Chapter 9

SOURCES OF AMERICAN-JAPANESE ECONOMIC CONFLICT

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An important issue raised by "revisionist" scholars such as Chalmers Johnson and Clyde Prestowitz is whether the clash between communism and capitalism has been replaced by conflict among rival models of capitalism. In a provocative article, Samuel Huntington declared that, with the end of the cold war, Japan had become a "security" threat to the United States.[1] According to these revisionists, whereas Western "regulatory" capitalism is consumer- and market-oriented, Asian "developmental" capitalism is characterized by a powerful role of the state and emphasis on production. High officials in both the Bush Administration (1989–1992) and the first Clinton Administration (1993–1997) shared this belief that Japan's distinctive capitalist system and trade pattern were responsible for America's huge trade deficit and the deindustrialization of the American economy. On the basis of this belief, President Bush launched the Structural Impediments Initiative (1989) whose purpose was to transform the nature of Japanese capitalism and President Clinton pursued a "managed trade" policy to open Japanese markets to American goods. These revisionist views have also been prevalent in Western Europe. A number of French intellectuals and business executives such as Albert Breton, Jacques Attali, and James Goldsmith have shared these revisionist opinions and have argued that the Western and Asian modes of capitalism are inherently incompatible.

Neoclassical economists tend to ignore the structural or systemic differences among national economies in the functioning of the world economy. Every economy, or at least every efficient one, is assumed to function according to the universal laws of the self-regulating market. International economists, for example, regard national economies as dimensionless points or as "empty boxes" connected by exchange rates and trade/financial flows. What is important, according to economic orthodoxy, is "getting the prices right" and letting unfettered markets work. For this position, the American trade/payments imbalance especially in manufacturing can be explained by the well-established theories of conventional economics. Although the tendency of economists to downplay the importance of national systemic differences has been modified with the increasing openness and interdependence of national economies, economists continue to neglect the important role of domestic institutions and structures in the functioning of the international economy.

The purpose of this article is to assess these conflicting explanations of the American-Japanese trade conflict that arose in the 1980s in response to the immense American trade/payments deficit. Although this conflict abated in the early 1990s due in large part to the economic revival of the American economy, the revisionist charges against Japan have not disappeared from the American political agenda and, in fact, resurfaced in the late 1990s as a consequence of the East Asian (including Japan) economic crisis. This crisis has given rise to the fear that the United States will be flooded by Asian imports. As I shall discuss below, this crisis and the failure of Japan to respond adequately to it are alleged to be responsible for a resurgence of the American trade/payments deficit with Pacific Asia. The place to begin this consideration of the sources of the American-Japanese trade conflict is with a discussion of the fundamental differences between the two economies.

DIFFERENCES AMONG NATIONAL ECONOMIES

Every national economy is embedded in a larger sociopolitical system. A nation's culture, social mores, and political system affect every aspect of economic affairs such as what is considered to be "fair" and "unfair" economic behavior. Although national systems of political economy differ from one another in many important respects, I shall focus on three principal differences: the primary purposes of economic activity, the role of the state in the economy, and the mechanism of corporate governance and private business practices. Although every modern economy must promote the welfare of its citizenry, different societies vary in the emphasis given to particular objectives. These objectives, which range from promoting consumer welfare to the pursuit of national power, strongly influence other features of an economy such as the role of the state in the economy and the structure of the economy. The role of the state in the economy differs in every market economy ranging from the generally laissez-faire, noninterventionist stance of the United States to the central role of the state in the overall management of the Japanese economy. The mechanisms of corporate governance and private business practices also differ; the relatively fragmented American business structure and the Japanese system of tightly integrated industrial groupings (*keiretsu*) provide the most dramatic contrast. Very different national systems of political economy result from variations in these three components of an economy.

The purpose of economic activity can differ considerable across national economies. As Karl Polanyi pointed out in *The Great Transformation*, the purpose of economic activities is culturally or politically determined.[2] The Western notion of individualism and of the market as an autonomous entity is unique and historically recent. Throughout history, Polanyi argues, economic activities have been deeply embedded in social arrangements and subordinated to more communal goals. The economy has seldom, if ever, been conceived as an end in itself or regarded as something separate and independent from the rest of society. Although the welfare of the consumer and the identity of the economy with the free market have become increasingly prominent in many analyses in the modern era, Japan, Germany, and many other societies continue to give a high priority to communal or collective purposes.

The role of the state in the economy is determined primarily by a society's conception of the purpose of economic activity. In those "liberal" societies where the welfare of the consumer and the autonomy of the market are emphasized, the role of the state tends to be minimal. Although liberal societies obviously differ in the extent to which they may pursue social welfare goals and some may be classified as "welfare states," the predominant responsibility of the state is to correct market failures and to provide public goods. On the other hand, in those societies where more communal or collective purposes prevail, the role of the state is much more intrusive and interventionist in the economy. Thus, the role of such states can range from provision of what the Japanese call "administrative guidance" to a command economy like that of the former Soviet Union.

Another important component of a national political economy is the system of corporate governance and the nature of private business practices. The major corporations of Japan, Germany, and the United States have very different systems of corporate governance, and they organize their economic activities (production, marketing, etc.) in distinctive ways. For example, whereas stockholders and their representatives have an important role in the governance of American business, banks play a more important role in both Japan and Germany. Although these national differences in corporate structure and business practices have evolved largely in response to economic and technological forces, the state has played an essential role in shaping the nature of business enterprise and business behavior through its regulatory, industrial, and other policies.

THE AMERICAN SYSTEM OF MANAGERIAL CAPITALISM

The American system of political economy is founded on the premise that the primary purpose of economic activity is to benefit consumers while maximizing wealth creation (regardless of its distribution domestically or internationally). Despite innumerable lapses, the American economy, which incorporates the fundamental principles of neoclassical economics as an ideal goal, approaches the neoclassical model of a competitive market economy. In the American conception of the economy, individuals are assumed to maximize their own private interests ("utility"), and business corporations are expected to maximize profits. The American model of the economy rests on the assumption that markets are competitive and that, where they are not,, competition should be promoted. Almost any economic activity is permitted unless explicitly forbidden. The economy is also assumed to be open to the outside world unless specifically closed. Such an emphasis on consumerism and wealth creation results in a powerful pro-consumption bias and a greater insensitivity (at least when compared to Japan and Germany) to the social welfare impact of economic activities. Although Americans pride themselves on their pragmatism, the American economy is founded upon the abstract theory of economic science to a greater degree than is any other economy.

At the same time, however, the American economy is well characterized as a system of "managerial" capitalism. The American economy was profoundly transformed by the emergence in the closing decades of the nineteenth century of huge corporations and the accompanying shift from a "proprietary" capitalism to one dominated by large, oligopolistic corporations. Management was separated from ownership and the corporate elite became virtually a law unto itself. Subsequently, with the New Deal of the 1930s, the balance shifted to some degree away from big business with the creation of a strong regulatory bureaucracy and the empowerment of organized labor. In effect the neoclassical laissez-faire ideal was diluted by the notion that the federal government had a responsibility to promote economic equity and social welfare. The economic ideal of a self-regulating economy was further undermined by the passage of the Full Employment Act of 1945 and by the Kennedy Administration's implementation of that Act when it accepted the Keynesian idea that the federal government had a responsibility to maintain full employment through its use of macroeconomic (fiscal and monetary) policies.

Commitments to the welfare of individual consumers and the realities of corporate power have been strong in American economic life, but there has been no persistently strong sense of business responsibility to the society or to the individual citizen. Japanese corporations, as will be shown below, have long been committed to the interests of their "stake holders" including labor and subcontractors, while German firms are more accepting than are American firms of the welfare state. American corporations are more detached from the welfare concerns of the other components of society than either Germany or Japan. For example, Japanese and German firms are much more reluctant to shift industrial production to other countries than are their American rivals. However, over time, the balance between the ideal and the reality of the American economy has shifted back and forth. In the 1980s, with the election of Ronald Reagan, emphasis on the unfettered market eclipsed the welfare ideal of the earlier post World War II era.

ECONOMIC ROLE OF THE STATE

The role of the American government in the economy is determined not only by the influence of the neoclassical model on American economic thinking but also by fundamental features of the American political system. The fact that authority over the economy is divided among the executive, legislative, and judicial branches of the federal government is vitally important. As Jeffrey Garten points out, whereas the Japanese Ministry of Finance has virtual monopoly power over the Japanese financial system, in the United States this responsibility is shared by the Treasury, the Federal Reserve, and several other powerful and independent federal agencies; furthermore, all of those agencies are strongly affected by actions of the legislative and judicial branches of government.[3]

The other important structural feature of the American political economy is the federal system itself, which fragments authority over the economy between Washington and each of the 50 states. Conflicts between the federal government and the individual states over economic policy occur again and again in the American system. Moreover, this fragmentation causes great consternation among America's economic partners, as it is extremely difficult for foreign nationals to know who has the last word in their dealings with the United States. A prime example of these complexities is found in the questionable attempts by individual states to tax the profits of the American subsidiaries of foreign firms. In addition, the U.S. constitutional system of checks and balances also greatly inhibits the fashioning of an effective role for the government in the economy. Added to these structural features is a weak civil service which cannot provide the independent leadership expected from Japanese and German officials.

Another restraining influence on the role of the American state in the economy is the opposition between the private and public sectors. The adversarial relationship between government and business in the United States make cooperation very difficult, while their mutual suspicions are reflected in American politics. Whereas political conservatives reject, at least in principle, any strong role for the state in the economy, political liberals are fearful that private business interests will capture government programs in order to "feather their own nests." A political stalemate frequently results from this situation. At the same time, however, the fragmented structure of the American government and its many points of access make it easier than in some other systems for private interests to challenge government actions. These ideological, structural, and public versus private aspects of the American political economy have restricted greatly the capacity of the American government to develop a coherent national economic strategy.

Macroeconomic policymaking does provide a major exception to the generally limited role of the American government in the economy. Yet, even in this area, the responsibility for macroeconomic policy has, in actual practice, been divided. Although passage of the Full Employment Act acknowledged that the federal government had an overall responsibility for maintaining full employment, both the Congress and the Executive Branch are responsible for fiscal policy. The control over monetary policy has rested with the Federal Reserve which functions largely independent of the rest of the Federal Government. However, starting with the fiscal policy excesses of the Reagan Administration in the early 1980s and the accumulation of an immense federal debt, the role of fiscal policy declined and the Federal Reserve, through its control over monetary policy, has become the principal manager of the American economy.

While there is general acceptance that the American state has a major role in the economy at the macroeconomic level, its role at the microeconomic level is highly controversial. The society generally assumes that the government should establish a neutral environment for business and should not involve itself in business affairs. From this perspective, the primary responsibility of the government is the regulation of the economy and to overcome "market failures." Among "market failures" that justify an active government role in the economy are the need to control monopoly power, to correct negative "externalities," and to compensate for inadequate consumer information. While economists and others differ over the definition of market failure and the proper scope of government regulatory policy, the legitimacy of a significant role for the government in this area is well established.

There are several implications that flow from this regulatory yet severely limited role for the American government in the economy. In the first place, this task means that the American government frequently assumes a role as an adversary to business. Indeed, American business and government seldom cooperate to increase the international competitiveness of the economy. Second, emphasis is placed on protecting American consumers even when this may weaken the competitiveness of American firms against their foreign rivals; for example, the strict application of anti-trust laws to prohibit monopoly prevents the type of cooperative research projects frequently found in Japan and Western Europe. Third, the government is inhibited from pursuing industrial and other policies that might develop or strengthen industries considered to be of competitive importance; instead, the role of trade or commercial policy is to create a "level playing field" on which American and foreign firms can compete fairly and not to favor American firms. In brief, the federal government is assumed to have only a limited role in promoting the international competitiveness of American business.

Industrial policy is an area of important differences between the U.S. and Japan. The term refers to the deliberate efforts by a government to determine the structure of the economy through such devices as financial subsidies, trade protectionism, or government procurement. Interventionist activity is justified by the assumption that some industries are more important than others for the overall economy, and that certain strategic industries create higher quality jobs (such as manufacturing jobs which are generally considered better than service jobs). Favored industries may also produce technological or other "spillovers" (externalities) that have a beneficial effect on the rest of the economy; frequently cited examples are the computer industry and other high tech industries. Those industries and technologies judged to be important to national security and to economic independence are also in this special category.

A high degree of consensus exists among professional economists and within the American business community (except of course among those industries demanding special treatment) that the American government should not and, in fact, cannot "pick winners." Most contend that the structure and distribution of industries in the United States should be left up to the market. In effect, the basic belief is that all industries are created equal and that there are no strategic sectors. In the oft-paraphrased expression of Michael Boskin, Chairman of President George H. W. Bush's Council of Economic Advisers, a chip is a chip, whether it be a potato or a computer chip, and there is no legitimate reason for the government to favor one or the other. There are, however, three major exceptions to this consensus against industrial policy: in the areas of agriculture, national security, and research and development. Since the mid-nineteenth century, the federal government has funded agricultural research. Under the rubric of national security, the Pentagon, as foreign governments charge, has long carried out an extensive industrial policy supporting technological advance on a broad front. Although government financing of research and development is generic and seldom attempts to promote specific industries, one can legitimately classify this activity also as a form of industrial policy.

CORPORATE GOVERNANCE AND PRIVATE BUSINESS PRACTICES

In important ways the American system of corporate governance and industrial structure parallels the national system of political governance and political structure. U.S. corporate governance and organization are characterized by fragmentation and an overall lack of policy coordination at both the corporate and national levels. Indeed, the strong American anti-trust tradition and competition policy are intended to prevent concentration of corporate power. American business is much more constrained than its rivals in its ability to share business information, to pool technological and other resources, and to develop joint strategies. As many observers have charged, such restrictions disadvantage American firms in global competition.

Control of American business is much more dispersed than in Japan or Germany. Whereas the largest stockholders in many of America's large corporations may own only one or two percent of the stock, it is not infrequent in Japan for ownership of seventy percent or more of the stock to reside in a cooperative business grouping (*keiretsu*). Also industry and finance are more completely separated from one another in the United States; this has meant higher capital costs than those enjoyed by foreign rivals and also frequent conflicts of interest between industry and finance that have been detrimental to national policymaking. At the national level, the National Association of Manufacturers, Chamber of Commerce, and other business organizations play no role commensurate with that of the *keidanren* in Japan or the Federation of German Industries. These Japanese and German organizations can speak with one strong voice and frequently act on behalf of business interests.

Underlying many of these contrasts between American and Japanese/German business is a fundamentally different conception of the corporation and of its role in society. In the United States, a business corporation is regarded as a commodity that is bought and sold like any other commodity regardless of the social consequences of such transactions. The 1980s wave of leveraged buyouts and corporate takeovers was a grotesque exaggeration of this mentality. In both Japan and Germany, on the other hand, the corporation tends to be regarded more as a semi-public institution with a responsibility to society and to a broard range of stake holders; it is expected to promote larger social and political objectives than just the bottom line of profitability. Japanese firms in particular are expected to increase the power and independence of Japanese society; while Germany places a high premium on social welfare. American law is designed to ensure neutrality and fair play in the competitive market for corporate control. In contrast to the United Sates, Japan, and Germany attempt to limit the struggle for corporate control.

THE JAPANESE SYSTEM OF COLLECTIVE CAPITALISM

G. C. Allen, the distinguished British authority on Japanese economic history, tells a story that provides an important insight into Japanese economic psychology. At the end of World War II, American economists and officials advised the Japanese that they should follow the theory of comparative advantage as they rebuilt their war-torn economy and that Japan's advantage lay with labor-intensive products. The Japanese bureaucratic elite, however, had quite different ideas and would have nothing to do with what they considered to be an American effort to relegate Japan to the low end of the economic and technological spectrum. Instead, the Japanese Ministry of International Trade and Industry (MITI) and other agencies of the Japanese economic high command set their sights on making vanquished Japan into the economic and technological equal, and perhaps the superior, of the West. This objective remains the driving force of Japanese society.

In the Japanese scheme of things, the economy is subordinate to the political objectives of society. Ever since the Meiji Restoration (1868) the overriding goals of Japan have been to make the economy self-sufficient and to catch up with the West. In the pre–World War II years, this national ambition meant building a strong army as well as becoming an industrial power. Since its disastrous defeat in World War II, however, Japan has abandoned militarism and has focused on becoming a powerful industrial and technological nation while also promoting internal social harmony among the Japanese people. There has been a concerted effort by the Japanese state to guide the evolution and functioning of the Japanese economy in order to pursue these two basic objectives.

These political goals have resulted in a national economic policy best characterized as neomercantilism. This policy has involved state assistance, extensive regulation, and protection of specific industrial sectors in order to increase their international competitiveness and thereby achieve national preeminence over the leading high tech sectors of the world economy. This economic objective of achieving industrial and technological supremacy over other countries arose from Japan's experience as a late developer and also from its strong sense of economic and political vulnerability. Another very important source of this powerful economic drive is the Japanese people's overwhelming belief in their uniqueness, in the superiority of their culture, and in their manifest destiny to become a great power.

Many terms have been used to characterize the distinctive nature of the Japanese system of political economy: developmental capitalism, tribal capitalism, collective capitalism, network capitalism, companyism, producer capitalism, stake holder capitalism, and, perhaps most famous or infamous, "Japan, Inc." Each expression connotes particularly important elements of the Japanese economic system such as: (1) its overwhelming emphasis on economic development, (2) the key role of large corporations in the organization of the economy and society, (3) emphasis on the group rather than the individual, (4) primacy of the producer over the consumer, and (5) the close cooperation among government, business, and labor. I believe that the term, "collective capitalism" best captures the essence of the system because this characterization conveys the priority that the Japanese give to working together to achieve the overriding national purposes of catching up with the West while also achieving domestic social stability and national harmony.

Perhaps more than any other advanced economy, the Japanese are willing to subordinate the pursuit of economic efficiency to social equity and fairness. The Japanese strive mightily to preserve their unity, independence, and uniqueness in a highly competitive and, at times, dangerous international system. These fundamental goals undoubtedly reflect the fact that the Japanese are as much a race as a nation. However, the uniqueness of Japan increases the difficulties of integrating that dynamic and important nation into the larger world economy.

THE ECONOMIC ROLE OF THE STATE

The role of the Japanese state in the economy is something of an enigma. Few Japanese or foreign commentators would deny that the Japanese state has played an extremely important role in Japanese economic development or that it continues to be an important factor in managing the economy. It is frequently asserted that the Japanese state, in American political science terminology, is a "strong" state with a pervasive presence in every aspect of Japanese economic life. Who could possibly doubt, for example, the powerful influence of MITI or of the even more powerful Ministry of Finance (MOF)! Yet, the size and the cost of the Japanese state are really quite small, particularly when compared to the American government. Moreover, the Japanese government is frequently stalemated and incapable of decisive action. Despite these important qualifications, however, the Japanese state has had and continues to have a profound influence over the direction of the economy.

It is very important to recognize that Japan, throughout most of the postwar era, has been ruled by a tripartite alliance of government bureaucracies, the ruling Liberal Democratic Party (LDP), and big business. This alliance achieved a consensus that Japan's primary objective should be rapid industrialization. Moreover, the state should play a central role in achieving this objective. In addition, the Japanese people themselves believe that the state has a legitimate and important economic function in promoting economic growth and international competitiveness. The government bureaucracy and the private sector, with the former taking the lead, are expected to work together for the greater collective good of Japanese society. Pursuing this goal, MITI and other Japanese bureaucracies have developed a number of policy instruments ranging from "administrative guidance" to financial support and trade protection to promote the development of specific industries.

Perhaps even more importantly, the Japanese state has supported aspects of Japanese society such as hard work, a skilled labor force, and a high savings rate, characteristics that account perhaps more than anything else for Japanese economic success. As an example, Japan's extraordinarily high savings rate has reduced the cost of investment and contributed to Japanese competitiveness. The Japanese state has also played an important role in supporting social, political, and legal aspects of Japanese society that make Japanese society frequently inhospitable to foreign firms and limit the importation of foreign goods.

An important and distinctive feature of Japanese society is that many of the "public" responsibilities of the American or German governments are delegated to the private sector. For example, corporations have a major responsibility for the social welfare of a substantial portion of the Japanese population. Whereas the American government delegates regulatory authority to quasi-autonomous public agencies, Japanese delegate much of the responsibility for the policing of business activities to private associations. This has been a highly pragmatic practice based on the close ties and mutual trust between private business and government. A remarkable example of this practice of delegating public functions is the privatizing of "law and order." One reason for the low level of street crime in Japan is that the Japanese Mafia (*yakuza*) police the streets in exchange for police toleration of their businesses.

At least in part, this practice of self-regulation and self-policing by business and other private associations is intended to provide social stability and to ensure fairness. However, it can and does lead to special treatment of particular groups, seemingly arbitrary decisions, and discriminatory behavior designed to protect the weak. This practice is directly counter to the American concept of universal rules that apply equally to everyone regardless of their status. This cultural difference in the definition of "fairness" has been a major source of American-Japanese economic tension and has, on occasion, erupted into open conflict. The Japanese practice of delegating what are considered in the U.S. to be essentially public responsibilities to private associations has raised significant problems for a Japan increasingly integrated into the world economy. For cultural and other reasons, it is virtually impossible for Japan to incorporate outsiders into the self-regulating associations that set the rules governing competitive behavior and other aspects of the conduct of business in Japan, and foreign companies seeking entry into the Japanese market naturally regard the practice of self-regulation as discriminatory, which it most assuredly is. The self-policing system with its emphasis on fairness and on tailor-made rules enforced in self-regulatory associations conflicts directly with the concept of universal and nondiscriminatory rules embodied in the General Agreement on Tariffs and Trade and is thus an immense hurdle to be cleared in opening the Japanese market and internationalizing Japan.

Japan's political and bureaucratic fragmentation also set the state apart. The economic and other bureaucracies of the government are virtually lords unto themselves in their own areas of responsibility. Johnson has made the point that the three major economic agencies responsible for foreign affairs at times have had different and conflicting foreign economic policies. Every Japanese bureaucracy tends to believe that it has a responsibility to protect a particular segment of Japanese society. Disputes over policy and conflicts over areas of responsibility are frequent.

Although bureaucratic struggles exist in every country, in Japan there is no effective way to resolve such conflicts because there is no powerful chief executive. In addition, the strong Japanese belief in consensus decisionmaking encourages stalemate and indecision. The one great exception to this generalization is a major crisis, especially one that originates elsewhere, and forces Japan to resolve its internal divisions. Although such external pressures (*gaiatsu*) are deeply resented by the Japanese, the outcomes produced by such pressures, as many Japanese will admit, are frequently beneficial to Japanese consumers and other groups. For example, reform of the "big store law" facilitated establishment of discount stores (both American and Japanese) with greater variety and lower costs than the traditional Japanese "Mom and Pop" stores.

The area of industrial policy is the most controversial aspect of the Japanese political economy. As I have already noted, industrial policy refers to the extensive and deliberate efforts of the government to guide and shape the development of the economy. Through such policy devices as trade protection, industrial subsidies, and "administrative guidance," the government attempts to determine the nation's economic and industrial structure. In the Japanese case, the government has sought to promote high value-added and internationally competitive industries.

The debate over the role and effectiveness of industrial policy in the postwar economic success of Japan has been extensive and contentious. The debate has centered on three questions: Did the Japanese state play a crucial and central role in the postwar development of the Japanese economy? Was Japanese industrial policy a major factor in Japan's outstanding economic success or was it, as some economists charge, an utter failure? Even if industrial policy did contribute to Japan's earlier postwar achievements, is it still relevant in an economically mature and technologically advanced Japanese economy?

On one side of this debate have been those revisionist scholars and commentators who have argued that MITI and other key Japanese bureaucracies have in large part been responsible for Japan's outstanding technological achievements and unsurpassed international competitiveness. The *locus classicus* of this positive assessment of Japanese industrial policy is Johnson's *MITI and the Japanese Miracle: The Growth of Industrial Policy. 1925–1975* (1982).[4] Johnson credits MITI for having orchestrated Japan's postwar economic and technological success.

On the other side of the debate are neoclassical economists and other detractors of MITI's role who argue that MITI's efforts to channel resources into specific industrial projects such as aircraft, shipbuilding, and fifth-generation computers were not only unsuccessful, but actually resulted in huge costs and were detrimental to the Japanese economy. These economists attribute Japan's postwar success entirely to such market-conforming policies of the Japanese government as stable macroeconomic policies, public investments in human capital, and the decisions of Japan's private sector that conformed to Japan's comparative advantage as a resource-poor and capital/skilled labor-rich economy.

Much of the debate over Japanese industrial policy has obscured the most important aspect of the role of the Japanese state in Japan's postwar economic and technological success. Even though neoclassical economists are essentially correct that Japanese bureaucrats have seldom been successful in picking winners and have made many mistakes this interpretation overlooks the critical and unique role of the Japanese state in facilitating and supporting the entrepreneurial efforts of Japanese business. The policies of MITI and other Japanese economic bureaucracies were very important in enabling Japanese firms to close the technological gap with American and other Western high tech industries.

The Japanese government has generally pursued a highly successful policy of "infant industry protection." It is important to recognize that the Japanese government was most successful when it supported those industrial sectors whose economic significance had already been proven in the United States and that the government was much less successful when it attempted to "pick winners." In addition, throughout most of the postwar era, the Japanese government has pursued a number of policies that significantly increased the economic and competitive success of Japanese business. These beneficial policies have included:

1. Taxation, financial, and other policies that encouraged extraordinarily high savings and investment rates.
2. Fiscal and other policies that kept consumer prices high, corporate earnings up, and discouraged consumption, especially of foreign goods.
3. Strategic trade policies that protected infant Japanese industries against both imported goods and the subsidiaries of foreign firms.
4. Government support for basic industries and such generic technology as materials research.
5. Competitive (anti-trust) and other policies favorable to the *keiretsu* and inter-firm cooperation.

However, in the 1990s, as Japan has closed the technological gap with the United States, as its corporations became among the most competitive in the world, and as its economy has opened, many of the long-term policies have become both ineffective and unnecessary.

CORPORATE GOVERNANCE AND INDUSTRIAL STRUCTURE

Although many American neoclassical economists deny it, the Japanese system of political economy differs significantly from Western economic models. While it is true that some of the distinctive features of the Japanese system are now changing, fundamental differences between the Japanese and Western economic systems continue. Certain important features of the Japanese system deserve particular study. The Japanese system of industrial organization with large closely connected industrial groups *keiretsu* and long-term relationships between major firms and their suppliers sets the Japanese system apart from the American and, to a lesser extent, from the German system of industrial organization.

The dualistic nature of the Japanese labor market is also distinctive. Some workers (primarily males working in Japan's major corporations) enjoy lifetime employment and are considered to be stake holders to whom Japanese firms have a responsibility. Simultaneously, however, a large portion of the work force (especially women and workers in smaller firms) has little job security and does not share equally in the benefits of the system. The distribution system is also unique; although Japan has a few large independent stores, the distribution system is generally dualistic. It is largely composed of major outlets controlled by the *keiretsu* and an enormous number of very small "mom and pop" stores. In this discussion, I shall concentrate on the *keiretsu* because of their central importance in the functioning of the Japanese economy.

The members of a *keiretsu* are bound together by mutual trust and long-term relationships among a number of firms. Informal ties are reinforced by overlapping memberships on governing boards, mutual stock ownership, and other mechanisms. The purpose of these structures is to serve the interests of stake holders rather than stockholders, and it is important to remember that those stake holders include not only the corporate members of the *keiretsu* but also labor and suppliers of components to those corporate members. The horizontal *keiretsu*, enterprise groups such as Mitsui, Mitsubishi, and Sumitomo, are composed of a few dozen members and include a large bank, manufacturing firms, and a distribution network along with other elements. The vertical *keiretsu* are composed of a parent manufacturing company and a large network of long-standing subcontractors and suppliers of services. The approximately two dozen vertical *keiretsu* include the leading Japanese manufacturing corporations in the automotive and consumer electronics industries such as Toyota and Matsushita. Together, the vertical and horizontal *keiretsu* control much of Japanese business. Dominant firms in a *keiretsu* may both exploit and promote the strengths of their junior partners. For example, the parent firms work with their extensive stable of long-term and trusted subcontractors to increase the latter's technological capabilities and to improve the quality of the components supplied to the parent. The parent even shares exclusive information with its affiliates, greatly enhancing the overall efficiency of the *keiretsu*.

The extensive presence of the *keiretsu* in the Japanese economy has profound consequences for the nature of Japanese domestic and international economic competition and for the dynamics of the Japanese economy. Contrary to the frequently issued charge leveled by some revisionist writers that the Japanese domestic market is noncompetitive, this market is in fact extraordinarily competitive. For example, Japan has a number of important automobile companies, whereas the United States has only three. However, competition in Japan does tend to be oligopolistic and Schumpeterian; that is, it is based on technological innovation and is quality-driven rather than based mainly on price competition. Furthermore, consumer prices in Japan are kept high by government policies in order to benefit the corporate sector.

In addition, whereas American consumers tend to be price-sensitive, Japanese consumers tend to be more quality-sensitive; they have a strong bias toward buying either “Japanese”or expensive and quite prestigious foreign goods. Market share (rather than the profit maximization familiar to Western industry) is the driving force behind Japanese competition; a large market share increases economies of scale and benefits the firm’s stake holders. Paradoxically, the Japanese economy is highly regulated, compartmentalized and overprotected, yet it is also the most fiercely competitive market in the world.

In his book on the governance of Japanese corporations, W. Carl Kester makes the convincing argument that the *keiretsu* is a highly efficient and rational mechanism for organizing economic activities.[5] Its distinctive characteristics make it a formidable competitor in world markets. Mutual trust, for example, substantially reduces transaction costs. Information exchange within the *keiretsu* decreases uncertainties and is conducive to innovative activities. Intragroup cross-shareholding protects members against “hostile” takeovers and significantly reduces the cost of capital. The system is a mutual assistance society; when a member firm gets into trouble, other members come to its rescue.

Corporate leadership’s independence from outside stockholders permits the firm, unlike American management, to pursue a corporate strategy based on maximizing market share rather than short-term profit maximization. The *keiretsu* is a crucial element in Japan’s remarkable capacity to adjust to economic, technological, and other changes; no other country was as successful as Japan in adjusting to the two oil price rises (1973–74 and 1979–80). Despite the troubles of the Japanese economy in the 1990s, the Japanese *keiretsu* has proved to be a successful innovator of new products and production techniques because of its immense internal resources and long-term perspective. The *keiretsu* appears to have effectively joined the financial and other comparative advantages of the large firm with the flexibility and innovativeness of the small firm.

Although (or perhaps because) the *keiretsu* is a highly effective means of industrial organization, it is deeply resented by non-Japanese. One reason for this resentment is that the *keiretsu* is a closed system and excludes all "outsiders." By outsider, I mean any firm, including any Japanese firm, that is not a member of the alliance of stake holders who share the monopolistic rents generated by this oligopolistic form of business organization. This exclusive nature of the *keiretsu* system significantly limits the access of foreign firms to the Japanese market. The *keiretsu* also makes takeovers of Japanese firms by foreign firms extremely difficult and gives Japanese firms a huge advantage in corporate expansion. Whereas Japanese firms can easily purchase a non-Japanese firm in order to acquire its technology or to gain market access, it is seldom possible for non-Japanese firms to purchase Japanese firms for the same purposes.

Furthermore, control by a *keiretsu* over distribution channels effectively shuts non-Japanese firms out of the Japanese market; this issue was at the heart of the Clinton Administration's conflict with Japan over automotive trade in the early 1990s. Non-Japanese firms and other governments regard *keiretsu* as significant barriers both to exporting goods to the Japanese market and to investment in Japan. The Japanese, on the other hand, regard the *keiretsu* as key elements in their economic success. The problem of differential or asymmetrical access was a major cause of conflict between Japan and its trading partners in the 1980s.

THE AMERICAN–JAPANESE TRADE CONFLICT

The issue of Japan's uniqueness and allegedly "unfair" behavior has been joined in the debate between revisionist scholars and neoclassical economists over Japanese trade.[6] This debate has centered on Japan's persistent and large trade/payments surplus and its alleged distinctive trade pattern. Although the tension between Japan and the United States abated somewhat during the 1990s, its underlying causes remain, and serious American-Japanese conflicts over trade and investment are very likely to arise again in the future unless radical changes are made in the economic systems and policies of both countries.

JAPAN'S TRADE SURPLUS/AMERICAN TRADE DEFICIT

Revisionists attribute Japan's continuing trade surplus to that country's neomercantilist economic strategy. They argue that the purpose of Japanese policy has been to generate a trade/payments surplus and to make Japan the world's dominant industrial and technological power. Japan's large trade surplus is cited as ipso facto proof that Japan has unfairly kept its economy closed to non-Japanese goods, protected its domestic market, and employed many devices like export subsidies and dumping to achieve a surplus vis-à-vis its trading partners. Even though Japan has lowered its formal tariff barriers and, in fact, has the lowest overall tariffs of any industrialized economy, both the government and business maintain a number of informal and nontransparent barriers that are continuing to keep imports out of the Japanese market. The mechanisms used as informal trade barriers include detailed specific product standards, the distribution system, and government procurement policies.

In opposition to the revisionist position, most neoclassical economists and the Japanese themselves argue that Japan's trade surplus and America's corresponding trade deficit can be explained entirely by macroeconomic factors. They remind us that a nation's trade surplus or deficit is primarily a function of the difference between its savings and investment rates; thus, a nation like Japan, with a high savings rate that exceeds its investment rate, will inevitably have a trade surplus whereas a nation like the United States with an exceedingly low savings rate and a high consumption rate will inevitably have a trade deficit. These differing macroeconomic situations, according to neoclassical analysts, clearly explain the Japanese trade/payments surplus and America's trade/payments deficit; for this reason, they argue, it is inaccurate to blame Japan for America's trade deficit. If the United States stopped all imports from Japan, the overall American trade deficit with the rest of the world would increase unless Americans decided to save more and invest/consume less. Stated succinctly, the neoclassical interpretation is that the American trade deficit originates in the United States itself.

JAPAN'S TRADE PATTERN

The other major issue in the American-Japanese trade dispute is Japan's distinctive trade pattern. Japan imports remarkably few of the manufactured goods that it consumes. Or, to put the matter another way, only a small fraction of Japanese trade is two-way trade within particular industries. Stated more formally, whereas a substantial portion of American and European trade has been intra-industry trade, Japanese trade has been largely inter-industry.[7] Japan imports mainly commodities (food, raw materials, and fuels) while exporting primarily manufactured goods (motor vehicles, electronics, and other high tech products). Although Japan did begin to import more manufactured goods following revaluation of the yen in 1986, many of the imports were from overseas subsidiaries of Japan's large multinational corporations.

Japan's unusual trading pattern contrasts with the more "normal" German pattern of intra-industry trade. Germany, which has traditionally been a much larger exporter than Japan and which has generally had an overall trade surplus in manufactured goods (at least before reunification) still imports many of the manufactured goods that it consumes. For example, Germany both imports and exports automobiles. Whereas German exports from many industrial sectors reach diverse foreign markets, Japan's exports are concentrated in relatively few markets, especially the American, and in relatively few industrial sectors, especially automobiles, consumer electronics, and auto parts. The United States, the world's largest exporter, has an intra-industry trade pattern similar to that of the Germans. These fundamental differences between trans-Atlantic and trans-Pacific trade are important in explaining why Americans and Germans, for example, have had little trade friction with one another and why many Americans and Europeans have been irritated by Japan's peculiar trade pattern.

For the revisionists, Japan's distinctive trade policy provides convincing evidence of Japan's neomercantilist economic strategy. Tyson has maintained that conventional trade theory does not apply to Japanese trade behavior. Instead, Japan's trade surplus and distinctive trade pattern are due to its policies of protection, preclusive investment, and industrial targeting.[8] Foreign manufacturers, it is charged, have been systematically denied access to the Japanese market at the very same time that Japan has carried out a trade offensive against other countries. Japan, revisionists contend, should be importing substantially more foreign manufactured goods. In addition, they point out, Japan has pursued a strategy of "preemptive investment" excluding foreign goods and investment from its domestic market until Japanese firms have become sufficiently strong to defeat foreign competition anywhere in the world.

Through governmental support of economies of scale and movement down the learning curve, it is alleged, Japan has been able to reduce its production costs and increase its international competitiveness. As Edward Lincoln pointed out in *Japan's Unequal Trade* (1990), the Japanese consider their distinctive trade pattern to be perfectly natural due to the noncompetitive nature of foreign products.[9] He charges that the Japanese government has deliberately promoted policies to limit manufactured and many other imports into its economy. In effect, Japan's trade surplus and distinctive pattern of trade are due to official state policy rather than to factor endowment alone. Japan's broad array of economic policies has been planned to make Japan the world's foremost industrial and technological power.

Rejecting such charges, neoclassical economists note that the Heckscher-Ohlin trade theory tells us that Japan's trade pattern is a product of its factor endowments, e.g., a shortage of raw materials, a highly skilled labor force, and abundant capital. Other countries with similar endowments, such as Italy, exhibit a similar trading pattern, and it is thus quite natural for Japan to export automobiles, consumer electronics, and auto parts and to import only a small percentage of the manufactured goods that it consumes. The impact of such inter-industry trading is magnified by Japan's concentration of its exports on the huge American consumer market. Neoclassicists are, therefore, convinced that Japan's distinctive trade pattern can be explained by economic science and does not result from the economic policies of the Japanese government.[10]

THE AMERICAN-JAPANESE TRADE PROBLEM: AN ASSESSMENT

Both the revisionist and the neoclassical positions provide important insights into the American-Japanese trade conflict; in some ways, they are more complementary than contradictory due in part to different levels of analysis. As the neoclassical interpretation correctly asserts, America's low and Japan's high saving rates do indeed account for America's trade deficit and Japan's trade surplus. Similarly, the neoclassical position is correct that Japan's distinctive pattern of inter-industry trade can be explained largely in terms of Japan's comparative advantage, namely, the fact that Japan is capital-rich and resource-poor. However, one must go behind these explanations and inquire why Japan's has such an extraordinary high savings rate in the first place and has a comparative advantage in high tech products and imports so few non-Japanese manufactured goods. As the revisionists argue, these distinctive features of the Japanese economy have more to do with Japan's neomercantilistic economic policies than with economic theories.

Why does America have such a low and Japan such a high savings rate? The extraordinarily low American savings rate has been due to a number of economic policies and a national psychology that encourages consumption rather than savings; for example, as Martin Feldstein and other economists have pointed out, Social Security tends to assure Americans that they need not save for their retirement. Similarly, the extremely high savings rate in Japan is due to government policies that have deliberately suppressed domestic demand and, thereby, encouraged saving. In this section, I shall concentrate on Japan's pro-savings policies.

The Japanese government for decades has pursued policies to reduce consumption and promote savings. Restrictive macroeconomic policies have suppressed Japanese domestic consumption. Consumer spending in Japan has reached only 56 percent of GNP compared to 64 percent for Europe and 68 percent for the USA; this helps to explain the more than 30-year-long Japanese trade surplus.[11] An Organization for Economic Cooperation report in 1989, noted that in Japan "there is still a substantial discrepancy between the country's economic strength and the relatively poor quality of life."[12] The report pointed out that the Japanese government and corporations have suppressed the Japanese standard of living far below what it should be in relation to its accumulated wealth resulting in a large trade/payments surplus with the United States and nearly every one of its trading partners. In addition, strict capital controls and the postal savings system along with no adequate national system of social security have also encouraged a high savings rate; the principal purpose of policies supporting high savings and underconsumption has been to promote Japan's overall strategy of export-led economic growth and a rapid industrialization.

In summary, well-established economic theory supports the neoclassical argument that Japan's trade/payments surplus is not responsible for the America's trade/payments; the answer lies in Japan's high and America's low savings rates.[13] However, Japan's high savings rate is due principally to the economic policies of the Japanese government that support a mercantile trade policy. On political grounds, this mercantilism has become increasingly unsustainable. At the very least, Japanese "free riding" on the international trading system does not make Japan a promising partner in the leadership of the world economy.

The neoclassical argument that Japan as a capital rich and resource poor nation has a comparative advantage in manufacturing is most certainly correct. However, the revisionist argument that the Japanese state has promoted manufacturing and has discriminated against non-Japanese imports through its industrial and protectionist policies are well-grounded. As the revisionists have argued, underlying the national emphasis on industrial production has been the strong and undoubtedly justified Japanese belief that Japan's comparative advantage is and must continue to be in the manufacture of quality goods in high volume at competitive prices. Behind this commitment is the fact that an increase in productivity in manufacturing is much more easily attained than in services. For this reason, the Japanese have been extremely reluctant to become a service economy as has been rapidly taking place in the United States and Western Europe. In addition, a strategy of export-led growth and a trade surplus enable Japanese manufacturing firms to reach a high volume of output and, thus, to achieve economies of scale that increase their competitiveness in high tech industries. If Japanese business is to have a high rate of productivity and economic growth, according to this analysis, then it must maintain a strong manufacturing base.

As neoclassicists correctly observe, Japan has the lowest level of formal tariff protection in manufacturing. However, even as formal Japanese trade barriers have been lowered or removed, excessive bureaucratic regulations, xenophobic consumer attitudes, and private business practices have continued to limit foreign goods entering the Japanese market. The most important obstacle to foreign-made imports has been the *keiretsu* system of business organization. This system of cooperative business arrangements has been nourished by a lax antitrust and other supportive policies of the Japanese state. The interlocking web of relationships composed of a *keiretsu*'s powerful firms and their "captive" supplier and distribution networks has constituted an almost unbreachable wall against foreign penetration of the Japanese economy.

In summary, while it is true that Japan's comparative advantage lies in manufacturing, this comparative, or rather competitive, advantage has been strongly influenced by the quite visible hand of the Japanese state rather than by the invisible hand of the market alone. The American government, on the other hand, has done very little to increase the U.S. savings rate and, thus, to decrease the trade deficit. Instead, one American Administration after another has pressured Japan to pursue a more expansionary economic policy and to shift from an export-led to a domestic-led growth strategy. In Japan itself, following collapse of the "bubble economy" in the early 1990s and the recession that followed, more and more Japanese, and even many large firms, have advocated a more open, deregulated, and expansive economy. The lengthy recession that began in 1991 has increased pressures to reform and stimulate the Japanese economy. The overall low level of Japanese productivity has also caused concern; a much higher rate must be achieved if Japan is to meet the challenges ahead, including the rapid aging of its population. Solution of the very serious aging problem will require significant reform of the Japanese economy and a more expansionary economic policy. However, as these policy changes are taking place very slowly, they may not prevent another America-Japanese trade dispute.

A RESURGENCE OF THE AMERICAN-JAPANESE ECONOMIC CONFLICT?

The United States abandoned its attack on Japanese trade and economic policies in the early 1990s. Although the United States continued to have a large albeit declining trade deficit with Japan, the strengthening of the American economy and the negative impact of the trade conflict on American-Japanese security ties convinced the Administration that it should cease "Japan bashing." However, the East Asian financial crisis and its consequences have raised once again the strong possibility of a powerful negative reaction by the United States not only to Japan but also to China and other Asian countries. The increasing trade/payments imbalance between the United States and East Asia including Japan is expected to rise dramatically. Such an imbalance is politically unsustainable. If recent history is any guide these imbalances will produce a powerful political reaction in the United States.

The trade/payments surplus or deficit of a country, as already noted, is due to a nation's spending patterns and in particular to the difference between national savings and investment. For nearly two decades, the United States has been spending much more than its national income and Japan has been spending much less. Over the course of the 1990s, this situation significantly worsened as the savings behavior of both the United States and that of Japan and the other East Asian economies changed dramatically. Throughout the decade, the overall American savings rate dropped considerably and the personal rate even became negative. The diversion of national savings into consumption helped fuel the extraordinary growth of the American economy throughout this period. At the same time, the long recession in Japan and, since late 1997, the recession in much of East Asia, has increased in relative terms the saving rates of these usually high saving economies. This imbalance in rates of national savings across the Pacific is primarily responsible for America's huge trade/payments deficit and the huge trade/payments surplus of Japan and East Asia.

It should be emphasized that the United States, given its extraordinarily low savings and high consumption rates, will inevitably have a huge trade/payments deficit regardless of what the Japanese and the East Asians do. The United States in the late 1990s, for example, had a large trade deficit with West Europe about which few Americans complained. Among the possible reasons for the contrasting negative American reaction to East Asia surplus are the immense size of their trade imbalance with the United States, the alleged effects of their closed economies on the trade balance, and the composition of their exports. Even if Japan and these other countries were to open their economies, as the United States demands, it would not change the situation unless they also decreased their rates of savings. Thus, even though the American trade deficit is not the fault of Japan and other Asian countries, these considerations do make these countries highly vulnerable to attack by American protectionists.

In addition to having high savings rates, the Pacific Asian economies are very competitive and have long targeted the American economy. Due to their depressed currencies, their exports will also displace some goods from other exporters that otherwise would have been imported into the United States. The overall result is a huge trade/payments imbalance. American concerns over the this imbalance are reinforced by the false belief that the trade imbalance is due to the closed nature of these economies. The Clinton Administration proclaimed over and over again the doctrine of "fair trade" and warned that these nations must either liberalize their economies and reduce their exports to the United States or else face increased trade barriers. In addition, the pattern of East Asian imports intensifies the negative political response in the United States. As I pointed out earlier, the industrial policies of the countries concentrated on a few key sectors such as steel, electronics, and automobiles. As the in the case of the increasing demands for protection against rising steel imports into the United States, these sectors are politically very sensitive ones with important domestic support. In effect, the United States in becoming the "importer of last resort" for the East Asian economies can be said to be performing a vital role in their economic recovery. However, this role will inevitably lead to increased protectionist sentiments in the United States. In the event of a prolonged American recession, these calls for protectionism against "unfair" Asian producers could become irresistible.

CONCLUSION

The resolution of the American-Japanese trade/payments requires fundamental changes in both economies. As I have shown, both sides must bear part of the responsibility. Although America's consumer-led economic growth has benefited the entire world, this policy is both politically and economically enviable over the long-term; there is a limit to how long Americans can borrow the savings of others to finance their high level of consumption. Americans must shift away from consumption toward saving; it would also be helpful (but highly unlikely) that Americans come to appreciate the extent to which they themselves are responsible for the huge American trade/payments deficit. The task facing Japan may be even more daunting. Japan must make a fundamental shift in the purpose of economic activities from an export-led to a domestic-led economic growth strategy. This would mean that Japan would consume more and save less. The achievement of this goal will require a more open and deregulated economy as well as more expansive macroeconomic policies. Unless fundamental changes in both economies are forthcoming, Japan and the United States will continue to be very uneasy trading partners.

ENDNOTES

1. Samuel P. Huntington, "America's Changing Strategic Interests." *Survival* 33, no. 1 (January/February 1991): 3–17.

2. Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Hill Press, 1957).

3. Jeffrey Garten, *A Cold Peace: America, Japan, Germany and the Struggle for Supremacy* (New York: Times Books, 1992).

4. Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy 1925–1975* (Stanford: Stanford University Press, 1982).

5. W. Carl Kester, *Japanese Takeovers: The Global Contest for Corporate Control* (Boston: Harvard Business School), 1991.

6. According to the revisionist position, Japan plays by different rules of economic behavior than those associated with Western economic science.

7. Intra-industry trade entails the exporting and importing of goods in the same economic sectors such as the exportation of one type of consumer electronics and the importation of another type of consumer electronics. Inter-industry trade, on the other hand, entails the exporting and importing of goods in different economic sectors such as the exporting of manufactured goods and the importing of raw materials.

8. Laura Tyson in Robert Z. Lawrence and Charles L. Schultze, *An American Trade Policy: Options for the 1990s* (Washington: The Brookings Institution, 1990). Tyson held high positions in the Clinton Administration and was a principal author of the Administration's "result-oriented" trade strategy toward Japan.

9. Edward J. Lincoln, *Japan's Unequal Trade* (Washington, DC: The Brookings Institution, 1990).

10. Gary A. Saxonhouse, "Differerentiated Products, Economies of Scale, and Access to the Japanese Market," in Robert C. Feenstra, ed., *Trade Polices for International Competitiveness* (Chicago: University of Chicago Press, 1989).

11. Kenneth S. Courtis, *The Nikkei Weekly*, May 17, 1993, p. 6.

12. Reported in *The New York Times*, December 27, 1989, p. D2.

13. An excellent discussion of these matters is Gary Burtless, et al., *Globaphobia: Confronting Fears About Open Trade* (Washington, DC: The Brookings Institution, 1998, pp. 103–9).