were American, with assets totaling some $225 billion; 11 were Japanese, with assets of more than $600 billion.

Although the United States is still the leading producer of new technology, and although we still retain the lead in many important areas of high technology, Japan is overtaking the United States in the technological content of its industrial output. For several years, Japan has had a trade surplus with the United States in products classified as "high technology" items. Given the continuing high rate of Japanese capital investment, the strong presumption must be that the trend is continuing in Japan's favor.

Thus, as we enter the 1980s, Japan is the second largest economy in history, with per capita GNP equivalent to that of the United States and growing faster. It is building new industrial capacity at a faster absolute rate. In terms of product quality and technological content, it is equal to, or slightly ahead of, the United States. It has a formidable base of modern, capital-intensive industries, postured to compete for market share on a global scale. It has a strong export position, a large trade surplus, a strong currency, and the highest rates of personal savings and capital formation among the major economies.

By contrast, the United States has suffered a steady loss of share in the world market for manufactured goods, and, indeed, to foreign competition in our own domestic markets. We have seen develop a large and threatening trade deficit, and have allowed the dollar to deteriorate to about 60 percent of its previous value against the currencies of our principal trade competitors. We are experiencing all the domestic strains and stresses which would naturally accompany a downward shift in our position in the international economic order: inflation, unemployment, pop-

ular resistance to rising taxes, budgetary cutbacks, erosion of confidence in our leadership, and a rising level of tension among business special-interest groups unable to survive in a competitive environment.

Why the dramatic difference in our two situations? Various explanations have been given for Japan's success in industrial competition and world trade. It was first attributed to cheap labor, until it was discovered that Japan became even more competitive as real wages rose. More recently, it has been explained by "a different work ethic," the "advantage" of having been destroyed by World War II, questionable trade practices, low defense expenditures, and so on.

Most of these factors have had some effect, but I believe the most important reason is much more straightforward. If there is a single, critical difference between Japan's economic performance and that of the United States, it is simply intelligent national economic policy. An economy, in a sense, is a collection of industries, each with its own characteristics: growth, productivity levels, capital intensity, all interacting with—like it or not—government. The pattern is dynamic, and the over-all strength of the economy (and the economic welfare of the average citizen) will be determined by the interaction of this evolving pattern.

Perhaps a few observations on the connection between market share and productivity will be of value here. As pressures on our economy continue, there is much talk about productivity; however, few Americans appear to understand what productivity really is and how to improve it. The critical parameter in productivity is the total unit cost of value added, regardless of how the value is added. How much does it cost to produce and market each candy bar, automobile, or ton of steel? Productivity is important in relative terms, and is most important relative to competition. Regardless of how productive you may be in the absolute, if your competitor is more productive than you are, he can make a comparable offering at a lower price. He can dominate your market. The true and critical measure of productivity is unit cost relative to competition. And the single most important *determinant* of relative productivity is *market share*.

This means that superior market share alone can convey a significant cost/productivity advantage on one producer relative to an equally diligent and intelligent competitor.

Japanese policy has recognized these basics, and has been structured to create an environment which supports growth-potential industries and, within national economic policy, downgrades the less productive ones. The mechanics of this policy are those commonly available to all democratic governments, including our own: taxation, tariffs, quotas, subsidies, and monetary controls. Through the use of these tools, together with an extraordinary emphasis on quality of education, a close working rela-

tionship between government and industry, and an understanding of the dynamics of international competition, the Japanese have been able to achieve competitive superiority in a long succession of major industries previously dominated by the United States and European producers.

At the corporate level, also, Japanese firms have been both aggressive and strategically astute. They have appreciated the leverage that derives from market share, and have single-mindedly pursued global share, seeking market opportunities around the world and designing their products to fit those markets. Their strategic time horizons are long, and their market-research efforts are painstaking. They have diligently managed their costs downward as market growth has increased scale and experience, shifting production offshore as required to maintain competitive factor costs, and they have used these cost reductions aggressively to price-compete for additional share. One area of unusual competitive strength has been the cooperative relationship between Japanese management and labor, and most notably the so-called lifetime-employment system. This arrangement, which almost any American can quickly prove will not work, has not only created a strong sense of loyalty and mutual dependence between Japan's corporations and their workers, but also, since new technology does not threaten jobs, has allowed Japanese industry to absorb technology during the past three decades at a rate which would have been difficult here.

In summary, then, Japan has identified growth industries for its major efforts, and has fostered those industries for global competition. Government and business, acting in collaboration, have systematically reallocated human and capital resources into industries of high growth, high technology, and capital-intensive productivity. There is nothing questionable, or inscrutable, or, for that matter, even particularly Japanese about this approach. It is simply sound policy for any large economy wishing to improve the living standards of its people, and it is adaptable to almost any governmental infra-structure.

The United States does not have an economic policy, and, at the national policy level, has little apparent understanding of the dynamics of international competition. We have protected our low-technology industries, most often *after* their loss of competitive position, and have shown little regard for the over-all quality of our industrial base, or for the competitive positions of those higher-technology industries on which our living standards and economic growth so largely depend.

There is too little policy dialogue between government and industry, and, indeed, no consensus about the proper role of government in economic policy formulation. I would suggest that there could be no more devastating weakness for any major nation in the 1980s than the inability to define the role of government in the economy. We have the lowest rates

of savings and capital formation among the major industrial powers—Japan the highest. Our relative productivity has steadily declined, and our once-enviable technological lead has been largely dissipated.

At the policy level, we have persistently ignored the mounting signs of our impending industrial crisis. The loss of world leadership in steel by the United States industry to Japan in the 1960s was perhaps the most significant single development in the postwar history of either country. A perceptive United States government would have recognized this development as a matter of the highest strategic importance, and would have set about urgently to assure the restoration of our competitiveness. What we did in practice was to attribute Japanese inroads into our markets to dumping, and impose import restrictions on Japanese steel. This saved jobs in the U.S. steel industry, and supported the revenues and margins of our steel producers. At the same time, however, it also raised the costs —and thereby eroded the competitiveness—of every other American producer who uses steel in his products.

This situation raises even broader questions with respect to economic policy. What *are* our national economic objectives, and how do we propose to achieve them? Which industries are contributing to our over-all economy? Which industries are critical to our longer-term national interest? Japan clearly perceives the computer and telecommunications industries as the watershed competitive areas of the 1980s, just as steel was in the 1960s. It is manifestly a Japanese policy objective of the highest priority that Japan become the global leader in those sectors, and all machinery of government and industry are organizing to compete vigorously toward that end. No other course makes sense for Japan, because leadership in those fields, combined with Japan's other competitive assets, would virtually assure Japan's industrial leadership well into the next century. The issue is, of course, equally compelling for the United States, but I wonder if anybody can tell what our policy is, and what our government is doing to promote our longer-term interests in this regard. How, for example, does the Justice Department's relentless pursuit of IBM contribute to the attainment of our national goals in this critical area?

We have treated our trade deficit with Japan as a political problem, to be negotiated away, rather than a symptom of declining competitiveness. Our attempts to reduce this deficit without addressing its basic causes—to reduce it through political pressures, protectionism, and devaluation of the dollar, have, at best, only moderated the downward spiral.

Particularly in the Japanese market, U.S. firms are performing far below their competitive potential, largely because very few have yet made a truly determined effort. With important exceptions, they have not developed specific strategies for Japan, nor have they committed the talent or resources needed to build strategically significant positions in mainstream Japanese markets. The effect is that we have provided our Japa-

nese competitors with a strategic sanctuary in which to gain experience and build cost positions from which to launch global export drives.

Looking ahead, the prospect, for both Japan and the United States, is for more of the same. There is no reason to expect that the Japanese will abandon the pattern which has thus far served them so well. Japan has all the machinery in place, with considerable forward momentum, to continue enhancing its position well into the future. Programs of increasing sophistication and productivity, propelled by Japan's extremely high levels of education, savings, and investment, and supported by its company-oriented and technology-receptive work force, will be expanded.

It also seems likely that the Japanese homeland will, as time passes, function less exclusively as a production center and increasingly as the headquarters of a global economic system, as the outward flow of technology, managerial skills, and capital investment increases. All these developments will be facilitated by Japan's ongoing trade surplus as will Japan's ability to develop and maintain raw-material sources, and to tap foreign sources of new technology through direct investment in research-and-development facilities abroad.

I would like to emphasize two points. The first is the seriousness of the issue. I believe that our declining economic performance is the most urgent problem confronting the United States today and for the foreseeable future. Everything else that we do or hope to do depends on our ability to support, through our economic effort, those activities necessary to the functioning of our democracy. Few Americans appear to be aware of the extent to which our national policies, our objectives, and, indeed, our aspirations for our society are based implicitly on the assumption of continuing U.S. world industrial leadership. Fewer still are aware that we are losing that position. We are fond of saying that the American free-enterprise system is the greatest economic machine in history. But, if we cannot make the machinery work under competitive stress, then the perception that it is the best system will be small consolation.

Second, however, there is no reason why we cannot make it work. We still have the world's largest economy, and its largest and most affluent domestic market. We have a well-established research-and-development base, and a head start in most of the advanced technologies where future industrial growth will be concentrated. Reversing the pattern I have described is well within our means, and will not require any fundamental departure from our free-enterprise system. It will require, however, much more coordination between government, industry, and labor than we have followed heretofore.

There is the most urgent need for a basic U.S. economic policy, developed and articulated by the executive branch under the leadership and direction of the President. I am *not* referring here either to an Amer-

ican version of the Japanese system or to a socialistic "planned economy," but rather to an integrated program of national economic priorities, to be debated, modified, and implemented through *our* established political process.

Our objective must be toward global market share in those higher-technology industries which represent potential for above-average productivity and growth. Difficult decisions must be made between the higher-productivity industries that drive the international competitiveness of our economy and those lower-productivity industries that hold us back. A successful policy will require not only industry-specific objectives, policies, and programs, but also measures to stimulate savings, capital formation, and the strategic penetration of foreign markets; rational application of antitrust legislation and protectionist actions; and central coordination to evaluate the effects of business decisions on over-all national economic performance.

All of this, of course, will require much stronger and more sophisticated leadership in both the executive branch and the Congress. It will require greater collaboration among government, business, and labor, and a much clearer understanding by the public of these issues, and of the ultimate consequences of the course on which we are now embarked.

And, as we undertake to set our own economic house in order, I would hope that the United States would develop a more realistic and sophisticated approach to our trade relations with Japan. Our unwillingness to face up honestly to the serious and progressive erosion of American industrial competitiveness, and our consistent exaggeration of the role of Japanese protectionism as the root cause of our difficulties has only diverted us from facing reality. If the focus of our imbalances with Japan can be found honestly and discussed frankly, both sides will benefit. World industrial leadership will not be an unmixed blessing for Japan if it is based in large part on an erosion in the strength and influence of its most important trading partner and principal military ally.

Finally, a decline in the economic vitality of the United States, coming at just the point when Japan is achieving its full potential, will deprive our bilateral economic relationship of what could be its finest era. With both nations at full potential and working in concert toward common economic goals, these two large industrial powers, with their combined populations approaching 350 million, their high incomes and education levels, and their superior technological and capital resources, could make technological advances, create trade flows, and generate economic benefits, for the two countries and others in the world, which would dwarf anything we have yet seen. But this is not the course we are on.

Japanese Quality: How It was Built Up and Maintained

Keiske Yawata

Much has been said about the success of Japanese foreign trade. In order to understand how this success was achieved, the postwar history of Japanese industrial development is here reviewed in relation to the quality of products. The six five-year plans of Nippon Telegraph and Telephone Corporation (NTT) had an impact on the quality concept in telecommunications and related industries. The quality concept was taught by two American consultants and further developed.

The Postwar History of Japanese Industry

When World War II ended in 1945, Japanese industrial production was at 30 percent of the prewar level. Agricultural production was 6 percent, real GNP 50 percent, real wages 30 percent, and real consumption per capita only 6 percent of the respective prewar indicators. The inflation rate was 100 percent in the six months starting August 1945. This economic chaos was overcome by cooperation between the occupation forces, the Japanese government, and private companies. The outbreak of the Korean war in 1950 triggered a large demand for war supplies and rapid development of industrial activities. Economic recovery was accelerated, and the U.S.–Japanese peace treaty was signed. Real consumption per capita in 1953 exceeded the prewar level. War-triggered developments in electronics, such as the miniaturization of vacuum tubes, had stimulated some sectors of industry—for example, radio manufacturing.

Transistors were in production as early as 1954, and development of a transistorized computer started before 1960. The transistor radio was a significant application of the transistor, and became the brightest star of the exportable electronics-equipment industry. Commercial color-television broadcasting also started around this time. The economy continued

to boom into the 1960s. The NTT launched its second five-year plan in 1958, spending 500 billion yen. Construction and service industries made maximum efforts to support the Tokyo Olympics in 1964. New roads and highways, subways, and hotels were built. Satellite communication, first experimented with in 1963, was fully used during the Olympics.

The desk-top calculator industry was born in the mid-1960s as one of the major applications of integrated circuits. The NTT's third five-year plan emphasized reducing the shortage of office and home telephones, a nationwide dialing system, and improved service in the countryside. Electric washing machines, refrigerators, and black-and-white TV were rapidly becoming commonplace in Japan, with automobiles and color TV following them. With the introduction of color TV, the quality image changed, primarily because of the price of color-TV sets. Consumers expected quality in a high-priced item like color TV, and TV-set manufacturers ran a quality competition with the cooperation of the components producers.[1] This quality concept later led to what is called "Parts Per Million (PPM) quality."[2] It was believed that quality should be built-in rather than tested for later, especially by semiconductor producers.

Because no defense industry existed, the Japanese electronics industry was developed around consumer goods. In addition to the consumer, the NTT played an important role. The stringent quality requirements imposed on suppliers resulted in companywide zero-defects campaigns and quality-control drives. These concepts originated in the United States and were introduced into Japan, but it was the Japanese[3] who took them so seriously that each employee in a company was made aware of the quality-control concept and encouraged to suggest quality-improvement ideas. All industrial goods being free of tariff barriers, the Japanese electronics industry had to strengthen its competitive position in worldwide trade. All electronics manufacturers are equipped in their domestic-production factories with fully automatic facilities to meet quality and cost requirements. In order to offset the export industry, the domestic economy is stimulated by government expenditures in the public sector. The mass production of microcomputers has opened up a whole new world of solid-state applications.[4]

To analyze the technological development of Japanese industry, some data are presented in Figures 1 and 2. World War II ruined research and development facilities and activities in Japan. Most of the postwar

1. "American Manufacturers Strive for Quality—Japanese Style," *Business Week*, March 12, 1979, p. 32M.
2. J. M. Juran, International Conference on Quality Control, 1978.
3. "American Manufacturers Strive for Quality—Japanese Style," *Business Week*, March 12, 1979, p. 32C.
4. "The Microprocessor: A Revolution for Growth," *Business Week*, March 19, 1979.

Figure 1

TECHNICAL LICENSES EXPORTED TO THE UNITED STATES (1976)

Chemicals	36.6%
Electronics	20.9%
Steel	6.6%
Textiles	8.1%
Others	27.8%

Worldwide: 83,404 Million Yen
United States: 12,898 Million Yen (15.5%)

Source: Science and Technology Agency, Tokyo

industrial efforts were aimed at restoring production. It took Japanese industry twenty years to achieve levels of research and development expenditure comparable to the United States. In 1951 the number of patents applied for in the U.S. by Japanese parties was less than 1 percent of the number of patents applied for in Japan by U.S. parties. In 1973 the gap was narrowed to about 40 percent. This means that the Japanese contribute much more today to technical development than twenty years ago. It is true that Japan imported much of its technology after the war to fill the gap, but the imported technology was further developed, and today Japanese technology is more sophisticated than the technology that was originally brought to Japan. Some of this technology is now being exported back to the United States. Figure 1 shows the volume of technical licenses exported from Japan to the United States in 1976, which should be considered a contribution by Japan to U.S. industry.

The Role of the NTT

A summary of the NTT's six five-year plans and an additional seven-year plan is shown in Figure 2. Until 1977, customers had to wait several months in some exchanges to get a telephone installed, so all plans emphasized volume expansion. Diversified services, such as data communication, started later, in the fourth five-year plan, when telephone saturation was foreseen and emphasis was switched to more or less qualitative expansion of telephone services.

In all these plans, the NTT has continued to emphasize the quality of the equipment used in its system, and an extra-reliable telephone service has been achieved by close coordination between the NTT's Electrical Communication Laboratories and suppliers. All equipment is developed

Figure 2

NTT FIVE-YEAR-PLAN ACHIEVEMENTS

1953–57	Restoration of telephone system; reduction of telephone shortage in the metropolitan areas of Tokyo and Osaka; completion of dialing system between six major cities and intercity dialing within economic regions.
1958–62	Nationwide dialing system planning; number of office telephones increased; expansion of dialing system to all major cities; use of public telephones in farming and fishing areas to spread telephone service.
1963–67	Improvement of telephone supply; intercity dialing and dialing between all prefectural capitals; extension of telephone service in provincial cities.
1968–72	Improvement of home telephone supply; increase in central offices in more congested areas and expansion of dialing service; continued rural telephone service expansion; development of data communication service; distribution of intercity repeaters.
1971–77	(Additional Seven-Year Plan) Lead time for telephone installation minimized; automation of all central offices; extension of data communication service; establishment of total communication network.
1973–77	Diversification of telephone service; shortening of lead time for telephone installation; continuation of data communication development; improvement of telephone charging system.
1978–82	Maintenance of short lead time for telephone installation; improvement of service to subscribers; security of communication service; contribution of telephone service to improved social security.

with the material and parts carefully specified at an early stage. Fundamental design is arrived at after extensive technical discussions between the NTT and the suppliers to fix the specifications, and every bidder is given a fair chance to supply the NTT. There has been much debate about the NTT's supply system, but I believe that there is an advantage to the traditional cooperative development over an open bidding system so far as built-in quality and reliability are concerned.

It is this stringent concept of quality, developed under cooperation

between the NTT and its suppliers, that has made Japanese semiconductors so reliable. Two of the four exchange-equipment suppliers, Hitachi and Nippon Electric Company, are also the two largest semiconductor suppliers and have consumer electronics divisions as well. They have applied the same quality and design philosophy to consumer-grade semiconductors as they do to NTT-grade semiconductors. By so doing, they have accomplished better quality and reliability with higher production yields, leading to lower costs. It is firmly believed in Japan that stringent quality control at the product design stage and in the manufacturing process ultimately results in lower production costs than screening each production lot to obtain high quality products.

Japanese Foreign Trade

The export of electronics started with the transistor radio. In the early 1960s, black-and-white TV, and later, in the mid-1960s, color TV took the lead among electronics exports from Japan. Toward the late 1960s, the variety of export items increased, as calculators and components were added. High productivity and high quality made these electronic products extremely competitive.

Both high productivity and high quality come from the traditional management style, loyalty of the employee, and proper training in quality control. Low manufacturing costs were achieved by production in volume and by cutting corners in labor and material wherever possible. The integrated circuit replaced discrete components and contributed to the improvement in reliability and cost reduction. Market studies were conducted to determine the needs of customers, and products were designed to fit these needs. Again, it was the Japanese who implemented what had originally been taught them by Americans, and again the student outshone the professor.

Quality Standards

For many years after the war, the image of Japanese products was one of low prices and poor quality, a typical example being the transistor radio. When Japan became competitive in the automobile, steel, and TV fields, the quality of products was an important tool in the marketing strategy of Japanese producers. Today many U.S. businessmen realize that quality is sometimes more important than marketing and financial know-how.

Japan owes the quality concept to W. Edward Deming and J. M. Juran.[5] Deming lectured to Japanese management in 1950 on the importance of the statistical quality-control method, which triggered innovation

5. "American Manufacturers Strive for Quality—Japanese Style," *Business Week*, March 12, 1979, p. 32F.

rather than imitation. Deming himself admitted that no other statistician had seen his work bear such fruit. J. M. Juran's *Quality Control Handbook* is still used as a textbook by Japanese quality-control managers. His emphasis on the quality-control function of modern management accelerated the Japanese quality revolution.

Leaders of the semiconductor industry often say that Japanese quality is the result of rigorous testing and screening. Japanese quality-control engineers do not believe in screened quality because it is the design and production process that determine the quality of the product and production lot. Thus, the design of a product is carefully examined by quality-control engineers, and each production lot is inspected many times during the production process. By enforcing such stringent quality control, each worker is made aware of the importance of quality, and workmanship thus improves.

In many Japanese manufacturing organizations, workers form small groups that meet regularly to define problems in their daily work and discuss each one to find ways to solve it by themselves. The quality-control concept has been adopted not only in engineering and manufacturing but in management as well. It is often wrongly believed that higher quality costs more. Actually, Japanese managers have proved that a good quality-control system reduces over-all manufacturing costs. Sony in San Diego and Panasonic in Chicago have demonstrated that it is not the high turnover of American labor that makes quality control in the United States more difficult than in Japan. Both Sony and Panasonic make high-quality television sets using American labor.[6] The difference between U.S. and Japanese management in quality-control policy may be that U.S. managers are oriented toward short-term defect detection and the Japanese toward long-term defect prevention.

Marketing Strategy for Foreign Firms

Japan, as an island nation, aims at self-sufficiency in production. During the Tokugawa period, from the seventeenth to the nineteenth century, the country was almost completely closed to foreigners. After the industrial revolution, many raw materials were imported and foreign currency had to be earned in order to maintain a balance. After World War II, more industrialization took place, and even agricultural products were imported. The circle of industrialization, raw material imports, and shortage of foreign currency pushed Japan's exports. As already noted, efforts to increase exports resulted in enormous success. Exports came to exceed imports. In order to sustain domestic industry and maintain the

6. "American Manufacturers Strive for Quality—Japanese Style," *Business Week*, March 12, 1979, p. 32E.

trade balance, imports had to be increased. It has often been said that it is impossible for a foreign firm to sell in Japan. Several reasons make it difficult to sell foreign manufactured goods in Japan: Japanese products sell in preference to foreign products because the label is in Japanese and easy to read, domestic brand identity has been established, after-sale service is better, or the design is more fitted to the Japanese people and environment. In other words, Japan has a built-in nontariff barrier which is culture-related and tough to break. Can this be overcome? I think the answer is yes. There are a few conditions, however:

(a) Long-term commitment must be made by the foreign manufacturers to get a share in the Japanese market.
(b) The foreign producers must try harder to study the Japanese consumer's needs and design products to fit them.
(c) The foreign producers must have their own sales organization.
(d) A good partner or a consultant is very helpful in understanding the culture and establishing good relationships with the local people.

Perhaps long-term commitment is the crucial factor for success. Japanese culture, as described in many books and articles,[7] is based on long-term relationships or connections, whether between customer and supplier, professor and student, or company and employee. A newly established company may perhaps hire experienced staff by offering higher wages. The fact that an employee chooses a higher wage over the relationship with his previous employer indicates that he is not a traditionally minded Japanese, and he may not be the best person to start a good relationship with his customers. How does a Japanese company get new employees? Usually by hiring new graduates. A manager in the personnel division will have a long-term relationship with a key professor in each college. Thus, everything depends on long-term relations. It probably takes ten years to become a factor of any kind in the Japanese community, starting from scratch. Such long-term relationships have given rise to the lifetime employment system. The employer assumes that each employee will stay with the company all his life and plans a career development for him. The employee also assumes lifetime employment without a written contract. This employment concept results in a strong paternalism on the employer's part and loyalty on the employee's part, and the quality of the latter's work is high.

Many have recognized that Japan owes its success in foreign trade to the quality of her products. Some U.S. firms have seemingly adopted a

7. Edwin Reischauer, *The Japanese*, (Cambridge, Mass.: Belknap Press, 1977). Mits Noda, "Business Management in Japan," *MIT Technology Review*, June/July 1979, p. 20.

policy similar to that of Japanese firms, but cultural differences make it difficult to use the same system of quality control and management, and modifications are needed. Yet in the combination of advanced quality control methods and greater attunement to the Japanese market lie the challenges to American industry.

Economic Rearmament for the United States and Japan

Walter E. Hoadley

A rigorous program of economic rearmament (as distinguished from the military concept) is called for at this time for the United States and Japan, albeit in different ways for the two nations. The success of such a program will largely determine the future course of financial trends in both nations, their ability to meet domestic and international market changes, and the outlook for the value of the U.S. dollar and the Japanese yen.

The world faces enormous challenges as it enters the decade of the 1980s. There is widespread apprehension about economic slowdown, social tensions, and political confrontations. With global population skyrocketing and staggering human wants to be met, the United States and Japan among other major nations must expect to be inundated with requests—more likely demands—for assistance from their own peoples as well as from others in all corners of the earth.

Never will the United States and Japanese economic and financial systems be put to a more far-reaching test. While both are now among the strongest and most powerful nations, neither seems adequately prepared for what lies ahead.

Lurking in the background of course is the smoldering issue of military rearmament.

For the United States, there are concerns about the spreading global military power and intentions of the Soviet Union. The United States now devotes about 5 percent of its GNP to defense, in contrast to 13–15 percent in the USSR, and less than one percent in Japan.

President Leonid Brezhnev's recent speech in East Berlin made some conciliatory gestures, but combined them with new threats, presumably to forestall deployment of updated Western atomic missiles in Europe. Thus, the arms race now continues, to offset Soviet missiles in place.

Earlier confirmation of Soviet military forces in Cuba and signs of growing unrest in Southwest Asia have stirred new American anxieties, stalling the SALT II treaty ratification and strengthening the position of those who feel the United States must enlarge its materially reduced defense capability.

President Carter's budget requests for 1980 also reveal that he feels that the U.S. defense budget must now be increased. It can be expected that the question will soon hit the headlines—how much longer should the United States provide a defense umbrella at minimal cost for Japan?

In Japan, the rearmament issue is similarly threatening. How much longer can Japan depend upon the United States for over-all defense? How safe from attack are the vital petroleum sea lanes from the Middle East to Japan? Will Japanese public opinion on the rearmament issue change in the future?

Major Fiscal Problems Loom.—Both the United States and Japan face rising governmental costs because of growing pressures for more military capability. Yet large internal budget deficits already generate economic and political problems for the United States and Japan.

The present voter mood across the United States and Japan is clearly not supportive of higher taxes. In the United States, a taxpayer revolt has already broken out in several localities (e.g., California's Proposition 13). The recent Japanese Diet elections also produced negative results for the ruling Liberal Democratic party of Mr. Ohira. Many voters apparently reacted negatively to the government's plan to raise taxes and wanted to show their displeasure.

Clearly the Japanese and U.S. governments have tough fiscal battles ahead. Inflation tends to increase government revenues disproportionately by pushing more taxpayers into higher tax brackets, but inflation also generates public unrest and undermines confidence in government policies, programs, and leaders.

Structural Changes Dominate Outlook.—The worldwide economy is currently in the throes of major structural changes, which will persist for many years. Far more changes than merely business cycles are involved, and some have profound implications for global finance and U.S.-Japanese economic-financial relations.

The financial markets in which the United States and Japan actively participate have already been greatly affected by such noncyclical changes as (1) energy shortages and price increases, (2) increases in over-all inflation and interest rates, (3) recycling of surplus OPEC oil revenues through the Eurocurrency markets, (4) the decline in the acceptance and value of the U.S. dollar, and the gradually increasing reserve role of the German mark and the Japanese yen, (5) the growing sophistication and numbers of global financial lenders and borrowers, (6) the resurgence of gold as an investment, especially as a hedge against inflation, and (7) the concerted

efforts of central banks, the International Monetary Fund (IMF), and other international organizations to try to influence the value of world currencies and reserves.

On the whole, the world's major financial markets have adjusted well to all these changes, but many observers are skeptical about the prospects for further such adjustments in the years ahead.

U.S. Economic-Financial Prospects.—Against this general background of change, let us look more closely at the economic rearmament needs of the United States and the financial trends and prospects of the United States.

To understand what is transpiring now in the United States requires an appreciation of the difference between cyclical and structural changes.

The U.S. economy is still very strong—at or close to its all-time high by most traditional economic measures. Recessionary slowing is underway because of inflation, restraint in government spending, reduced new housing, and lower consumer outlays, mainly for large-sized automobiles and household durables. To date, "rolling adjustment" has been a much better description of the recent course of our economy than "recession."

In fact, despite massive fears and predictions, technically a recession has not yet occurred, because there have not been two successive calendar quarters of negative U.S. real growth. But recent strong Federal Reserve anti-inflation measures will almost certainly bring about further economic slowing and a technical recession in 1980. Moreover, the *impending* presidential election campaign of 1980 is likely to produce some further disruptive governmental measures, ranging from tax cuts to mandatory wage, price, credit, and other controls.

For many years to come, the United States will be wrestling with its current major economic problems—inflation, energy, the balance of payments, the dollar, domestic fiscal and monetary discipline, and productivity. None of these problems is primarily cyclical and none can be resolved in a short period.

Economic Rearmament Means Resolving Major Problems.—In my view, in meeting these problems, the United States will be seeking to rearm itself economically by correcting some economic excesses and mistakes of the past two or three decades. No doubt there will be intermittent periods of uncertainty and probably some temporary setbacks, but I firmly believe solid progress will be made during the 1980s on each problem —and hence in over-all economic rearmament. Let's also recognize that complete success could in due course raise entirely different questions about a major new U.S. competitive threat to the rest of the world.

Important to Japan, each new corrective goal promises to affect U.S.-Japanese relationships. There will be excellent opportunities for closer ties, but also for possible new clashes and tensions.

Inflation is now widely accepted in the United States as America's primary problem, well ahead of unemployment, which had dominated national concerns since the 1930s. A slowing U.S. economy in 1980 is certain to cause some added unemployment, but it is likely to be concentrated in a few industries and regions. Full employment, that is, the jobless rate which will cause inflation neither to increase or decrease, is now about 6.5 percent in the United States.

Efforts to check U.S. inflation will draw attention, among many other things, to costs of imported goods and services, sources of external credit, especially from foreign lending institutions, and drains on the U.S. Treasury for expenditures to support foreign nations and overseas programs. In each of these instances, Japan can be expected to be drawn into the discussion.

Strengthening or weakening of the exchange rate of a country can be used conveniently as a scapegoat if one wants to criticize that country. Japanese products selling in the United States are now higher priced, and have added to U.S. inflation, in contrast to the situation a few years ago. The recent weakness in the yen may have temporarily slowed this import price advance trend from Japan. Japanese banks in recent years have sharply increased their dollar lending in the United States and elsewhere. The Federal Reserve's latest efforts to curtail credit expansion in domestic markets still leave a loophole for foreign bank lending from offshore directly to U.S. domestic borrowers. Should Japanese and other foreign banks decide to take advantage of this loophole, they can no doubt expect some criticism and perhaps even some demands for official restraint through tax levies or other means.

The cost to U.S. taxpayers of providing a military umbrella for Japan is likely to come up in media and official discussions, even though the Japanese government has been increasingly sharing U.S. military costs in Japan. The Japanese are seen by many from the U.S. side as getting a "free ride." However, if analysis should reveal that military rearmament by Japan could aggravate the global arms race, the higher costs to the United States could well exceed present expenditures to protect Japan.

Clearly, Japanese leaders must (1) become increasingly and openly sensitive to efforts to reduce the serious U.S. inflation rate, and (2) seek diligently to avoid being charged, either correctly or incorrectly, with aggravating rather than helping to solve our inflation problem.

Energy has been accepted as a very real problem for the future by the principal U.S. business leaders, but most Americans still believe that the problem is contrived. To some extent, the Japanese are seen as compounding the U.S. petroleum problem by aggressive buying efforts to insure their own supplies from diversified sources, with resultant still higher world and domestic oil prices. No doubt, the Japanese have some similar feelings about U.S. oil-purchase policies.

After many pledges, made at Shimoda and elsewhere, the United States and Japan have made very limited joint progress in exchanging some technical papers on energy development and research in the fields of liquefying coal and solar energy, and various technical fields, such as drilling for coal and oil, and extracting oil from shale. However, almost no one in the United States is aware of any joint progress in energy areas. Probably nothing at the moment could help strengthen U.S.–Japanese economic relations more than well-publicized, even if modest, energy successes resulting from strong joint efforts. A substantial energy program, with expenses shared by the two countries, would also help unblock present U.S. political reluctance to allow Alaskan oil to be shipped to Japan in exchange for oil purchased by the Japanese from the Middle East, with substantial savings for both sides.

The Japanese have made some strides in energy conservation in many products sold in the United States, but these energy-reducing features need to be publicized far more to the American consumer.

The *U.S. balance of payments* deficit, of course, is greatly influenced by massive oil imports. Further expected OPEC price advances will mask the corrective process which is now underway in other aspects of the U.S. international trade and payments accounts. The U.S. trade deficit with Japan, even though declining in the short run, continues to be looked upon with suspicion in the United States because of its magnitude. This will remain true despite repeated Japanese explanations of the need for greater over-all global reserve balances to shield Japan from its substantial economic and financial vulnerability as a nation almost entirely dependent upon foreign resources and trade, as well as to enable Japan to continue to provide aid to developing nations.

At the moment there is some optimism among U.S. and other officials that the American current account, covering trade and services, will move from deficit to surplus in 1980. The contention is that the lower value of the U.S. dollar and the slowing of the U.S. economy will reduce imports, and together with higher interest rates will bring the U.S. balance of payments into closer equilibrium with other industrial nations, including Japan.

This favorable prospect certainly would help ease problems between the United States and Japan over the persistent Japanese trade surplus. In my view, these expectations should be monitored closely and not taken for granted because (1) further oil price increases must be anticipated, (2) productive capacity places limitations on most major U.S. exports, (3) unusual U.S. consumer hedge buying is underway for quality foreign products, even to the point of drawing down savings, and (4) there are strong convictions among many financial executives worldwide that the U.S. dollar will continue to lose status as a reserve currency, probably reinforced by eventual implementation of the new International Mone-

tary Fund dollar substitution account. The latter is designed to ease the pressure of unwanted dollars, but its very existence also tends to confirm the chronically lower status of the U.S. dollar in the world's financial markets.

A weaker U.S. dollar has now come to be a pocketbook issue among the American people, because it means higher prices for imported goods. U.S. voters are therefore willing to support promising efforts to strengthen it.

There is rather conclusive evidence—on technical economic grounds —that the U.S. dollar is now undervalued against European currencies, but not against the Japanese yen. Thus, financial officers in Japan, the United States, and around the world confront a treacherous situation. On the occasion of any positive economic or political development, the U.S. dollar can easily rise 2 to 5 percent in some markets in a very short period. Yet, until the general negative attitude abroad toward the U.S. dollar changes for the better, it is unlikely that there can be sustained restrengthening generally.

Japan definitely has a major stake in shaping the future course of the U.S. dollar because of its heavy dependence on dollar trade and the emerging role of the yen as a more important trading currency. The yen's position as a modest de facto reserve currency is now established and must be expected to increase gradually.

Domestic fiscal-budget discipline is a chronic problem in the United States, as well as in Japan and most other nations. For several decades, U.S. economic policy has mainly emphasized putting idle labor forces and resources to work, almost in the absence of any concern about the economic-financial costs or the resulting inflation. Budget deficits have persisted in good times and bad times, only to be validated and accommodated by expansive Federal Reserve monetary policy.

As inflation has come to be recognized as an evil—i.e., a tax—by the American people, there has been mounting pressure to find the root causes. Generally now, there is public agreement that excessive government spending, leading to excessive monetary expansion, is the primary source of inflation. Accordingly, there are definite signs that large segments of the public currently abhor more than modest increases in government outlays, and in particular object to fiscal deficits.

The U.S. federal budget process involves budget expenditure and receipt proposals from the White House, but has more recently included a parallel congressional budget system, also designed to estimate revenues and expenditures, so as to place some advance legislative limits on projected budget deficits. In part this congressional procedure was set up to counterbalance the fiscal power of the president. In fact, however, the Congress has become more deeply involved in the federal budget process because the nation's voters are demanding more fiscal-budget discipline by electing more officials who agree with this objective.

All this means that prospects for greater restraint in government spending are slowly but steadily increasing across the United States. Certainly this is no guarantee against future deficits, especially in recessionary periods, when so-called "built-in stabilizers" reduce tax receipts and pour out benefits to the unemployed. Nevertheless, some machinery is in place to force more fiscal-budget discipline which in time should mean less monetary expansion and less inflation.

Japan again has a clear-cut interest in the outcome. Its success or failure will have a direct impact not only on the course of U.S. inflation and U.S. interest rates, but on the value of the dollar, as well as on the buying attitudes of American producers, consumers, and investors.

Productivity is another matter of structural concern for the United States. Traditionally, productivity gains have averaged three percent or more annually, but in recent years there has been a pronounced drop in this measure. Very recent official estimates have reported very small gains or net losses in U.S. productivity. Nonetheless, the over-all absolute level still remains at the top of world performance.

The unfavorable aspects of slowly growing or declining productivity are that they reduce the living standards of U.S. citizens, aggravate inflation, and undermine the international competitive position of the United States. For many years, U.S. productivity advances helped cancel inflationary developments, but this is obviously no longer true. Japan has managed to keep its productivity improvements much higher.

As the economy adjusts toward slower growth and becomes more service-oriented, Japan will probably be unable to maintain the high productivity experienced in the past, but its productivity is still forecast to be higher than that of other major countries. (Productivity in all industries in Japan increased by 9 percent in the fiscal year 1978, ending March 1979. In May 1979, the increase was 12 percent, largely due to the increase in capacity utilization.)

Clearly, an essential part of any U.S. economic rearmament program must be rebuilding productivity. This is not likely to take place quickly, however, because the most rapid national productivity advances in any nation are derived from (a) shifts of workers from rural to urban jobs, (b) substantial increases in educational achievements, and (c) output gains from installed capacity.

None of these now offers a major potential for the United States. In each instance, improvements have already been largely realized. The United States now has only about 5 percent of its population on farms; illiteracy is at the one percent level; 50 percent or more of adults have some college education, and full-employment conditions prevail widely, except for some older industries and facilities.

Since the United States is no longer predominantly an agricultural or industrial nation, it follows that its major new productivity breakthroughs will probably have to come in the broad personal, business,

and government-related service field. There are no satisfactory measures of productivity in these areas, so it will be difficult to judge progress accurately.

Closely allied are effort and motivation, which too often seem to diminish as taxes increase and personal economic security is achieved. Incentives to invest and produce are also adversely affected where inflation increases effective tax rates and erodes purchasing power. These circumstances now prevail in the United States.

U.S. Financial Trends and Prospects

As the decade of the 1970s comes to a close, the United States and most other financial markets around the world are marked by volatile exchange rate changes, high interest rates, surging movements of capital funds, and strong but ebbing credit demands. This unsettled period follows two earlier crises in the same decade. The U.S. and global financial systems successfully met the two previous challenges and seem prepared to cope with the new one as well.

The principal difference this time, however, is the growing force of inflation in stimulating unusual demands for credit, as well as driving up the cost of money to record levels. In particular, financial market responses to restraining government policy changes have been dramatic, but not always in the direction desired officially, as in the past.

One of the most significant recent U.S. financial market developments for Japan has been the tendency for many Americans to cut their financial savings rates and use more credit in order to maintain or improve their living standards. This has been the source of much financing of final sales in the United States in 1979 of products made in Japan. Obviously this cannot be sustained indefinitely.

Until recently the real rates of interest in the United States (i.e., nominal rates corrected for inflation) have been negative. Thus, there has been a strong economic incentive for many to borrow. In the recent past, however, both short and long rates have climbed sharply. In fact, the real short-term rate has become positive and tangibly expensive.

Long-term nominal rates are still generally below the current rate of inflation for prime quality borrowing organizations, but this gap could close in the coming months. Much depends, of course, on the outlook for U.S. inflation.

So long as long-term interest rates remained relatively low, it could be assumed that long-term lenders were convinced that inflation would not get out of control. More recently, some doubts about the future course of U.S. inflation have arisen. Long-term lenders have become less willing to make extended new commitments, and many financial executives have made fundamental reappraisals of their strategic financial plans for the years ahead.

Accordingly, the U.S. capital markets are now reflecting more structural changes. The recent General Motors agreement to adjust retirement benefits for inflation has similarly caused a basically new look at long-standing corporate pension-investment policies, which "locked up" future actuarial payment obligations by purchases of seemingly adequate high-yielding long-term bonds. The wisdom of such policies is at least now open to question.

For the first time in probably fifteen years or more, the question is again being raised whether common stocks may not be a better inflation hedge than bonds. Inflation hedging by equity investments had been an American assumption, but actual adverse experience in recent decades has driven many stockholders entirely out of the market. It is possible now that more professional and public interest in buying and holding common stocks will occur.

For Japan, these major structural changes in U.S. financial affairs bear close watching. They mirror shifting American attitudes toward the future and to some extent the attitudes of foreign financial leaders as well.

Japan Also Faces a Need for Economic Rearmament

In contrast to U.S. *demand*-oriented economic and financial policy, Japan has long given the highest priority to *supply*-enhancement policy. Some reversal in this emphasis seems inevitable in the period ahead.

Japanese average personal income in U.S. dollars may well equal or surpass U.S. personal income early in the 1980s, but actual real average living standards in Japan are now recognized to be substantially lower than in the United States.

The difference lies in the prevailing higher price level, shortages of housing and many general public infrastructure facilities, practical limitations on some imports, and the absence of a comprehensive social security system, which necessitates a higher level of personal saving for retirement years. Moreover, there is only limited use of consumer credit in Japan.

Economic rearmament in Japan seems likely to take the form of strengthening consumer real purchasing power, reinforced by stepped-up investment in the public sector to broaden the infrastructure base for higher living standards. The changing attitude of many Japanese seems increasingly to reflect the complexity of the people's demands for a greater sharing in their country's economic achievements. The Japanese government is acutely aware that its general economic strategy must now be driven heavily by the domestic economy. The economic plan through 1985 stresses this point.

In addition, consumer research in Japan also indicates a slowly rising demand for more extensive use of retail credit. More and more

Japanese travelers overseas recognize the extensive use of retail credit in the United States and elsewhere.

In the field of *corporate accounting and financial markets*, Japan has long lagged behind the principal industrial nations, particularly the United States. The key point here, of course, is that Japanese companies have been permitted to employ considerably more leverage or debt. The concept of maximizing return on total assets, capital employed, or equity, which is the backbone of management goals and performance measures in the United States, ought to be emphasized more in Japan.

The world's financial markets have traditionally accepted strikingly lower financial standards for Japanese companies, initially because of the limited financial resources available to them and subsequently because of the assumption that the Japanese government stood firmly behind all major Japanese companies engaged in international business and borrowing.

The principal question now is when the majority of Japanese companies will be able to stand the full test of global market evaluation of their performance, especially if the monetary situation should tighten appreciably. Up to now, Japanese managements have apparently judged their results largely on market share, sales gains, and profits on sales—a system which major U.S. and many other leading transnational companies deemphasized years ago as inadequate to gauge how well all aspects of the business are being managed.

Closely related, these same tighter measures of financial results are widely used by analysts who evaluate performance as a basis for recommending purchases or sales of common stocks on the U.S. and other major securities exchanges. Few Japanese common stocks are now listed on these same leading world exchanges, in part because of prevailing financial performance standards.

Perhaps it also should be noted that U.S. corporate accounting evaluation standards are currently undergoing still more far-reaching changes to include greater disclosure of adequacy of internal control systems to insure that values of assets and liabilities are more carefully monitored, some inflation impact measures, and extensive information on possible corrupt practices as well as corporate governance procedures.

While there is still considerable debate in the United States over the need for all this additional disclosure, the trend is clear. Managements listing their securities on U.S. exchanges will have to tell more about how and why they are conducting their businesses, so that stockholders will be more fully informed, and therefore better protected from surprises. Needless to say, Japanese businesses require more improvement in this area.

The Japanese securities markets, of course, function very differently from those in the United States. Price fluctuations are subject to official

control, listing is not too rewarding for foreign corporations, and the truly international dimensions of the market are limited. Nevertheless, Japanese government policy is slowly moving toward liberalization of some longstanding constraints.

There is still great Japanese official reluctance to establish an open yen market in Tokyo, but a start has at least been made in the short and medium maturity sector of the market.

For Japan to achieve financial stature commensurate with its economic accomplishments, there must be a greater commitment to making Tokyo a major effective capital market. Admittedly, time-zone differences do not permit current transactions between Tokyo, London, and New York, but an international financial organization with offices in these three cities can avoid any time-zone problems.

There is clearly a larger place for Japan in the future global financial system. Japanese financial institutions have expanded widely into the United States and elsewhere, in the world's major cities, capitalizing fully on the opportunities in these countries for foreigners. However, the opportunities for foreign banks and other financial institutions in Japan are far less clear. In general, such "outsider" organizations appear to be judged as necessary, but more for emergency or shock assistance than for regular growth purposes.

Japan has long managed its international finances with great skill, using funds from abroad extensively, leveraging capital substantially, and engaging in currency-exchange operations to maximize gains with minimum risk to the yen.

There has been considerably less success, however, in management of internal finances. Since 1974, the Japanese government's budget has had an annual deficit, with expenditures running 20 to 40 percent ahead of revenues. About 40 percent of this continuing deficit has been covered mainly by directed sales of government bonds to Japanese commercial banks.

It now seems evident that this budget financing practice cannot be sustained indefinitely. Either government spending must be cut, or additional taxes must be levied.

Here is the crux of Japan's homeland need for economic rearmament. Higher taxes on businesses will reduce already very thin profits. Higher taxes on consumers will inhibit higher living standards. Lower government spending will rule out some essential infrastructure projects and certainly not permit much military rearmament.

There is a real quandary for Japan here, rooted in expansionary overseas policies through the years. Performance over-all has seemingly been exemplary, but not in the same fundamental economic terms that U.S. companies and many other world leaders have employed. It is not clear how Japan can continue to meet its home financial needs, continue to

spread its capital over the world, persist in using overseas financial resources more or less on the same terms and conditions as other prime borrowers, and provide increasing aid to developing nations. There seems to be a need for some reappraisal in Japanese priorities. Certainly, it will not be possible to continue all present policies and programs and add many new ones without some rescaling of the order of preferences.

Japan and the United States Must Find Major Projects for Joint Efforts

Through the years there has been much close cooperation between Japan and the United States on many matters. There have been few instances, however, where the results have been strikingly in the interests of both countries and widely publicized and acclaimed as such. It is not clear why this has been so—is it because of limited tangible results, proprietary rights, few truly mutually beneficial agreements, political and competitive restraints, or inadequate attention to public education as regards the successes of joint Japanese–U.S. endeavors?

In my judgment, the time has come for a purposeful new effort on both sides to find at least a few major projects which are important to each nation and the world, and which would demonstrate U.S.–Japan solidarity. Successful pursuit of these projects could also go a long way toward helping the needed economic rearmament of the two countries.

Three areas of intensified mutual efforts seem promising:

1. Energy Development and Conservation

Japan is almost entirely dependent upon overseas energy sources. The United States is roughly 50 percent dependent upon foreign petroleum. Both nations have an enormous stake in this global and national issue. There seems to be little political interest in sharing currently available energy resources with each other, but sharing net additions to energy should be more feasible, and acceptable to both sides. This could encompass such items as new dimensions of nuclear safety, more synthetic fuels, improved coal-conversion systems, and similar developments, as well as breakthroughs in energy consumption in automobiles, other transportation, electronics, and buildings.

It would be worthwhile to undertake more joint financing of some new research and development projects, with scientific and technological innovations cross-licensed as evidence of lasting mutual benefits. There will be problems, no doubt, over present vested interests and some private or public desires for exclusivity. Nevertheless, the current crisis in energy provides a unique opportunity for solid cooperation between Japan and the United States. Moreover, there are intriguing possibilities for innovation in financing as well as in scientific techniques.

2. Dollar-Yen Capital Market Linkages

Against a general background of continued dominance of the U.S. dollar, but still some lessening of its role in future world financial markets and reserves, there is need for more attention to future dollar-yen relationships. The yen seems destined to become more important in global financial affairs, but is unlikely to be offered or accepted as a general substitute for the dollar for some time to come.

The yen cannot continue indefinitely to be heavily shielded from global market demand-and-supply forces and restricted mainly to Japanese national interest use. The availability of yen is a persistent concern across the world.

Would it not be useful to have top authorities in both nations explore the *mutual* interests of stronger dollar-yen relationships in, for example, trade, securities markets, consumer credit, capital markets, travel, and housing? An orderly transition for the yen to full international currency status would seem to be in the interest not only of Japan and the United States, but of many other parts of the financial and economic world. The Japanese have now lost total control over the movement of their currency, and many past policies are thus obsolete.

3. Assistance to Developing Countries

Population projections alone indicate massive problems ahead for developing countries trying to meet the rising expectations of their peoples. Japan has been much more pragmatic than the United States about developing stronger ties with developing nations, particularly those which have raw materials needed by Japan. Again, the time seems at hand for closer U.S.–Japanese working relationships.

These could include greater (1) joint development support for some nations by special financial programs related to international development banks, (2) joint training systems for enlarging the corps of managers and technicians necessary to use modern equipment in developing nations, (3) attention to political-ideological differences evident in North-South dialogues, and (4) possible joint cooperation in furthering economic and financial relations with the People's Republic of China, as well as the USSR. Neither the United States nor Japan can expect the world of the 1980s to be the same as in recent decades, when our national priorities tended to deal lightly with the role of most developing nations. There is no reason to believe any two countries can sufficiently assist or satisfy aspiring developing nations, but the United States and Japan could reinforce their own goals and programs by much more closely coordinated efforts.

These joint efforts should be openly bilateral to insure that close working relations are being pursued with vigor. They would supplement other activities through official international organizations.

Conclusion

The United States and Japan must now move beyond the stage of being friends, competitors, and opportunists to become realists. This means finding a new basis for more tangible cooperation—well beyond innumerable conferences—mutually successful for each, and helpful and visible to the world. There is no time to lose, because the 1980s will repeatedly test U.S.-Japanese relationships, not only in economics and finance, but in other aspects as well.

Japan's Fiscal and Monetary Policy and U.S.–Japanese Financial Cooperation in the Pacific

Koei Narusawa

In the economic development of Japan a dramatic change took place in 1979. First, a marked turnaround in the nation's current balance of payments occurred; its persistent large surplus, which had been causing widespread anxieties, turned into a deficit after March 1979. Second, the size of the monthly deficit has been on the rise since then. The International Monetary Fund applauded this rapid and successful balance-of-payments "adjustment process." As a part of this over-all adjustment, the trade imbalance between the United States and Japan, in favor of the latter, has been slashed substantially. The bilateral trade imbalance between the European Community and Japan, on the other hand, has changed, albeit slightly, in the latter's favor.

Japan's balance-of-payments turnaround is attributable to a number of factors. The government policy to cope with Japan's external surplus proved successful. This policy included fiscal stimuli designed to enhance over-all domestic demand, flanked by an "easy and cheap" monetary policy which induced a higher demand for imports of raw materials in particular, while lessening internal pressure for exports. A substantial part of the government expenditures for public works, in particular, was financed by issuance of government bonds, the share of which in the aggregate revenue will reach the historic high of approximately 40 percent during the current (1979/80) fiscal year. On top of this, the government took special measures to facilitate the process of balance-of-payments adjustment, which included emergency imports amounting to $4 billion; advanced implementation of a number of cuts in

import duties to which Japan committed herself in the Multilateral Trade Negotiations (MTN); and voluntary restraint in respect to some major Japanese export items, such as TV sets.

Some incidental factors have also contributed to the upsurge in Japan's import bills: substantial rises in the prices of primary products almost across the board—which in my view contributed to worldwide inflation—particularly of crude oil, tantamount to that of the previous oil shock. Furthermore, the movement of the exchange rate of the yen vis-à-vis major currencies, including the U.S. dollar, played a major role. The corrective effect stemming from the sharp rise in the value of the yen before November 1, 1978, when a package of U.S. measures to defend the dollar was announced, started to make itself felt after a time lag (phase 2 of the J-curve effect). This appeared, ironically enough, to coincide with the initial adverse effect of the ensuing depreciation of the yen, thus accelerating the already increasing imports while putting the brake on Japan's exports (phase 1 of the J-curve effect).

Another factor of Japan's balance-of-payments turnabout was the resurgence of price inflation. In Japan, this was mainly due to the higher import prices mentioned above, which in turn were accelerated by the exchange depreciation. Hence the present inflation in Japan can be described as predominantly "imported inflation," although a part of the general price increase, mainly in the upstream sectors of industry, resulted from brisk domestic demand generated by the enhanced economic activities. These factors will give a clue to the conspicuous contrast between the Wholesale Price Index and the Consumer Price Index. To give a few figures, the WPI in October 1979 is reported to be 14.5 percent above the corresponding level for 1978, while the latest similar figure for the CPI remains as low as 4.3 percent. It is true that the performance of wholesale prices is bound to be transmitted to that of consumer prices with a certain time lag. It is, however, generally anticipated by economic analysts in Japan that a substantial part of the pressure deriving from the higher price of basic manufactures will be absorbed by the finished-goods manufacturing industries without being passed on to the final selling price. This has mainly been made possible by the relatively efficient use of productive capacities, as well as by remarkable improvements in labor productivity in these downstream sectors.

Japan's economy is still immune to cost-push inflation, the typical feature of so-called homemade inflation. For this reason, I am not seriously concerned about the present inflation in Japan. Whether the traditional favorable relationship between productivity and wage hikes will be maintained in the future constitutes a crucial question for Japan's economy. Finally, the rate of growth in the fiscal year 1979/80 will turn out to be more than 6 percent net, substantially higher than the corresponding rate for the previous year.

It will be relevant in this context to make two comments. First, what matters is not so much the difference in the percentage rate of growth as the driving forces sustaining economic growth: while a stimulative fiscal policy, coupled with the external surplus, was responsible for economic recovery in 1978, the accelerated rate of growth for the fiscal year 1979/80 is almost exclusively due to enhanced personal spending and private capital investment, both of which are more autonomous in nature than those which played a major role in the preceding year. Second, the resurgence of the oil crisis was doubly bound to affect oil-consuming countries adversely: the initial inflationary impact generated by the higher oil price will be relayed to the ensuing deflationary bias to be brought about by the huge transfer of real purchasing power from oil-consuming to oil-producing countries. In Japan, the degree of deflationary gap thus produced is estimated to be as high as more than 1 percent of her total GNP. (The figure for West Germany is reported to be in the region of 0.7 percent.) We have, therefore, to anticipate a slowdown of Japan's economy in 1980. Tentative forecasts made by a number of institutions in Japan regarding the magnitude of this deflationary impact vary widely, ranging from zero growth, predicted by the most pessimistic school of thought, to an optimistic 5 percent growth rate.

Many economists in Japan refer to the following factors as major causes for the yen's recent weakness: the growing deficit in Japan's balance of payments mentioned earlier, the huge interest-rate differential existing between the United States and Japan, and Japan's extreme vulnerability to the oil situation. Nevertheless, another factor, in my view, is more decisive than those mentioned. Let me start with a comparison of the economic performance of West Germany and Japan. West Germany has also registered a deficit in her monthly current balance of payments since June 1979, which is reportedly likely to continue well into 1980. The German rate of inflation does not differ too much from the Japanese. West Germany is less vulnerable to the oil situation than Japan, but is by no means immune. A more or less similar interest-rate differential does exist between the United States and Germany. The exchange performance of the DM, however, is entirely in contrast to that of the yen. The present rate of the DM to the U.S. dollar is maintained as a result of intensive intervention by the Federal Reserve Bank in support of the dollar.

I have high regard for the so-called confidence theory, advanced mainly by European bankers in connection with the currency problem. The German mark has continuously enjoyed the status of the strongest currency in the world for two decades, whereas the Japanese yen emerged as one of the strong currencies only in the wake of President Nixon's announcement in August 1971, which included the virtual devaluation of the U.S. dollar. In addition, Japan had a bitter experience of hyperinflation in 1974 as an aftermath of the previous oil crisis, which was

not shared by Germany. On top of this, Japanese tend to look at things pessimistically. Such pessimism is likely to have its echo outside Japan. Japan's vulnerability to the oil crisis is also likely to lead to excessive uneasiness inside and outside Japan. These are the major reasons for the lack of confidence in the yen, which by no means corresponds to the relatively healthy performance of the economy.

The Japanese authorities have been keen on trying to forestall an excessive weakening of the yen, with little success. In the first place, major policy measures taken by the Central Bank comprise heavy intervention in the market, totaling more than $10 billion dollars since the beginning of 1979. In the second place, new measures to curtail capital outflow from Japan have been implemented. The present rate of around 245 yen to the U.S. dollar does not reflect the fundamentals of Japan's economy by any standard of measure. This undervaluation of the yen is not only generally accepted in Japan but seems to be getting increasing support in the United States as well. Comments we hear from time to time implying that Japanese economic management is tacitly intending to turn away from its domestic-demand orientation back to the previous export orientation are totally without foundation. On the contrary, both Japanese government and business are worried about the present yen rate, at which the currency is undeniably undervalued. The reason is twofold: for one thing, it is no doubt accelerating the imported inflation. For another, Japan is afraid of the growing danger of escalating protectionism as a result of her regained competitive edge over the United States and the European Community countries in the wide spectrum of manufactured goods.

In view of the described changed domestic economic situation, the Japanese authorities took the necessary policy measures, characterized, in the first place, by a succession of hikes in the discount rate, up to the present level of 6.25 percent per annum, coupled with stricter "window guidance" with a view to restricting lending by commercial banks. Furthermore, the government has been endeavoring to postpone already budgeted outlays for public works. One of the major objectives of fiscal policy in 1980 will, no doubt, focus on how to restrain the growth rate of the total budget, while lessening its heavy dependence upon borrowing by means of government bonds.

How about the yen rate in the future? A turnaround in the exchange market may be expected sometime in the near future. It could be triggered by a number of factors: (1) a growing perception in Japan and abroad that the yen rate has depreciated in excess of the degree justified from the balance-of-payments-adjustment point of view; (2) improvement in the world oil situation, which will inevitably diminish uncertainties about the future, with Japan the largest probable beneficiary; and (3) prospective improvement of Japan's balance of trade. There are several indicators pointing to the narrowing of the trade deficit in the months ahead, which

include regained price competitiveness, the expected slowdown of Japan's economy, and improvement in Japan's terms of trade, mainly due to sluggishness in the world commodity markets resulting from the anticipated worldwide recession in 1980.

Finally a comment on possibilities of U.S.–Japanese financial cooperation. Major geographical regions in this context will be both the ASEAN countries and the People's Republic of China. Of particular importance will be the question of financial cooperation with regard to the latter. Japan has no intention of establishing a monopoly in her economic presence in China. Three declared principles governing Japan's financial assistance to China are: (1) close collaboration with the United States and European countries; (2) due consideration to be given to Japan's existing close ties with friends in the ASEAN region; (3) no military assistance to be given to the People's Republic of China.

With respect to principles (1) and (2), I see many opportunities presented for mutual cooperation both on a private basis and in cooperation with international lending institutions such as the World Bank or the Asian Development Bank. The Western Pacific is the area generally recognized as the most dynamic part of the world when we look ahead to the remaining two decades of the century. As the leading industrial countries which already have strong involvement with this region, the United States and Japan will have to cooperate more closely and successfully than ever. Such cooperation will be in the interests not only of the recipient countries but of the donor countries as well.