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THE JAPANESE ECONOMY: FUTURE IMPACT

by
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ABSTRACT

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The Japanese economy has made an amazing recovery from its post-war ruin to become one of the most prosperous and dynamic in the world. In order to develop their economic base after the war, the Japanese made significant sacrifices through hard work and reinvesting the return on their efforts. These sacrifices, along with astute industrial and trade policies, helped create the Japanese economic "miracle" that has been the envy of the world. I will examine Japan's current role and policies concerning the world economy; next, I will consider domestic factors that have raised questions about Japan's economic prospects; finally, I will consider international challenges to Japan's economy. The conclusions are that Japan's period of explosive growth has ended, but that it will continue as one of the leading economic powers. Since the continued economic prosperity of Japan and the US are interdependent, both sides should be more cooperative. Finally, due to geopolitical imperatives, America should discourage Japan from significantly improving its military capability.

INTRODUCTION

In many ways, the Japanese economy is the most prosperous and dynamic in the world, and the end of the Cold War has reduced the current importance of military power -- further increasing the importance of Japan's economic power. With its economic success, Japan has faced increasing friction in its economic dealings with the U.S. and other trading partners. These partners complain of loss of jobs and industrial base due to Japan's export success and market penetration, as well as the difficulty they have in penetrating Japan's own market. These issues are aggravated by charges that much of Japan's success has been due to unfair practices.

Some people in the U.S. and other countries fear this increased Japanese economic strength, and believe strong measures should be taken to "redress" the situation at Japan's expense. There are others, especially in Asia, who fear that Japan's economic strength will translate into eventual military strength that could be threatening to their countries.[1] An example of this concern with Japan can be found in a recent study contending that Japanese economic and resource needs will eventually result in war with an economically and militarily weakened U.S.[2]

The status of Japan's economy is obviously an issue of significant geopolitical import. Despite the above concerns about Japan's success, however, there is another part to Japan's economic story. The collapse of the Japanese stock market in 1990, the stock market scandal that caused several prime ministers to fall, and other domestic and international economic problems indicate that the Japanese economy faces significant challenges. By examining Japan's economy and its relations with international trading partners, this paper will assess the future of Japan's economy to discern its likely impact on the U.S. and global economies and the world order in the years ahead.

A Period of Transition

Fifty years ago, Japan was one of the major military and economic powers in the world. It was locked in mortal combat with the U.S. and its allies, largely because of economic reasons. Forty-five years ago, Japan was a vanquished nation under U.S. military occupation. Its economic base had been turned to rubble, its Greater East Asian Co-Prosperity Sphere had been dismantled, and its Imperial Fleet had been put on the bottom of the Pacific. Thirty years ago, "Made in Japan" meant cheap and shoddy, and Japan's military was little more than a constabulary. But under the protective military umbrella of the U.S., Japan's people worked hard and long, they saved more money than any other people, and their government and industry channeled their savings and efforts in productive directions. Today, Japan is one of the two outstanding economic powers in the world, however, its economic success has also created significant friction with its U.S and European trading partners. Also of note, Japan spends more on its military than any Western industrial power -- except for the US.[3]

The success of Japan's post-war climb to the top of the economic ladder is magnified by the recent change in the world order. The Cold War victory of the U.S. and its allies over the Soviet Bloc has transformed the international arena in a fundamental way. Although the strategic weapons of the former Soviet Union still exist as a potential threat, the ideology that gave those weapons purpose has been discredited, and the new Commonwealth of Independent States government has turned its focus inward. In victory, the military power and treaties of the U.S. and its allies now appear much less relevant.

The world is now in a transitional period and former relationships are adjusting. Regional disputes will no longer be seen as part of a worldwide ideological struggle between the U.S.-led West and the Soviet-led East. As a result, the U.S. is less likely to become politically, economically, or militarily involved in many situations where it would have in the past -- just to deny the Soviets a marginal advantage. This U.S. tendency to withdraw will be magnified by serious economic problems in the U.S., which put downward pressure on defense spending. There will be a concomitant Japanese tendency to reduce its political, military and economic deference to the U.S. The end result will be less U.S. influence on Japan.

These emerging trends indicate that military alliances and power will be much less important and that economic factors will be relatively more important. As Prestowitz noted, "As a hegemonic power, the United States has got used to trading economic concessions for geopolitical advantage."[4] Without the global Soviet military threat, and with the current U.S. economic problems, the U.S. has little reason to continue such concessions. In addition, Japan and other countries have less reason to make concessions to the U.S. in return for military guarantees.

Economic Superpower

In the absence of a realistic military threat, the economic arena is emerging as the most critical category of national interests and as a more relevant measure of national power. This situation increases the importance of Japan's economic performance. The

GNP of Japan has grown to twice that of former West Germany, almost four times that of the United Kingdom, and could pass the U.S. in the first decade of the 21st Century.[5] The current U.S. lead in GNP of $5.3 trillion to Japan's $3 trillion is mostly accounted for by the larger U.S. population (more than double Japan's).[6] Further, per capita income in Japan has already passed that of the U.S. and the other major Western industrial powers.[7] In addition, Japan has had the world's most favorable trade balance for years (its trade surplus was more than $93 billion for the most recent twelve months).[8] The cash surplus generated by this perennial trade surplus with the world has helped make Japan the world's biggest creditor, while its trade surplus with the U.S. has made America the world's biggest debtor.[9]

Politico-Military Junior Partner

Despite these advances in the increasingly important economic arena, Japan remains as a relatively minor player in international political and military affairs. Since the end of World War II, Japan has generally been content to follow the U.S. lead in the international arena, in return for U.S. military protection and for favorable economic treatment and access.

Even with Japan's current worldwide economic power and interests, it continues to see the world from a narrow national view. As Rafferty noted, "... Japan's politicians are probably the most insular of any anywhere in the world with the possible exception of certain backwoodsmen in the U.S. House of Representatives."[10] The halting way the Japanese dealt with the recent Persian Gulf War demonstrated their rudimentary skills and vision in the international politico-military arena. It also reveals the depth of popular Japanese feelings against military involvement in foreign activity.

Japan's Future

As indicated in this section, at present, the U.S. stands alone as the world's only politico-military and economic superpower. Based on economic trends and projections a generation ago, there were predictions that the Soviet Union would join the U.S. in this unique club. But the economic trends did not hold, as is often the case, and the Soviet Union no longer even exists.

In a similar light, there are questions concerning Japan's future. Behind the often sensational headlines, what are Japan's real economic trends? Will Japan's economic growth be at very high rates, or will problems slow down its economy? What will be Japan's economic impact on the U.S. and world economies? Will Japan become a politico-military superpower? What should Japan and the U.S. do to optimize the situation? We will try to answer these questions in the following sections.

JAPAN'S ROLE IN THE WORLD ECONOMY

With the collapse of the Soviet economy, Japan became the world's second largest economy -- right behind the U.S. Japan has few natural resources, so a prerequisite for its success has been its decades-long ability to import raw materials and to export relatively more expensive manufactured goods. The U.S. defense umbrella provided the reliable sea lanes for access to those raw materials and markets, and allowed Japan to spend less money and effort on defense and more on economic development. A number of domestic factors were also key to Japan's success. These fa~tors include: a well educated and industrious work force, a high savings rate, high capital investment rate, and a very cooperative attitude among government, management and labor. Japan's growth rates averaged 10 percent in the 1960's and 5 percent in the 1970's and 1980's.[11]

Importance of Trade

Let's consider Japan's exports and imports, which are important to understanding its situation in the world economy. In 1990, Japan's exports rose to about $286 billion; main exports were machinery (38 percent), motor vehicles (17 percent), and consumer electronics (10 percent). The major 1990 destinations of Japan's exports were the U.S. (31 percent), Southeast Asia (29 percent), Western Europe (21 percent), and the Middle-East (3 percent). By comparison, Japan's 1990 imports were valued about $50 billion less, and equaled $234.7 billion. These imports largely came from the U.S. (23 percent), Southeast Asia (23 percent), Western Europe (18 percent), and the Middle-East (13 percent).[12]

Considering Japan's success as an exporter, it has an unusual import profile among industrialized countries -- a profile that has added ammunition to critics' charges that Japan's import practices are restrictive. Japan's proportion of manufactured imports is significantly lower than the other industrialized countries, amounting to only 49 percent of its total 1987 imports. As a comparison, the 1987 proportion of manufactured imports amounted to 78 percent in the U.S. and 71 percent in West Germany.[13]

Complaints by other members of the world economy about Japan's low percentage of manufactured imports are not all of the problem. Japan's restrictions on agricultural imports are also a major point of contention. Only about 15 percent of the country's land is available for agriculture and livestock, yet Japan provided 71 percent of its own food in 1987. This result is largely due to artificially high food prices and stiff protection against imports, which encourage the use of very marginal agricultural land.[14]

The foundation of Japan's economic success has been its industrial base. Industrial production accounted for 30 percent of Japan's 1990 GDP (including mining and manufacturing) and about 97 percent of its exports.[15] Manufacturing also accounts for 25 percent of its employment, and has become identified with innovative quality control and technologies. In fact, Japan leads the world in automated industrial applications.[16]

Economic Growth

Exports of manufactured products were the main factor behind Japan's economic growth until the late 1980's. By 1987, foreign pressure concerning its large current account surpluses led to some softening in exports and a new emphasis on domestic markets. Japan's change in emphasis was also encouraged by the negative influence of the stronger yen on exports. Domestic demand is expected to be the engine that drives Japan's future economic expansion.[17]

The large current account surpluses over the years also provided much of the money that made Japan a financial leader in the world economy. The size of this accumulated capital helped to drive the increases in the prices of Japanese stocks and land, which became major areas of investment by Japanese banks and corporations. By the late 1980's, Tokyo overtook New York as the world's largest stock market (in terms of capitalization).[18]

As the surpluses became too large to easily invest domestically, the Japanese became big players in foreign investments -- in stock and bond portfolios, as well as in direct purchases of properties and businesses. In many instances, the degree of Japanese penetration of foreign financial, property, and industrial arenas also created friction with the countries involved. The devaluation of the dollar by the Reagan administration made the yen buy a lot more in the U.S., and further encouraged Japanese investments in America.[19]

All of this economic success led the Intelligence Unit of The Economist to note that Japan (as well as Germany) will be a quasi-independent center of economic growth. This makes the world less dependent on the U.S. economy and makes it less vulnerable to a U.S. recession. It also greatly increases Japan's importance to the U.S. and global economies. Despite Japan's importance as an export powerhouse, the expansion of its domestic demand in the last few years has taken over the leading role in its own economy.[20]

This relative insulation of Japan's economy from the U.S. economy was demonstrated in the 1990 recession. According to the U.N.'s World Economic Survey 1991, "Among the Group of Seven, Canada, France, the United Kingdom and the United States ended with output declining, while Germany and Japan continued to grow, albeit at much reduced rates."[21] The continued growth in Japan was related to the restructuring of its capital stock. Fixed capital formation has been the main source of

Japan's growth, and it has the highest investment ratio of the major industrial countries. Restructuring of the capital stock has been brought about by these developments:

> First, the tightening Japanese labour market is inducing firms to seek more labour-saving techniques. Second, the pace of technological innovation is so rapid in Japan that new investment is being driven more by competitive forces than by physical obsolescence. Finally, Japanese firms are pursuing Joho-ka, a "computer communication network" revolution, which aims at comprehensive computerized information and control systems ...[22]

With the broad overview of Japan's powerful economic role in this section, we will now consider three key elements of its economy that impact the U.S. and world economies -- Japan's monetary, fiscal, and trade policies.

JAPAN'S RECENT MONETARY, FISCAL, AND TRADE POLICIES

Within the last five or six years, Japan has preferred to use monetary policy to guide the economy, while holding fiscal policy fairly steady.[23] I think it is safe to say that both Japan's monetary and fiscal policies are very conservative, perhaps excessively so given the size and resiliency of its economy. As noted above, trade remains as the foundation of Japan's economy, because it must import raw materials to feed its industrial production. Also, Japan must export part of that production to pay for the raw materials. But to continue as a successful trader, Japan needs a strong domestic economic base supported by intelligent monetary, fiscal, and trade policies.

Monetary Policy

First, let's examine Japan's recent monetary policy. In general, increased monetary growth will help depreciate a c untry's exchange rate, and through its impact on interest rates, increased monetary growth should help increase domestic investment.[24] Therefore, in the face of the 1986-1987 recession, the Bank of Japan (BOJ) cut the discount rate from 4.0 percent to 2.5 percent. As a result, interest rates fell and domestic demand increased strongly -- pulling the economy out of the recession.[25] The BOJ responded in a similar way to the stock market crash in October 1987, by pouring liquidity into the economy, and the broad money indicator increased by 23 percent over the next two months.[26]

In 1989, the BOJ's concerns were focused on inflation caused by asset-price increases and expanded borrowing. In particular, the BOJ was troubled by the speculative increases in the stock market and in land prices. To confront these problems, the BOJ turned restrictive and raised its discount rate from 2.5 percent in May to 6 percent by the end of 1990.[27] The BOJ was explicitly trying to ease the stock and property markets down before the speculative bubble burst.

By the end of 1990, the BOJ's policy had a significant impact -- the Nikkei stock market index had fallen 39 percent from its 1989 high, and a break had been put on the rising property values as well.[28] While this action ended the speculative spiral and eased inflationary pressure, it also did a lot of financial damage by wiping out large amounts of "paper" stock profits on bank and corporate books. Many bankruptcies followed, and they continue to the present.

In 1991, there was fear that another crash in the stock market would undermine public confidence in the financial system and in the overall economy. After the 24 June resignations of several brokerage firm presidents over a scandal, the Nekkei-225 stock average fell more than four percent in in just a few days (approaching the 23,000 level, where extensive damage can result due to multiple linkages). The BOJ apparently decided to help the brokers and bankers by reducing interest rates. So the BOJ announced a half-point cut in the official discount rate to 5.5 percent on 1 July. In addition to helping the brokerages and banks and staving off another market crash, the reduction was advertised as an attempt to combat the general economic weakness.[29]

Corporations and banks in Japan have very large amounts of outstanding convertible and warrant bonds. These bonds will become severe liabilities unless the stock market returns to higher levels, where investors have a reason to convert them into equity. So despite the BOJ's two year program of raising interest rates to purge asset-inflation and excess liquidity (especially in the stock and property markets), it relented to Ministry of Finance and corporate pressure for more narrow and immediate reasons and made the above interest rate cut. The Nikkei average rose by 817.8 points by 1 July, although by the Third it had dropped back to slightly over 23,000.[30]

Despite this interest-rate cut, the economic slump continued. Bank balance sheets had still not recovered from the stock market and land price falls, and they were facing problems with official capital-asset ratios. Corporate bankruptcies were also continuing at a fast rate. In an attempt to help liquidity and restore confidence, the BOJ lowered interest rates again on 14 November.[31]

More recently, an announcement to further reduce interest rates was made on 30 December 1991, to combat Japan's continuing economic slide. It was also announced that restrictions on bank real-estate lending would be lifted. The lifting of the lending curbs comes too late to to ward off what looks like a sharp slide in property values in Japan. The National Land Agency announced on 20 December 1991 that land prices in the Tokyo area had fallen by 7-9 percent between July and December.[32]

As I have shown, the BOJ has employed deliberate monetary policies a number of times over the last five or six years. First, it increased liquidity to help combat a recession; next, it cut the money supply to reduce inflation; and most recently, it eased rates again to reduce the damage caused by its own anti-inflation policy. (Author's note: a "fine tuning" problem we often see with our own Federal Reserve).

Fiscal Policy

Despite this emphasis on monetary policy, Japan did not ignore fiscal policy. The central and local governments in Japan have traditionally run deficits. At the same time, the social security trust-fund has built up a substantial surplus (in anticipation of the graying of Japan early in the next Century). In a change during the late 1980's, a consolidated effort was made to reduce this public borrowing. Local deficits were largely eliminated and the central government began to follow a medium-term goal of eliminating the issuance of deficit financing bonds by 1990.[33]

Much of this policy of fiscal consolidation was pursued by severely limiting government spending. Annual real growth rates for government spending grew at an annual rate of less than one percent per year during the period of 1980-1985. Almost amazingly (from the perspective of an American), the central government's deficit fell from 5.5 percent of GNP in 1978 to 1.5 percent in 1986. Public sector borrowing fell from 7 percent of GNP in 1978 to 3 percent in 1986.[34]

Despite this deficit reduction program, Japan's central government announced an emergency economic package to increase domestic demand by 6 trillion yen. This program was in response to "endaka" (the post-dollar devaluation high yen), which increased the world price of Japan's products, and reduced its ability to compete in export markets. The resulting economic package was designed to be spread over several years, using a combination of tax cuts, new public works programs, and speeding up progress on previously approved projects. By June 1987, the cabinet had approved a 2.08 trillion yen supplementary budget to begin implementing the package.[35]

It can be seen that Japan was continuing its policy of trying to transform its economy into one led by domestic demand, rather than by export growth. This policy reduces the danger of political reprisals by the U.S. and other trading partners due to Japan's perceived unfair practices, and it insulates the Japanese economy from problems in those other markets. Further, as we will discuss in the domestic section below, Japan is worried about the aging of its population and the condition of its economic and social infrastructure. Both concerns require significant additional government investment, which could lead to deficits.

Concerning Japan's goal of not issuing bonds to finance budget deficits, success was achieved in its fiscal 1990 budget. In keeping with this program, net public debt fell from 27 percent of GNP in 1984 to only 10 percent in 1990 (including central and local governments, and social insurance). The budget for fiscal 1991 continued this policy for its second year.[36]

The driving factor behind this policy of reducing public debt was stated by Japan's Economic Planning Agency:

> ... fiscal policy management must be aimed at reconciling fiscal consolidation and domestic demand expansion ... [and] an effort should be made for flexible and appropriate management in keeping with changing economic conditions.[37]

In December 1991, the Ministry of Finance (MOF) announced plans to increase taxes to maintain tight fiscal discipline, to avoid U.S.-style deficit spending. The draft budget included a $5.7 billion tax increase to ensure that the government will not have to borrow to cover current operating expenses. The extra taxes are necessary, according to the MOF, because Japan's continued economic slump is causing government revenue to fall short of expectations.[38] (Author's note: if the BOJ can be like the FED, then the MOF can be like Herbert Hoover.)

These tax increases will not be large compared to the almost $4 trillion economy, and will be at least partially offset by putting the money back into the economy by spending it on long-term projects. For instance, the budget for public works (bridges, roads, and airports) will be increased by 4.5 percent to $68.83 billion.[39]

The proposed tax increase reflects the strongly held belief in the MOF that Japan must not fall into a U.S.-style deficit spree -- even though Japan's economy has been sluggish for a couple of years. Also, this fiscal consolidation (this is the smallest rise in government spending in five years) leaves monetary policy by the BOJ to carry the burden in stimulating the economy.

Trade Policy

While the monetary and fiscal policies may seem arcane, Japan's trade policies are what steal the headlines and fuel demagoguery. Lee Iacoca renewed his charges that

Japanese trade policy is "unfair" when he returned from Japan in January. Also, Japanese trade practices (alleged "dumping" in the U.S. and restricting imports in Japan) are emerging as issues during this U.S. election year and U.S. protectionist sentiment seems to be on the rise. Because of their importance in this tense atmosphere, we will consider formal and informal Japanese trade barriers, Japan's current account surpluses, and recent Japanese developments in trade policy.

According to the U.N.'s Department of International Economic and Social Affairs, trade balances basically are due to macroeconomic factors:

> ... reflecting the greater part of the net transfer of financial resources ... they are also the sum of exports and imports of hundreds of individual commodities. Trade balances are thus seen ... as evidence germane to the question of fairness of particular countries ...[40]

Concerning the issue of formal barriers to imports, Japan lowered its tariffs significantly in the 1960's and 1970's. Japan continued this trend in the 1980's, and in 1985 duties were eliminated on about 1800 tariff lines with tariffs below 5 percent.[41] Japan's formal tariffs are no longer a major problem. Japan's tariffs on raw materials are .7 percent; the EEC's are 3.6 percent; the U.S.'s are .3 percent. Japan's tariffs on manufactured goods are 11.9 percent; the EEC's are 10.2 percent; the U.S.'s are 4.2 percent. Japan's tariffs on food items are 9.7; Canada's are 6.2 percent; the U.S.'s are 4.1 percent.[42]

A large portion of Japan's agricultural imports are covered by official non-tariff measures, such as quotas and minimum price requirements, which push domestic prices well above world market prices. Between 1960 and 1980, agricultural prices in U.S. dollars rose eightfold in Japan, while tripling in Europe and merely doubling in the

U.S.[43] Japan's rate of protection above the world market price for 13 major agricultural products (wheat, rye, barley, oats, maize, rice, beef, pork, chicken, eggs, milk, sugarbeets, and potatoes) increased from 41.1 percent in 1960 to 83.5 percent in 1980. The rates for the same period in the EEC rose only from 32.8 to 35.7 percent, and they actually declined in the U.S. from 0.9 to -0.1 percent.[44]

In the case of manufactured goods, Japan's informal barriers are much more important than the formal barriers discussed at the beginning of the section. Informal barriers include such things as: administrative guidance, customs procedures, standards, testing, certification requirements, public procurement practices, the defense of depressed industries, the protection of high-technology industries, regulations on intellectual property, and distribution channels.[45]

It is often argued that these informal barriers, as well as cultural preferences for domestic products, are responsible for the uniquely low levels of penetration of Japan's domestic market by foreign producers. For example, the percentage of import penetration in manufacturing in 1985 was:

Canada	-- 38.7
Germany	-- 31.7
U.K.	-- 33.2
U.S.	-- 12.9
Japan	-- 5.3[46]

Others argue that Japan's import performance is not unusually low, given its lack of natural resources and its productivity in manufacturing.[47] Several studies, however, indicate that Japan's import levels and ratios are not explained or excused by its mix of natural resources and manufacturing productivity. For example, Balassa's empirical investigation of the relative openness of national economies shows Japan to be the only negative outlier. That is, Japan imports considerably less than would be expected, given the above national attributes. Balassa found Japan's disparities to range from 25 to 45 percent below what would be expected. In another study, Lawrence also found that unusual preferences and barriers reduced Japanese imports of manufactured goods by about 40 percent below what should be expected.[48]

In the face of growing criticism from its trading partners and for fear of trade reprisals, the Japanese government has worked to decrease its trade surplus in the last few years. This attempt was helped by the rise of the yen in 1987. The stronger yen made Japanese goods relatively more expensive, reducing their attractiveness in the U.S. and world markets, while making U.S. goods relatively cheaper, increasing their attractiveness in the Japanese and world markets.

After decreasing for four years, Japan's current account surpluses with the U.S. are on the rise again. The typical response to the reappearance of the surpluses is to charge that things have not changed, and that the Japanese are returning to their normal practices. So the popular view is that the surpluses are new proof of Japan's success and U.S. weakness. The Economist, however, points out a more likely explanation -- the surpluses are widening because Japan's economy is doing worse, not better.[49] For instance, Japan's imports rose by 83 percent between 1985 and 1990, but now they are down along with Japan's slowing economy and reduced domestic demand. Uncertainty in the financial markets and higher interest rates have helped reduce Japan's consumer demand, and in general the economic slump is continuing. Japan's exports are also gaining momentum and are being helped by a weaker yen (down 12 percent from its 1988 peak).[50]

The surpluses were growing so fast in 1991, that Japan's Ministry of International Trade and Industry (MITI) asked more than a dozen trade and business organizations to support a government designed program to boost imports. These organizations and businesses have been asked to develop programs for buying more equipment and inputs from foreign suppliers. They were also asked to buy more parts for their offshore production plants from sources in the host countries. Compliance is voluntary.[51] But this issue of host-country sourcing for Japanese plants is a major point of conflict.

This resurgence in Japan's trade and current account surpluses can not be allowed to continue forever, it could kill the U.S. "goose laying the golden egg." Japan, the U.S., and other trading partners are all working to reduce the surpluses to more reasonable levels, and they will probably succeed -- because it is in the interest of all parties to do so. If the U.S. suffers really serious reverses, Japan loses its biggest external market, and if Japan does not grow, the U.S. looses its second biggest market (after Canada). This economic interdependence has helped both the U.S. and Japan. And keeping Japanese products out can hurt us more than it helps. According to the Center for the Study of American Business, steel-import restrictions have saved an estimated 17,000 jobs in the steel industry since 1984. On the other hand, industries using steel have lost 54,200 jobs because of the higher cost of steel due to the restrictions![52]

One final note on the trade balance. The National Academy of Sciences (NAS) recently announced that in terms of international competitiveness, the U.S. is doing better than official figures indicate. According to the NAS, the government uses old fashioned accounting procedures to track sophisticated activities such as intra-company sales (exports to one's own affiliates), which under represents our successes -- while diligently tracking tariff producing imports. As a result of NAS recalculations for 1987 exports and imports, the U.S. trade deficit was only $64 billion -- or 57 percent less than the official figure of $148 billion.[53]

As demonstrated in this section on monetary, fiscal, and trade policy, Japan has had a fairly rough economic time over the last five or six years -- which goes against the conventional wisdom. Its stock market has had two major drops; fear of inflation has been a problem; the speculative land-price bubble has caused severe problems for the banks and speculators; its fiscal conservatism is being bumped by looming major expenses for Japan's aging population and infrastructure; and its trade partners are leaning toward protectionism in response to Japan's predatory trade practices. Worse, Japan's monetary, fiscal, and trade policies have not been very successful in addressing these problems.

DOMESTIC CHALLENGES

Despite Japan's exceptional economic performance since World War II, and despite the common perception that Japan has the "perfect" economy, Japan does face a number of growing economic challenges. As we noted in the first section, economic trends do not extrapolate forever -- for instance, Mexico has reversed its downward trend to become an economic success story in Latin America, and the post-war trends of U.S. economic hegemony were impossible to maintain as the war-torn European and Japanese economies recovered.

The monetary and fiscal moves by Japan that were noted in the section above, were not academic exercises, they were to correct significant problems that had emerged in the Japanese economy: stock market crashes, inflation, land and stock speculation, loss of confidence due to scandal and corruption, bankruptcies, and recessions. In this section, we will consider a number of domestic challenges to Japan's continued economic success, including its recent slow growth, the adverse effects of a maturing economy, its weak financial foundation, and a number of demographic and cultural changes that may have long-term negative impact.

Recent Slowdown

Japan was an unusual economic case in 1991. Its "real" economy continued to grow, while its financial "paper" economy remained weak -- as it has since the 1990 stock market crash. Last August marked Japan's 57th consecutive month of growth, as consumption and investment seemed to ignore the problems in the financial sector.[54] Although recent growth in the real economic sector has continued, it has done so at a slower rate, and the real economy may merely be lagging behind the downward financial trend -- not defying it.

Despite Japan's attempts to keep its boom going (noted in the section on monetary and fiscal policy), the Economic Planning Agency announced that Japan's price-adjusted GNP grew at an annual rate of only 1.6 percent during the July-September 1991 period. Therefore, the real economy seemed to be in the early stage of a slowdown. Housing starts had declined for the fourth quarter; business investment grew only slightly; only exports continued to be fairly strong.[55]

The Problem Of A Maturing Economy

Many of the economic problems we have considered may be part of a normal economic cycle, and may have been "helped" by BOJ and MOF policy decisions that were less than optimum. At least some of the trouble, however, appears to be because of deeper systemic problems. In particular, Japan may have a maturing economy -- which means it will no longer have its spectacular and relatively easy high rates of growth.

From the 1940's to the 1960's, Japan was building its economy from scratch and all gains were statistically significant, and relatively "easy." Initial rapid gains in productivity could be made by simply importing current technology, which was vastly superior to what was left in the rubble of war.[56] As the gap in infrastructure and industrial base closed between Japan and the mature economies of the U.S. and Europe, incremental gains relative to these economies became more difficult, and absolute rates of growth alsc became more difficult.

Japan's average annual real (inflation adjusted) growth rate in the 1960's was 12.1 percent, it averaged only 7.5 percent between 1970 and 1973, and from 1974 to 1985 it averaged 3.8 percent.[57] And from 1986 to 1989 it averaged 4.3 percent.[58] As Lincoln noted, in the 1960's Japan's economy grew three times as fast as the U.S., but it grew only one-and-a-half times as fast from 1974 to 1985 -- as it became a more mature economy.[59] This phenomena is similar to the proverbial contractor's "80 percent solution," where diminishing returns apply to each incremental gain above a certain point.

By 1973, Japan had the second largest economy in the Free World, and its per capita GNP was 14th among the members of the Organization for Economic Cooperation and Development (OECD). Its quick movement up the list then slowed, reaching eighth place by 1985. As a legacy of the 1985 depreciation of the dollar, Japan's per capita income has passed the level of the U.S.[60] As a reflection of standard of living, however, the Japanese consumer still has only 60 percent of the purchasing power of those in the U.S.[61] So a significant real gap between the two countries is still present.

The closing of the technology gap between Japan and the U.S. was critical to slower growth of productivity and of capital formation in Japan. Rapid increases in productivity based on imported technology were no longer reasonable, so investment in this area decreased.[62] Costs of new technology were becoming higher because Japan had to spend more of its own money on research and development. Since new technology was not bought off-the-shelf from more advanced economies, time-lags began to effect Japan as they had the U.S. and Europe.

By the mid-80's, Japan was the world leader in iron, steel, random access chips, and automobiles. But, the profit incentive from investments incorporating new technologies was relatively smaller than when Japan was catching up. Because of the smaller profit incentive, corporate investment grew slower, which helps explain the reduced productivity growth Japan has demonstrated compared to its developmental period. For example, fixed nonresidential capital investment grew at a 16 percent real annual rate from 1956 to 1973, but it grew at only a 3.9 percent rate from 1974 to 1985. Part of the investment difference can be explained by the 1973 oil crisis, but when the economy returned after 1985, investment grew to only 7.3 percent -- still far lower than during the pre-crisis period.[63]

While Japan continues to lead the other industrial countries in economic growth, it is growing at significantly slower rates than it did before its economy became more mature (in the sense of technology, capital plant, and infrastructure). In addition to this reduction in Japan's growth-rate potential because of its increased economic maturity, there are other changes in Japan that also adversely effect Japan's prospects for economic performance.

Problems With The Financial Foundation

The earlier consideration of monetary and fiscal policy covered information concerning Japan's recent financial policies and the events that provoked them. Also, many books and popular accounts have covered the arcane workings of Japan's interlocking business and financial operations called "keiretsu". In this section, the focus will be on several other components of Japan's financial foundation, and the problems they cause.

The basic element of Japan's financial system seems to be its very high rate of national savings. Japan saves almost 20 percent of its GNP, while Germany and France save less than 10 percent, and the U.S. saves less than five percent.[64] Every day, individual Japanese families and corporations put over one billion dollars into savings![65] These high savings rates provided much of the capital necessary for Japan's reindustrialization after World War II, and they helped fuel the high rates of growth that Japan continued to realize until recently.

Not only has Japan been able to save more money than most countries for investment, but it has been able to do it at a low cost. The interest rate paid to Japanese savers has been quite low by international standards, so Japanese banks have been able to make their profits and still charge low rates of interest to their corporate borrowers.[66]

This low savings return, born by the Japanese public in the form of lower financial rewards, is fairly typical of Japan's systemic restrictions on the public. One way of keeping interest paid to savers low was to artificially limit opportunities for higher rates. For instance, the minimum size for money market certificates was $20,000 until April 1990, when it was reduced to $6,667 -- allowing savers a better opportunity to consolidate their low-paying passbook accounts for a higher return.[67]

Maintaining this cheap capital has been done through strict control by the government in other ways as well. If individual savers and corporations could have moved their savings to overseas markets for a better return, much of this cheap capital would not have been available for domestic capital investment. Therefore, interaction with international financial markets had been strictly limited until recently, when the Japanese domestic market could no longer absorb the large amounts of savings their system was generating. For instance, until the late 1980's, Japanese insurance companies could not invest substantial assets overseas. After a series of moves to relax the regulations, these companies still must keep 70 percent of their assets in Japan.[68]

These restrictions mean that Japanese businesses have had more money for investment at lower costs than their international competition, with all of the obvious advantages that fact brings. Meanwhile, the restrictions forced sacrifices on the Japanese public due to low rates of return on savings and limited options for saving.

In addition to the large pool of cheap capital from savings, the financial and banking industries are heavily dependent on the stock market and the price of land. Property is the favorite loan collateral in Japan, and almost 40 percent of all bank loans are formally backed by land and mortgages.[69] As Japan's inflated property market falls, due to the slower economy and the fiscal policies I discussed earlier, banks are left with loans backed by collateral worth much less than when the loans were made.

The number of corporate bankruptcies has risen as the economy has lost steam. These bankruptcies leave many banks in trouble because the lower value of property no longer covers the debts they secure. According to estimates, interest is not being paid on almost $25 billion of bank and trust loans (a figure The Economist considers an understatement). If the banks lose too much money due to the increased bankruptcies, secured by land with depressed value, the already weakened stock market will suffer additional shocks. Falling bank stocks, which account for 24 percent of the Topix index (Japan's equivalent of the Standard and Poor's 500), would pull the stock market even lower.[70] Since the banks hold large amounts of stock and have other loans secured by stock, this fall could turn into a downward spiral -- putting even more pressure on the weakened banking system. The BOJ tried to circumvent this danger by bringing the market and land loans down in 1990, as I discussed in the section on monetary policy, but the move still precipitated a severe economic problem.

The increasing corporate bankruptcies began to soar more than a year ago. At that time, they were largely related to failures of property speculators, caught between the BOJ's rising interest rates and the resulting reduction in sales. More recently, the corporate failures have represented a wider range of businesses. According to Teikou Data Bank Ltd., a private credit research agency, the bankruptcies were especially high in the real estate and financial investment sector, and were due "to higher interest rates, major stock market losses and Japan's ongoing labor shortage."[71] Also, although property related bankruptcies are now a smaller percentage of overall bankruptcies, they still rose by 260 percent during April-September 1991.[72]

All of these economic problems, the fall of the speculative stock and land markets, the resulting financial weakness of banks and corporations, and the following general economic slump, have put Japanese businesses in a cash-flow problem. During the 1986-to-1990 period, Japan's net long-term capital outflow averaged more than $100 billion per year. In 1991, however, Japan's net outward flow of long-term capital was

$36.6 billion less than investments in Japan by foreigners. This change resulted in the first net inflow of such capital to Japan in 11 years! These economic problems have forced some Japanese investors and corporations to sell foreign holdings, in order to cover losses and cash-flow problems in Japan.[73]

As a result of these cash shortages, a number of economists believe that Japanese corporations will have to act more like those in the U.S. and Europe. Japanese corporations may have to abandon unprofitable product lines and price products to get a better return. These are changes that will help reduce Japan's trade surpluses.[74] These changes will also reduce Japan's ability to operate at a loss in other countries, in an attempt to eliminate the competition and seize market share.

Social and Demographic Problems

In addition to these problems with its financial foundation, Japan's economy faces important social and cultural problems. As we noted at the beginning of this paper, an important ingredient to Japan's post-war success was based on cultural values: hard work, high savings and deferred consumption, and a government-business-labor arrangement that was very favorable to business interests. The basic social contract meant significant sacrifices in quality-of-life by an obedient population, in return for stable employment and the hope of long-term economic security. Japan has succeeded in becoming one of the economic superpowers -- but the people have yet to see their fair share of the return.

Quality-of-life and fairness are issues of increasing importance in Japan. We noted that although Japan's per capita income is higher than that of the U.S., the people have only about 60 percent of the purchasing power of Americans. Also, the average house in

Japan was 25.2 square meters per person less than in the U.S., yet the house costs 5.7 times the average owner's annual income (8.7 in Tokyo), compared to only 3.4 times in the U.S. and 4 times in Europe.[75] And less than half of the houses in Japan have flush toilets!![76] In addition, many Japanese consumer goods are cheaper in New York City than in Tokyo, leading to charges the Japanese businesses are either "dumping" products in the U.S. market, or gouging their domestic market -- or both.

Japan's prime minister, Kiichi Myazawa, pledged in Japan's version of a State of the Union address, "I plan to aim for a society in which each and every Japanese person in his daily life can genuinely feel prosperous."[77] This pledge resulted from U.S. pressure on Japan to improve its quality-of-life, which the U.S. hopes will improve Japanese demand for U.S. products (as well as diverting Japanese resources from investments that hurt U.S. competitiveness). Pressure was also generated by a Japanese population that increasingly wants to share in its country's wealth.[78]

In addition to the public's increasing desire to share in Japan's economic success, several demographic changes also are having a downward influence on the Japanese economy. Younger Japanese are coming into the work-force who have no memory of the very difficult post-war years. They generally have never suffered the way their parents did, and they have come to expect an increasingly comfortable life. Rather than saving, many are running up large debts on credit cards from excessive shopping and entertainment. Personal bankruptcies were estimated to be at 13,000 for the first eight months of 1991, up from 11,500 for all of 1990. Over half of these bankruptcies involved workers in their 20's and early 30's.[79] There is also pressure from young shorter work hours, and better pay and benefits.

In addition to these changes in "work ethic" in the younger worker: almost unique problem in the proportion of the population that will be (wave of the baby-boom generation will face retirement in just 15 years. of retirees will increase the problems of an existing labor shortage (see l will put strains on the social security system.[80] As the older workers reti disproportionate contribution to the economy will become a disproportic retirement, they will withdraw savings instead of making very large dep(reduction in savings will reduce the amount of capital available for busir retirements will remove the most experienced and dedicated workers fro

The world's longest life expectancy, and a shrinking birthrate are n point early in the next Century when only three workers will be working of these retirees, instead of the current six. Japan follows a trust-fund a| security (as does the U.S.). Japan's problem is that its population over 6 every 26 years, or almost three times as fast as in the U.S. This increase ir population will divert significant resources for their care, as a portion of G

To reduce these problems, Japan is looking at a number of options raising the retirement age, reducing benefits, and raising the premiums.[82] 1989, Japan imposed a three percent consumption tax to help pay the in(care for the elderly.[83] Japanese pensions average 40 percent of the aver: which is less than in the U.S., but the difference is made up by Japan's h rate (which is encouraged because of the relatively Spartan government social security program). According to Peter Morgan of Barclays, because of aging, the Japanese population will cut savings from three percent of GNP in 1987 to zero by the end of the Century, and it could be massively in deficit by 2010.[84] Regardless of the reforms to the system, the basic demographic change will be a drag on economic growth compared to the present population composition.

As if the aging population was not a big enough long-term problem for economic performance in Japan, there is already a labor shortage -- before the high rates of retirement take effect. By 1989, there was a shortage of at least 100 thousand in the construction industry alone.[85] According to the BOJ, the present tightening of the labor market has been more acute compared to economic growth than in the past. The shortages are most evident in the processing/assembly and non-manufacturing industries, although there is also an acute shortage of professionals and engineers.[86] Among other reasons, the labor shortage is due to the structural move of the Japanese economy into service industries, which has created more jobs than was the case when other fields dominated.[87]

The macroeconomic impact of the labor shortage is of great concern to the BOJ, because the combined decline in population growth and the increased number of older people could have a serious impact on Japan's economic future. The good news is that the labor shortage has forced Japan to automate faster than other economies. The bad news is that the labor shortage puts upward pressure on wages and encourages inflation, and the shortage itself constrains the development of the Japanese economy.[88]

As this section has demonstrated, Japan's systemic economic problems on the domestic front present challenges every bit as important as the monetary, fiscal, and trade policy problems previously discussed. The relatively slow growth-rate due to a maturing economy, as well as troubling demographic trends and growing social fairness issues will all serve as additional friction on Japan's economy.

INTERNATIONAL CHALLENGES

In addition to the domestic economic problems of a slowing mature economy, the weakness of its financial foundation, and cultural and demographic change, Japan faces serious political and economic challenges in the international arena. These challenges include finding a role in the post-Cold War world, retaining access to resources and markets, and defusing protectionist sentiment in Europe and the U.S.

Post-Cold War Framework

As we noted in the introductory section, the end of the Cold War is making a major change in the world's political, military, and economic relationships. In the old bi-polar world, many problems between the U.S. and its allies and friends were papered over in order to concentrate on the major threat -- the military threat posed by the Soviet Bloc. Today, the Soviet glue that held us together is gone, and nations are beginning to confront the new political, military, and economic realities from a more narrow national focus.

According to Mochizuki, Japan's main post-Cold War objective should be to keep the U.S. diplomatically and militarily involved in Asia, while keeping it committed to a liberal international economic order.[89] Such U.S. diplomatic and military involvement would help maintain regional security, and would make it unnecessary for a much higher Japanese diplomatic and military profile that would be counterproductive. It would also leave U.S. markets open to Japanese exports, markets which are very important for continued Japanese economic success.

If the U.S. significantly reduces its politico-military involvement in Asia, and if it reduces its free trade philosophy, the Japanese would probably reduce their commitment to reformist political and economic programs. The failure of these programs, which are being adopted partly due to U.S. pressure, would likely result in Japan's reversion to neo-mercantilist policies and business practices.[90] The end result of this reversion could be a cycle of U.S.-Japan trade restrictions and recriminations, which would damage both economies, and which could lead to more serious politico-military problems.

A major move by Japan to rearm (in the absence of the U.S. umbrella) would be undesirable for Japan for two reasons: first, Japan would have to divert resources from its slower growing economy to its military build-up -- rather than use the resources in the more productive economic or social arenas; second, significant rearming would renew the hostility toward Japan that is still strong almost fifty years after World War II -- hostility that might lead to opposing build-ups and trade restrictions.

Within the context of a continued U.S. engagement in Asia, Japan has several alternatives. Takashi Inoguchi, of the University of Tokyo, has enumerated four basic options for Japan: "Pax Americana II," in which the U.S. remains engaged in the world and retains its leading international position, and Japan continues to fulfill its role of economic support; "Bigemony," in which the economies of the U.S. and Japan become much more integrated and they jointly manage the world economy; "Pax Consortis," in which no single power predominates and shifting consortia settle issues and maintain the world system -- in which Japan would promote the interests of the Asian-Pacific region; and "Pax Nipponica," in which Japanese economic power emerges as supreme, and in which it plays a role of balancer to continental powers.[91] Inoguchi believes that the most likely outcome is a "soft landing," starting with Pax Americana II and evolving to a Pax Consortis.[92] Regardless of the specific outcome (and it may be "none-of-the-above") it is almost certain that U.S. influence will be reduced and Japan's economic as well as politico-military influence will increase -- especially in Asia and the Pacific.

Access to Resources and Markets

As the world order begins its post-Cold War transition, a key weakness in Japan's economy could become an important factor in its continued success or ultimate failure. That economic weakness is Japan's almost total dependence on imported raw materials. For example: over 80 percent of Japan's fuel needs are met by imports; it must import about 60 percent of its food; and it must import virtually all of its minerals -- it is self-sufficient only in sulfur and limestone.[93] A corollary to the need for access to raw materials is a need for access to foreign markets. While domestic consumption is the largest segment of the Japanese economy, exports amount to about 13 percent of GNP and keep the vital financial pump primed to pay for Japan's unusually high percentage of imported raw materials.[94]

Because it is a small island-nation lacking important natural and agricultural resources, Japan is economically more vulnerable to events beyond its control than other major nations. Japan is particularly concerned with the possibility of another oil crisis, like the one in the 70's.[95] Access for Japan is not merely a financial problem, it is also a politico-military problem that could derail Japan's economy.

Access is a political problem because countries could embargo raw materials bound for Japan and they could refuse to accept Japan's exports -- for political reasons. The U.S. oil embargo against Japan before Pearl Harbor is a case in point, concerning Japan's vulnerability to such political moves. Access to raw materials and markets is also an economic problem. Japan's economic gains and reputation for unfair trade practices are turning it into a pariah, and strong protectionist political sentiment is evident in the U.S. and Europe (see below). This sentiment could result in tariffs and other restrictions to resources and to markets that could seriously hurt Japan's economy.

Access also can be a military problem. In order to import raw materials and export manufactured products, Japan needs physical access to its suppliers and its markets over secure sea-lanes. The guarantee of physical access has been made by the U.S. during the post-World War II period. As the U.S. begins to reduce forces in the post-Cold War period, these guarantees are less reliable.[96] Further, as the major politico-military blocs wither, the world may be more unpredictable -- endangering the sea-lanes and Japan's economy. Finally, the U.S. might decide it is not in its interest to protect sea-lanes for an unfair competitor!

As Friedman noted:

> Japan places such an enormous pressure on the world's shipping system that any significant dislocation in that system for an extended period of time would pose serious dangers to Japan's economy ... The world's largest consumer is always at the mercy of anyone who can interfere with its consumption.[97]

Remilitarization

Due to these questions about a U.S. willingness and ability to maintain regional stability and sea-lanes in Asia, and due to Japan's military-economic vulnerabilities, questions concerning potential Japanese remilitarization are becoming more common. As noted above, Wilborn has reported on the perception by Chinese and South Korean security elites that Japan is their greatest danger.[98]

The questions should not concern whether or not Japan will rearm, they should concern to what degree and for what purpose? Japan has already rearmed to a large degree. Japan spends more money on defense than any member of NATO, except for the U.S.[99] Compared to military spending by other countries in the region in 1989, Japan spent $36 billion, South Korea spent $12 billion, China spent $11 billion, Australia and Taiwan spent $6 billion each, and North Korea spent only $4 billion.[100] This year, the Japanese Defense Agency asked for a 5.4 percent increase, while most nations are involved in "peace dividend" cutbacks in defense spending.[101]

The Japanese Self-defense Force is a modern force by any standard, and is quite capable compared to any forces other than those of the U.S. and the former Soviet forces of the CIS. As U.S. and CIS forces are reduced, the Japanese forces will become relatively more capable. And if the Japanese technological base continues to outstrip that of the U.S., the potential for a qualitative breakthrough increases.

As Burstein noted:

> The relevance of Japanese finance to military developments is threefold. In the first place, the increasing extent of investment abroad creates a compelling new reason for Tokyo to rethink its lack of forward military capability. Second, Japan's wealth ... provides it with the means to build one of the world's most technologically advanced arms industries in a comparatively short time. Third, as Japan becomes richer and America poorer, the antagonism is heightened ... exacerbating the very Japanese fear of American unwillingness to meaningfully defend Japan.[102]

The real unanswered questions concerning Japan's military spending are to what degree will Japan divert resources from more productive economic and social uses, will the diversions be large enough to be a significant drag on Japan's maturing economy, and will a continuing build-up draw negative regional political, economic, and military reactions?

Europe-In-92

While Japan's Asian neighbors fear its military potential, things are different in Europe. The members of the European Community (EC) fear Japan's economic power and its penetration of European markets. As a result, the momentum has increased behind an EC plan to have a single borderless internal market in place on 31 December 1992. This market will make the EC entity one of the world's three most powerful markets, along with the U.S. and Japan. The desire to strengthen Europe internally and to reduce Japan's access is bad news for the Japanese, since 21 percent of their exports go to Western Europe.[103] According to Andreas van Agt, the former EC ambassador to Japan, fear of "Japanese industrial-economic-financial hegemony" was a driving force behind the move.[104]

The Japanese continue to run a large trade surplus with the EC countries, much as they have with the U.S. As with the U.S., Japan's surpluses with the EC are on the rise again after shrinking somewhat.[105] French Prime Minister Edith Cresson has been particularly vocal in complaints about Japanese trade practices. She charged Japanese businesses of charging high prices at home to subsidize cheap exports, and she complained that Japan's own domestic market is "hermetically" sealed.[106] She and Lee Iacoca could be sharing the same speech writer.

Trade is not the only Japanese problem with the EC. Japan is investing heavily in EC countries in an attempt to become a producer inside the system before the trade-wall goes up in 1992. In fact, Japanese investment in Europe is larger than European investment in Japan by 17-to-1, and is causing concern in the EC similar to that in the U.S. over increasing Japanese influence in its internal market.[107] EC officials and businessmen are wary of the Japanese investments. They believe the Japanese plants will be little more than assembly plants set up to avoid the EC import restrictions, and that the plants will use imported Japanese components.[108]

As a result of these concerns, the EC has proposed a 16 percent limit on Japan's share of its car market by 1999. This share will be up from its present 10.5 percent share, but it is low compared to Japan's 30 percent share of the U.S. market. Also, another requirement will be to count cars made by Japanese factories in EC countries as imports subject to the above limit.[109] This last move has drawn an outcry from Japan, because much of its investment in the EC was obviously to circumvent the coming import limits by becoming "domestic" producers. A Toyota official noted,"We were told in the past that the EC preferred local production by Japanese firms, rather than direct imports. Now we just don't know. The EC is not being consistent."[110]

These Japanese trade problems with the EC, and any additional strong EC countermeasures will diminish Japan's economic prospects in Europe. If the EC is successful in counting Japanese car production in the EC as imports, and if this principle is applied to other products, then Japanese penetration of the EC market will be significantly restricted. Restrictions in the large EC market will not be complete, but they may further reduce the growth in Japan's maturing economy. The restrictions will have a negative impact on the EC as well; Japanese investments in the EC will be reduced -- hurting job creation, and EC taxpayers and consumers will pay more for lower quality products from protected and subsidized EC companies.

The U.S.

As most of us know, the situation with the U.S.-Japan economic relationship is very similar to the one we have just described between the EC and Japan. In 1988, the U.S. was on the receiving end of 34 percent of Japan's exports.[111] Although the share of Japanese-made imported cars fell from 20 percent in 1986 to 19 percent in 1990, Japan's U.S. market share has risen to 30 percent when cars made at Japanese plants in the U.S. are counted.[112]

As an example of growing protectionism in the U.S. because of Japanese market penetration, the AFL-CIO recently called for the U.S. to follow the EC lead and sharply restrict the number of Japanese cars and parts imported into the U.S. during the next five years.[113] Cars and car parts account for 75 percent of the $42 billion-a-year trade deficit the U.S. runs with Japan, and such restrictions would have a severe impact on Japan's economy.[114]

The economic friction between the U.S. and Japan is not limited to cars and other imports. Although the U.S. has become more competitive, and its trade balance with Europe has moved from a $30 billion deficit in 1986 to a $15 billion surplus, America has continued to run an annual deficit of about $40 billion with Japan since 1990.[115] According to a recent Rand Corporation study, much of the U.S. problem appears to be with Japan's non-tariff trade barriers. These barriers put strong upward pressure on the prices of U.S. and other foreign products -- limiting the ability of U.S. products to penetrate the Japanese market.[116]

The Rand study found that the prices of Japanese products in the U.S. were very close to the prices charged in Japan. For instance, a Japanese camera priced $578 in Japan sold for $23 less in the U.S.!! A VCR selling for $424 in Japan cost $430 in the U.S. On the other hand, about 60 percent of U.S. products exported to Japan were priced at least 40 percent higher than in the U.S., and the average "premium" was about 65 percent. For example, U.S. tires cost 37 percent more in Japan than in the U.S. at a price of $65 instead of $48. At the same time, Japanese tires sold for $66 in both countries. Also, a U.S. laser printer selling for $449 was priced at $825 in Japan. The study noted that most of the products were not subject to tariffs and that U.S. products manufactured in Japan also cost Japanese consumers 30 percent more than U.S.

consumers.[117] This is the type of information that feeds U.S. suspicions concerning Japan's peculiar trade practices.

The growing protectionist sentiment in the U.S. to retaliate for apparent unfair Japanese business practices may lead to U.S. policies that will hurt Japan's economy through restrictions to our markets. Combined with the potential for restrictions by the EC, Japan could be facing a serious trade-war, unless it adopts practices that the U.S. and the EC regard as fair.

In addition to damage to Japan's economy from potential trade sanctions, Japan faces an America that has awakened and is getting more competitive. The U.S. has strongly improved its performance in the foreign-trade sector. As noted above, the U.S. has moved to a trade surplus with Europe. Exports in November 1991 were up almost 12 percent over the previous November, despite a global slowdown.[118] Part of this success is due to the depreciation of the dollar, which helped price U.S. products more competitively. But restructuring of U.S. industries over the last decade has also helped gain efficiencies. U.S. manufacturing productivity rose 30 percent between 1983 and 1990, compared to 13 percent in Canada and 19 percent in Germany -- and just behind Japan's 35 percent. In fact, U.S. factory productivity has climbed slightly faster than Japan's in recent years.[119] Also, U.S. productivity has always been higher than Japan's -- average Japanese productivity is only about 80 percent of the U.S. level.[120]

Progress has been made by the U.S. semiconductor industry, which has stopped erosion of its global market share. The U.S. share has actually risen from 37 percent in 1988 to 39 percent in 1991, and the leading U.S semiconductor producer has gained much of the global market share for the new "flash memory" chips. According to a consultant to the electronics industry, "Our companies are beginning to figure out how to compete with the Japanese."[121] This improvement is not only true in electronics; the quality gap has narrowed significantly in cars since the mid-80's, and Daihatsu has decided to pull out of the U.S. car market; and Japanese security firms have not done well in the U.S. market.[122]

Finally, the proposed North American Free trade Agreement among the U.S., Canada, and Mexico presents Japan with another challenge. The agreement would set up another large trading bloc, similar to the EC-in-92, that would significantly help promote trade among the members -- but which could severely restrict outsider access. Further, the Bush Administration is seeking strong rules of origin to prevent Japan and others from using Mexico as a duty-free back door into the U.S.[123]

This section has demonstrated that Japan faces significant challenges in the international arena. There is fear and some hatred of Japan on the part of many neighbors in the Asian region. The result is potential instability in the region if U.S. interest and influence decline significantly. The U.S. and the Asians have good reason to be concerned if Japan develops a power projection capability. In addition to these potential diplomatic/military problems, Japan faces serious current political/economic problems with virtually all of its trading partners -- a difficult situation for a nation that must import and export to live.

CONCLUSIONS

In the post-Cold War era, Japan and the U.S. are the only two countries that have each achieved the position of an economic superpower. Each also has economic problems and weaknesses, and these elements interact due to the interdependent trade and financial relationships between the two countries. Because of this interdependence, each needs the other to succeed economically. They each need to seek ways to resolve their differences in mutually beneficial ways. "A rising tide lifts all ships."

In addition, it seems that Japan's systemic problems of a maturing economy, and demographic and social change will continue to keep Japan's growth below its earlier highs. Japan, however, will continue to be among the top two or three economic powers for the indefinite future -- if it can get beyond the "myth" of its own success and make progress in those domestic and international economic problems where it can take meaningful action.

The Myth

While Japan has obviously had great economic success, it seems as though world and Japanese popular opinion have an inflated -- almost mythological -- view of Japan's economy that distorts how its success is handled politically. In particular, a more realistic view would make the Japanese less full-of-themselves and more likely to make necessary compromises, while a more realistic view by others would reduce fear and defuse their protectionist sentiment toward Japan.

A few myth-busting examples follow. Despite Japan's great economic strides, its GNP is still far smaller than the U.S. GNP; Japan has made great strides in productivity, but its rate is still only 80 percent of U.S. productivity; Japan technically has a higher per capita income, but its people still have only 60 percent of the actual purchasing power of an American; and in many areas, U.S. business has regrouped and is newly competitive. Japan is also a fairly regimented and docile society that has made great sacrifices in quality-of-life for its economic success -- calling the basis for that success into question.

The Problems

In addition to Japan's economic success being overblown in the media and the public consciousness, we have noted a number of problems that indicate Japan's economic performance will be more difficult to maintain than in the past. It has the systemic problems of a mature economy, with incremental improvements becoming more difficult -- resulting in a much lower growth-rate than it is used to. Its peculiar financial foundation also seems to have a systemic flaw because it is based on stock and land holdings that are still over-valued, and subject to contraction and possible collapse. As with other economies, Japan's is also subject to cyclical problems -- which much of its recent monetary and financial policy has tried to address. And its MOF and BOJ gnomes have not gotten the solution much better than our own FED gurus.

These systemic and cyclic economic problems are not the only drags on Japan's long-term economic performance. Japan's economy also faces a number of unique social and demographic problems: a reduced drive in the younger work force; a disproportionate segment of the workers will retire soon; strains on the social security and medical systems from these retirees; a continuing labor shortage; and pressure to "spread the wealth" and improve the national quality-of-life.

The cumulative effect of these domestic trends is to reduce the potential performance of Japan's economy. There are also international issues that pose economic problems. Japan is uniquely dependent on imported raw materials, and exports also play a vital role in its economy. Yet, Japan does not have the military capability to guarantee its access to resources and markets, and its trade practices virtually guarantee that political-economic retaliations will limit its access.

Its narrow focus on Japanese corporate economic success and its singular lack of noblesse oblige have resulted in trade practices that (as a minimum) have created the appearance of predatory capitalism. The backlash against Japan's practices in the export and import arena has led to an increasingly protectionist sentiment in Europe and the U.S. EC-92 and the North America Free Trade Agreement are just two regimes that could significantly reduce Japan's access to important markets. Also, Japan's Asia-Pacific neighbors fear its economic and potential military influence, and could also take steps harmful to Japan's economy, unless Japan becomes more accommodating. The specter of protectionism is out there, and it could seriously disrupt the post-war free-trade regime that has made Japan, the U.S. and the EC economic giants.

RECOMMENDATIONS

This paper has tried to take a fairly comprehensive look at several areas that relate to Japan's economic success, its impact on the larger economy, and its prospects. I have tried to keep the focus on broad long-term issues, and I have tried to stay away from the problems of the current business cycle. I will attempt to maintain a similar focus in the policy recommendations.

There is not much that can be done about some of Japan's systemic economic problems. The dynamics of a mature economy are just there; marginal improvements in productivity will be more expensive and Japan's rate of growth will be smaller than in its halcyon days. Japan's population size and age distribution are also immutable. Its current cyclic slowdown is also beyond our scope and expertise, other than as a symptom of Japan's economic fallibility.

The Envelope Please

There are, however, areas where Japan can shape its future. First, Japan needs good political, military, and economic relations with other countries because it must import and export to survive. Second, the economies of Japan, the U.S. and the EC are highly interdependent. All of the following recommendations follow from these two principals:

1. Japan needs continued U.S. diplomatic and military engagement in Asia to reduce Japan's need for unilateral military programs that could only harm good relations in the region (reducing access to resources and markets).

-- Japan should willingly increase its financial offsets for U.S. forces in Japan (this provides security without scaring Japan's neighbors).

-- Japan should be much more solicitous of favorable U.S. government, business, and public opinion so that support for this engagement will not be undermined.

2. Japan needs to improve its free trade credentials, since its current practices will further harm its relations with trading partners around the world (reducing its access to resources and markets).

-- Japan needs to adopt noblesse oblige; a broader longer-range economic focus of helping its foreign trading partners while helping itself (an international version of its domestic keiretsu system, where there is more give and take, looking for long-term mutual success).

-- Japan needs to reduce its trade and current accounts surpluses, which aggravate economic tension and lend credence to charges of unfair practices:

** Offshore plants need to actively seek locally produced components, and engineering and R&D need to be conducted to a greater degree in the local economy.

** Agricultural import restrictions need to be greatly reduced. In addition to encouraging imports, this will help the labor shortage by freeing up poorly utilized workers for other assignments.

** Prices for Japanese produced goods should be similar in Japan and foreign markets to stop actual or apparent dumping in the foreign market or gouging in the Japanese market.

** Structural impediments to manufactured imports must be reduced. In addition to reducing the surpluses by encouraging imports, many inefficiencies in the Japanese economy will be rationalized -- freeing valuable labor resources, and generally improving productivity.

3. Japan needs to improve its credentials with its own people by finally sharing the fruits of economic success with them and improving the nation's quality of life.

-- This will reinforce the legitimacy of the system improving social stability, improving the infrastructure, and improving foreign opinion ("if they are now fair with their own people, maybe they will be fair with us").

-- This will improve the balance of trade and current accounts by keeping more money in country to pay for the infrastructure, and social and work benefits.

-- This will improve the balance of trade surplus by reducing investments R&D and production facilities that compete with foreign markets.

-- This will also reduce the surpluses to the extent foreign companies have a legitimate chance at construction contracts for the infrastructure; and to the extent that better paid workers can pay for imported consumer goods.

4. The U.S. should, with its EC partners, continue to apply political and economic pressure on Japan to significantly reduce formal, informal, and cultural impediments to imports.

5. The U.S., and its EC partners, should continue to apply political and economic pressure on Japan to eliminate predatory practices in their domestic markets.

6. The U.S. should continue to remain actively involved in the Asia-Pacific: to reassure Japan of its continued protection, to keep Japan from diverting resources from its economy to military expenditures, and to reassure Japan's neighbors that Japan has no need to move into the military arena.

7. All of the parties should hold the others "hostage." Free trade and open markets are in everyone's long-term interest. The U.S. is better today because of changes to meet Japan's economic challenge. Japan would also have a more efficient economy if it allowed free access to its market. If Japan does not bow to U.S. and EC pressure and seek compromise, all three economies -- and that of the world -- will suffer.

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