

Japan-United States Relations in the Global Context

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Review of the Postwar Japanese Economy

The Japanese economy had been utterly devastated by the time Japan surrendered in August 1945 to end World War II. All overseas territories had been lost, Japan had been placed under Allied occupation, foreign trade was nonexistent, and production had fallen to unprecedented lows. It was not until ten years later that Japanese per-capita income regained prewar levels.

In 1960, the Japanese government devised a plan to double national income. At the time, I was responsible for this income-doubling plan as Director-General of the Economic Planning Agency's Planning Bureau. Begun in 1960, the plan was designed to double national income within ten years, but this target was attained in only seven years as Japan embarked upon a period of rapid growth in which the average per-annum growth rate was more than 10 percent for more than a decade. This income-doubling plan played a significant role in getting the postwar Japanese economy back on its feet.

In November 1982, Professor Lester C. Thurow coordinated a symposium on Japan's postwar economic performance at the Massachusetts Institute of Technology, the discussions and conclusions later published by MIT under the title *The Management Challenge: Japanese Views*. Reporting on "Economic Planning in Japan," I recapitulated the income-doubling plan and attempted to draw a few lessons from the experience. Commenting on the five main policy targets of this plan in his summarization, Professor Thurow noted:

Consider the five elements in the Japanese economic strategy at the beginning of the income-doubling decade: strengthen social overhead capital, push growth industries, promote exports, develop human ability and technology, and secure social stability by mitigating the dual structure of the economy. This list could easily serve as strategic objectives for the American economy by the year 2000.

With the 1973 oil crisis, Japan's economic growth rate was halved, and Japan has gone from an era of rapid growth to one of more moderate expansion. The sharp increases in oil prices were a major blow to the Japanese economy, given its dependence upon imports for its energy resources, and the cost of oil jumped to nearly half of Japan's total import bill at one point. Happily, the Japanese economy was able to respond flexibly to the two oil crises and, even though the recorded growth rates of 4 percent to 5 percent were far lower than those enjoyed in growth's heyday, Japan's was still one of the better performances within the OECD.

Along with the energy problem, environmental issues, especially air pollution and water pollution, were another major concern in the early 1970s. During this same period, policies were promoted to encourage energy conservation, with special emphasis on oil conservation, and considerable progress was made in achieving environmental targets for sulfuric oxides and other pollutants. In energy conservation, technological development and investment were promoted to reduce per-unit energy consumption, such that it has now become possible for Japan to produce real GNP that is over 50 percent larger than 1973's yet uses 30 percent less oil. On the environmental front, Japan has succeeded in reducing sulfur dioxide emissions to one-third what they were ten years ago.

Not coincidentally, the Japanese people have become strikingly more healthy, and the average life expectancy as of 1984 was 80 for females and 75 for males, ranking Japan right at the top along with the Scandinavian countries. Infant mortality is the lowest in the world, at only six per 1,000. At the same time, the gap between rich and poor has been narrowed. In 1960, the top 20 percent of the population had annual incomes 4.8 times as great as the bottom 20 percent. By 1984, this had been reduced to 2.7 times, and 90 percent of the population now considers itself middle-class.

The 1970s also saw major transformations of the Japanese industrial structure as steel, petrochemicals, and the other heavy industrial sectors that had sustained the rapid growth of the 1960s gave way to electronics, fine chemicals, and other science- and technology-intensive fields. Steel production, for example, has fallen from 120 million tons in 1973 to only about 100 million tons in recent years. Aluminum is down 80 percent from its peak production year.

Japan's Response to Trade Imbalances

Looking at some recent Japanese economic indicators, the economic growth rate was 5.1 percent in 1984 and 4.6 percent in 1985, the consumer price index rose 2.1 percent and the wholesale price index declined 0.5 percent in 1985, and unemployment averaged 2.6 percent in 1985.

The problems are in trade and Japan's international balance of payments. In 1985, Japan's balance of trade was \$56 billion in the black, and the current account including invisibles was \$49.3 billion in surplus. By contrast, the long-term capital account was \$82.1 billion out and only \$17.3 billion in, leaving a net outflow of \$64.8 billion. While Japan's vast trade surpluses have drawn complaints in the United States, Europe, and elsewhere, the fact that Japan's net outflow in its long-term capital account is even more than the surplus in its current account means that Japan is recycling these export surpluses to the rest of the world.

Japan's trade surplus with the United States last year was \$39.5 billion according to Japanese figures and \$49.7 billion according to American figures. This has been a major factor in the trade friction between Japan and the United States, and the United States has been calling upon Japan to promote import expansion by further opening its markets and stimulating domestic demand.

In its trade with the EC countries, Japan recorded a total surplus of \$11 billion last year. In fact, these surpluses with the EC countries have been stable at about \$10 billion a year for the last five years. By contrast, the surplus with the United States has grown from \$12 billion in 1980 to \$50 billion last year. Normalizing our trade balance with the United States is thus an urgent concern for Japan.

The Japanese Advisory Committee for External Economic Issues which I chaired submitted a report to the government last April calling for reforms in five policy areas:

1. Further improvements in market access
2. Sustained growth centered on domestic demand
3. Expanded overseas investment and industrial cooperation
4. Promotion of the New Round in GATT
5. Responding to the concerns of the developing countries

Drawing upon these recommendations, the government of Japan

announced an Action Program for expanded market access on July 30 including the reduction or abolition of tariffs on over 1,800 items, the simplification of import procedures, the acceptance of foreign-generated test data, greater harmonization with international standards, and other import-facilitation measures. Prime Minister Nakasone has repeatedly called upon the people to recognize that, while exports have long been considered indispensable to Japan's economic survival, import expansion is now even more important.

On September 18, the Japanese Cabinet approved a plan to double Official Development Assistance (ODA) in seven years, with the understanding that the total ODA disbursements over this seven-year period will top \$40 billion. In October, a set of policy proposals was approved to stimulate domestic demand, and on October 31, 1985, an Advisory Group on Economic Structural Adjustment for International Harmony, of which I am a member, was formed with the purpose of advising the government on medium-term policy recommendations. The group submitted its report to Prime Minister Yasuhiro Nakasone on April 7 this year.

This group was composed of 17 members from various sectors, including business, academia, journalism, labor unions, ex-bureaucrats, and more, and chaired by Mr. Haruo Mackawa, former Governor of the Bank of Japan. The group had 19 sessions, 18 of which the Prime Minister personally attended. As the report stated in its introductory part:

It is imperative that we recognize that continued large current account imbalances create a critical situation not only for the management of the Japanese economy but also for the management of the world economy.

The time has thus come for Japan to make a historical transformation in its traditional policies on economic management and the nation's lifestyle. There can be no further development for Japan without this transformation.

The report recommended the following policy measures.

1. Expanding domestic demand by (i) promoting housing policies and urban development and (ii) stimulating private consumption by such measures as tax cuts and reduction in working hours.
2. Transforming the industrial structure to an internationally harmonious one by (i) promoting positive adjustment policies, (ii) promoting direct overseas investment, and (iii) promoting agricultural policies befitting an

age of internationalization.

3. Further improving market access and encouraging imports of manufactured goods.
4. Stabilizing exchange rates and liberalizing and internationalizing financial and capital markets.
5. Promoting international cooperation and a Japanese contribution to the world economy commensurate with its international status by (i) expanding imports from the developing countries, (ii) contributing to the alleviation of the debt problem, (iii) expanding economic and technical cooperation with the developing countries, (iv) promoting research and development in basic science and technology for the benefit of the world community, and (v) promoting the GATT New Round.
6. Fiscal and monetary policy management including (i) maintaining fiscal policies to end the dependency on deficit financing and restore flexibility in fiscal management, (ii) reviewing tax policy from an international perspective, (iii) abolishing existing tax exemptions on interest on small-amount savings, and (iv) maintaining flexible management of monetary policy to forge an economy led by domestic demand growth.

Japan in the Year 2000

In 1984, Japanese GNP was ¥298 trillion, which translates (at 1984's average exchange rate of ¥238 to the dollar) as approximately \$1.2 trillion. In the same year, the United States GNP was \$3.6 trillion, or three times the Japanese GNP. Since the United States population of 240 million is twice the Japanese population of 120 million, this means that Japan's per-capita GNP was two-thirds the United States figure.

But using more recent figures, Japan's GNP this year (1986) is expected to be about ¥330 trillion and the exchange rate is closer to ¥180 to the dollar, which works out to a GNP about 45 percent of the United States'. This means Japan's per-capita GNP is now about 90 percent of the U.S. figure and approximately on a par with the nations of Europe. By the same token, Japanese GNP has jumped from less than 3 percent of the world total in 1960 to 10 percent today.

This naturally raises the question of what the future holds for the Japanese economy. In June 1982, after more than a year of study, the Economic

Planning Agency's Long-term Outlook Committee which I chaired issued a report entitled *Japan in the Year 2000*. In compiling this report, the Committee drew upon the expertise of 127 academics, businessmen, labor leaders, journalists, and other people. Appropriately enough, the report was subtitled "Preparing Japan for an Age of Internationalization, the Aging Society and Maturity."

The first projection was that economic relations with other countries will become increasingly close and our economies increasingly interdependent as Japan develops. Although international harmonization was not so important when Japan was a minor factor in the world economy, it is imperative now that Japan has come to have a major impact on the rest of the international community. In the past, Japan was able to export manufactured products in large volume, but Japanese companies must now join forces in tie-ups with companies in other countries to share in the profits, promote joint technological development, and expand employment opportunities in other countries. In so doing, there will be increasingly frequent opportunities for Japanese to work together with non-Japanese. While Japan used to be isolated both geographically and culturally, it is obvious that there will have to be closer contacts not only in economics but also in culture, education, and the entire range of human concerns. For example, there are now about 15,000 foreign students studying in Japan, which is far fewer than the 300,000 in the United States and the 110,000 in France. A five-member Council on Foreign Student Policy for the 21st Century formed in 1983 with myself as one of the five recommended increasing the number of foreign students in Japan to about 100,000 by the year 2000. This goal cannot be attained unless Japan is much more open to the rest of the world, economically, socially, culturally, and otherwise.

The second major long-term problem for Japan is that of population aging. In 1960, only 5 percent of the population was 65 years old or older. Last year it was 10 percent, and by the year 2000 it is expected to be over 15 percent. While many of the other industrialized countries currently have aged population ratios of 13 to 14 percent, Japan is expected to overtake these countries and have the highest aged population ratio in the world by the start of the 21st century. Moreover, the population is aging about three times as fast in Japan as in the United States and Europe, and this has major

implications for the Japanese economy and society.

Looking just at the issue of pensions, for example, there is bound to be a rapid increase in the number of people eligible for pension-funding but a decline in the labor population, which means a sharp increase in the burden per wage-earner. There are major questions about how to maintain the dynamism of our economy as the society grows older.

The third major long-term issue for Japan is that of industrial restructuring. Some people predict a shift to more science- and technology-intensive industries, others the onset of the information society, and still others a greater role for the service sector. In *Japan in the Year 2000*, it was predicted that the three economic sectors' employment percentages would go from 10 percent in primary, 35 percent in secondary, and 55 percent in tertiary in 1980 to 5 percent, 33 percent, and 62 percent respectively by the year 2000 as the percentage of the labor force employed in direct production drops and the percentage in the service sector takes up the slack.

Japan as an Asian Country

Situated off the east coast of Asia, Japan has close economic relations with such nearby neighbors as China, the Republic of Korea, and the South-east Asian countries. This region includes the Asian NICs (e.g., Korea, Taiwan, Hong Kong, and Singapore) known for their rapid modernization and strong economic growth. The six countries of the Association of South-east Asian Nations (ASEAN: Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand) are also enjoying very dynamic economic development.

In 1984, the total trade by the eight countries of Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand, was \$316 billion, topping Japan's total trade figure of \$307 billion. Their trade pattern with the United States was also very similar to Japan's, as they exported \$50 billion and imported \$25 billion while Japan exported \$60 billion and imported \$27 billion. Thus it is little wonder that many people have spoke of this emerging region as "another Japan."

In the 1960s, Japan's rapid economic growth was a stimulus to these countries, but in the 1970s these countries achieved economic growth rates even higher than Japan's. China is also expanding its economic relations with the rest of the world as it pursues modernization and liberalization.

Over the last three years, Chinese economic growth has been around 10 percent per annum and its trade has shown phenomenal expansion. Japan accounts for about one-fourth of Chinese trade, and exports from Japan have been \$4.9 billion in 1983, \$7.2 billion in 1984, and \$12.5 billion in 1985 while our imports from China have been \$5 billion in 1983, \$6 billion in 1984, and \$6.5 billion in 1985, with the result that Japan had a major surplus in its trade with China last year. China is ambitiously pursuing economic modernization, and it has set itself the target of quadrupling its agricultural and industrial output by the year 2000. Yet because China has a population of one billion, its per-capita GNP will only rise from about \$300 in 1983 to about \$1,000 in 2000.

Korea is also attracting worldwide attention with its rapid economic growth and vigorous trade expansion. Last year, for example, Korea scored major success in its small-car exports to Canada, and it is rapidly becoming more competitive with Japanese companies in shipbuilding and iron and steel. Last year, Korea had a per-capita GNP of about \$2,000.

Taiwan is likewise making rapid progress on both industrialization and the expansion of its manufactures exports, recording a \$13 billion surplus in its trade with the United States last year.

With the agreement between the British and Chinese governments guaranteeing that there will be no major change in Hong Kong's economics status after 1997, Hong Kong has recovered from its temporary falter and regained its stable growth momentum. Singapore had been enjoying double-digit growth, but last year's growth was minus 2 percent, indicating that Singapore is entering a period of adjustment. Even so, its per-capita GNP is over \$6,000. Although the three countries of Indonesia, Malaysia, and Thailand are experiencing sluggish economic growth as prices have plummeted for the agricultural commodities and oil that they export, they still have strong growth potential for the future.

The East and Southeast Asian region has perhaps the most dynamic economic development anywhere in the world. While Japan looms large in these countries' trade, investment, and economic assistance, there is also a need for Japan to expand its imports from these countries, including its imports of manufactures.

Japan-United States Relations

Relations between Japan and the United States in recent years have been marked by frequent friction, and the following four areas have been pointed out as the main causes of United States frustration with Japan.

1. It is felt that the Japanese market is more closed than the American market.
2. America's \$50 billion deficit in its trade with Japan is felt to be too much, regardless of the reasons.
3. There is the impression in the United States that Japan has not taken on international responsibilities and roles commensurate with the growth in its economic might.
4. Japan has emerged as a strong competitor for the United States in such high-technology fields as semiconductors.

At the same time, the leaders of both countries agree that Japan-United States relations are very important both politically and in the security field, and that the basically good bilateral relationship must be preserved. Trade friction notwithstanding, there is active cooperation between Japanese and American companies.

Japan has long maintained that the overvalued dollar is a major cause of the trade imbalance and that currency exchange rates need to be brought into line with reality. At the September 22, 1985, G-5 meeting of finance ministers and central bankers from the five leading economic countries, it was agreed that there is a need to rectify the dollar's overvalued position and that the five countries will cooperate in intervening, if need be, in exchange markets. Since then, there has been a very rapid depreciation of the dollar and a corresponding appreciation in the yen's value. Before the G-5 meeting, the yen was running around ¥240 to the dollar. Today it is around ¥165-170 to the dollar, and it is hoped that this adjustment will substantially reduce the trade imbalance between Japan and the United States. Yet the United States has trade imbalances not only with Japan but with most of its other trading partners as well, and there is a need for the United States itself to implement forceful economic policies to substantially rectify its trade imbalance and improve its international balance of payments.

International Economic Issues

There are several problems in the world economy today. One of these is the issue of achieving harmonious development among the Western industrialized countries. In 1985, the United States ran a \$148.5 billion trade deficit. At the same time, Japan showed a \$46.1 billion trade surplus. While it may seem as though it would be to other countries' advantage for the United States to continue to run these massive trade deficits, since that would mean that they could continue expanding their exports to the American market, such a situation is obviously untenable in the long term. It is imperative both for the United States and for the world economy at large that the United States restore balance in its international payments. By implication, it is also imperative that Japan and Europe cooperate in policy coordination so that this transition period in the United States does not create turmoil in the world economy. We must cooperate in GATT both to preserve the free trading system and to alleviate economic friction.

The world economy today is a complex mix of trade, finance, currency exchange, and other factors, and it is imperative that we deal with the many problems before us from an overall perspective and promote our macroeconomic policies, industrial restructuring policies, and other policies in full awareness of the impact they have on other countries. At the same time, we must also deal with the difficult problems of North-South relations, including the precipitous decline in commodity prices, the barriers to developing countries wanting to expand their exports to the OECD countries, the financing difficulties epitomized by cumulative external debts, the hard currency shortages in some oil-exporting countries as oil prices have collapsed, and the stark poverty in many parts of South Asia and Africa.

With its large balance of payments surplus, excess domestic savings, and highly developed technology, Japan can and should play an important role in promoting world economic development. On April 18 this year, a Study Group of the World Institute for Development Economics Research (WIDER), Helsinki, a subsidiary institution of the United Nations University (UNU) in Tokyo, announced a proposal entitled "The Potential of the Japanese Surplus for World Economic Development." The group members are Dr. Lal Jayawardena, Director, WIDER; Dr. Arjun K. Sengupta, member, WIDER Advisory Group on International Economic Issues; and myself as

Chairman of the Board, WIDER. In our proposal, we recommend that:

1. The international community should find methods to sustain higher growth in Japan in order to offset the decline in the growth momentum of the U.S. and counter any tendency toward world deflation.
2. While the required policies would in part involve stepping up Japanese investment geared to its domestic market, there are real difficulties in absorbing domestically a rate of savings running 27 percent of GNP.
3. To sustain this momentum, there is therefore a need for Japan to continue to reply to a substantial extend on export-led growth and to maintain a significant current account surplus so as to be able to continue to "export" excess savings abroad.
4. Japan's large current account surplus was primarily due to its comparative advantage in export sectors, but was it also helped by the vast U.S. budget, and consequently trade, deficits.
5. Any reduction in the U.S. budget and trade deficits would tend, in the absence of offsetting policies, to shrink Japan's external market, slow Japan's economic growth and hence slow growth in the world economy. One possible offsetting policy measure would be to enhance the import capacities of the developing countries. This can be accomplished by re-directing the Japanese surplus to finance the developing countries' deficits. This means using excess Japanese savings that cannot be absorbed domestically or in the U.S. to finance productive capital formation in the developing countries.
6. There is a need, therefore, to evolve mechanisms for financial intermediation for Japan's surplus.
7. Once this principle is accepted, the specific financial instruments and mechanisms can be worked out. These range from the notion of a Japanese Marshall Plan for the developing countries to mechanisms for promoting Japanese investment in the developing countries and increased lending by Japanese international banks. Since the intermediation mechanisms have to enable private Japanese savings to find an outlet in developing countries, there may be a need for the Japanese government to promote this process either by subsidizing the interest rate on loans to developing countries or by providing collateral to Japanese private savings institutions to make investment in developing countries

attractive. The considerable reductions in recent years in Japan's fiscal deficit as a percentage of GNP and in Japanese interest rates should permit this to happen with relative ease in the coming years. In this context, the Japanese government could take the initiative of contributing one-tenth of one percent of GNP to set up an international fund, while simultaneously inviting other industrial countries to join the fund by making similar contributions. Properly applied, the leverage provided by this fund should make it possible to supply the concessions and incentives needed to mobilize private capital flows to developing countries that are a substantial multiple of the resources available from the fund.