THE U.S. RESPONSE TO THE JAPANESE ECONOMIC CHALLENGE: WHY AND HOW IT WAS INADEQUATE

Stephen D. Cohen*

There are two words that can be used succinctly to capture the essence of the United States' response to Japan's steadily rising economic power: "inept" and "brilliant." This apparent contradiction is neither intended to be humorous nor to convey confusion by the author. In fact, there are at least two planes of reality by which to assess the response of the American government and business sector to the domestic dislocations caused by the rise of Japan to economic super-power status. The purpose of this analysis is not to select one of these over the other; rather it is to suggest that this is a complex issue requiring a reconciliation of competing values and judgments.

ECONOMIC POWER VERSUS ECONOMIC THEORY

By conventional commercial measures, the United States has been on the receiving end of a one way onslaught of Japanese export success in the area of manufactured goods. The magnitude of Japan's economic sales success in the American market is measured in the near disappearance of some domestic production (e.g. televisions and radios), reduced market shares for domestic producers in their own home market (e.g. automobiles), reduced corporate earnings, and intimidation against pursuing new technologies if Japanese competitors are known to be devoting significant resources to their development. In terms of head to head business competition, the United States has been, and still is, doing quite badly in responding to the Japanese economic challenge. Price increases, due to the effects of restricting Japanese imports and the relatively recent appreciation of the yen, have done relatively little to shift U.S. consumer preference to domestically produced goods.

The second possible measure of the U.S. response to Japan would be more easily appreciated in an economics journal, because it is based on an economic theory that only an economist can embrace at first reading. A country's real wealth comes from its consumption of real economic resources or its use of capital goods to produce other goods or services. Money is not a real economic resource. It is a means of exchange, store of value or unit of account. This concept was at the heart of Adam Smith's revolutionary idea that the wealth of nations comes from importing goods, not directly from exporting. If a government's concern is to maximize consumption, exports are important only for generating the revenues to buy imports. In sum, the primary purpose of production in a country would appear to be domestic consumption, not the subsidization of foreigners' standards of living.

By economic theory measures, the United States has responded intelligently to Japan's exaggerated export zeal; we are exchanging depreciating paper money (dollars) for real economic resources, produced in Japan, that contribute directly to our material standard of living. The Japanese, by virtue of their enormous trade surplus, have little alternative other than to return the dollars back to the United States as a supplement to our inadequate savings.

Throughout the mid-1980's, the United States has been consuming more than producing. This economic trick is simply performed: we have been running a large trade deficit financed by an equivalent net capital inflow from abroad. Japan, undaunted by inadequate housing

---

* Stephen D. Cohen is a Professor in the School of International Service, The American University, Washington, D.C. He is the author of *Uneasy Partnership: Competition and Conflict in U.S.-Japanese Trade Relations* (Ballinger, 1985). The third edition of his book, *The Making of U.S. International Economic Policy*, has just been published by Praeger.

and other infrastructure at home, has been content to be the leading net supplier of incremental goods and capital to the U.S.

Japanese workers seem content to forego consumption and leisure time in order to subsidize Americans' standard of living and augment the inadequate U.S. savings rate. In return they have acquired tens of billions of dollars, a currency that lost half of its value relative to the yen in the 1985–87 period. In the meantime, the American economy in the spring of 1988 was enjoying its longest peacetime stretch of consecutive quarters of real economic growth. The unemployment rate of 5.6 percent in March of that year was the lowest in 14 years.

It is therefore not clear who is conning whom, at least in the short run, in the U.S.-Japanese economic relationship. To pass judgement on the quality of the U.S. response to the Japanese economic challenge is to select between the greater of two conflicting interpretations, not merely to cite the unambiguous arithmetic of the mammoth bilateral trade disequilibrium.

Economic theory, however, is only a limited guide to how the real world operates. A policy-oriented analysis of bilateral economic relations should not simply congratulate American naivete on its possibly clever, if inadvertent, assault on Japanese real economic resources. Perhaps more importantly, there is a distinct possibility that this "free trade" option may be smart in the short run, but costly to disastrous in the long run for the overall health of the U.S. industrial sector and the American economy in general. No country, not even the United States with its massive economy and international currency, can expect to be able to indefinitely sustain a massive, current account disequilibrium. At some point, the United States will find the costs of financing current account deficits in the range of $150 billion annually to be prohibitive.[1]

In sum, the evidence suggests that it is unsound economic policy to recommend that Washington's policymakers be unconcerned about this country's continued consumption above levels of national production (i.e. a continuous trade deficit). Nor can there be much self-satisfaction at the prospect of the Japanese, in the future, attaining competitive leadership in one industrial sector after another.

HOW THE U.S. RESPONSE HAS BEEN INADEQUATE

There is reason to believe, given the military stalemate among the great powers inherent in the balance of nuclear terror, that economic power will become the key determinant of a country's international strength and influence in the twenty-first century. If this is the case, the American response to the Japanese economic challenge has been a failure.

When measured in terms of producing and exporting increasing quantities of cheaper and better quality manufactured goods, the Japanese, since the early 1970s, have outthought, outworked, outsmarted, outflanked and outran most of their U.S. and other foreign competitors. The Japanese were pioneers in discovering that:

[1]The potential for "Prohibitive" costs originates from the basic economic fact that U.S. current account deficits must be financed by net capital inflows from abroad of approximately equal magnitude. With the U.S. already having borrowed more than $500 billion since 1983 and no end to the current account deficit in sight, foreign investors eventually will need more inducements to further increase their already large currency exposure in dollars. The two major inducements would be: 1) additional dollar depreciation that would make acquisitions of dollar assets cheaper to foreigners, but cause intensification of inflationary pressures in the American economy; and 2) higher U.S. interest rates that would increase yields on foreigners' investments, but eventually would choke off domestic economic growth, causing a recession.

(1) Innovative governmental and corporate strategies could introduce competitive advantage and that the former could be as important as inherited comparative advantage.

(2) Positive cooperation between the business and governmental sectors could induce industrial achievements of a magnitude and speed that were unlikely to have been produced solely by the invisible hand of the marketplace.

(3) Wise industrial strategy emphasized long-term market development over immediate profits. As we move into the 1990's, these concepts still have only limited acceptance among American political, business and academic leaders. A continuation of the stubborn U.S. indifference to the nature and advantages of Japan's forward-looking economic strategy could assure a further loss of relative competitiveness.

The United States lacks the will, not the resources, to respond effectively to Japan's string of economic successes. The United States belatedly and only partially woke up in the 1980s to the prospect of being relegated to second place industrial power status. Prior to that, three factors contributed to a near paralysis in initiating an effective American economic counterattack to Japan's growing economic strength:

(1) Having emerged from World War II as a hegemonic power, the U.S. did not perceive the need to be alarmed with the status quo.

(2) The U.S. did not appreciate the full magnitude of the challenge: Japan's growing economic strength was unprecedented, underestimated and misunderstood.

(3) The U.S. *could* not have appreciated this challenge; national security as well as domestic economic ideology, social priorities and domestic political distractions dissipated, a more effective invigorating of national policies.

This analysis leads to a basic conclusion: the Japanese have been and apparently are still better prepared than the United States for the inevitability of economic change. Emphasis on long-term strategy leads the Japanese to target industries of the future for development. Emphasis on the short-term leads U.S. officials to rely on relatively unproductive foreign trade tactics such as demanding "voluntary" export restraints and a long series of shallow market opening measures by Japan.

WHY THE U.S. RESPONSE HAS BEEN INADEQUATE

There are a variety of ways to empirically demonstrate American economic ineptitude since the mid-seventies in dealing with Japan. One is to list the industries decimated by Japanese competition: steel, consumer electronics, automobiles, motorcycles, semiconductors, watches, etc. Another is to highlight the bilateral trade deficit in manufactured goods:[2]

1983—$30 billion
1984—$45 billion
1985—$56 billion
1986—$68 billion
1987—$68 billion

Of course, the above numbers would be much larger in the absence of self-imposed export restrictions by the Japanese on such products as automobiles, steel and semiconductors.

What went wrong? There are three basic components in the inability of the United States to mount more efficient responses to intensifying Japanese competition:

[2]Data source: U.S. International Trade Commission, *International Economic Review,* March, 1988, p. 23.

(1) A failure to understand the cultural dynamics and industrial policies that imbued the Japanese economy with extraordinary internal and foreign trade strengths.

(2) A failure of U.S. economic policies to maximize increases in productivity, investment, production line innovation and other key determinants of industrial competitiveness.

(3) A failure to provide easier access to the Japanese market for American industry and agriculture.

Hence, a more detailed discussion of these three factors is warranted.

THE FAILURE TO UNDERSTAND JAPAN

Americans have an exaggerated tendency to assume that the peoples of all countries share the same values, needs and desires. Japan, to the casual observer, has become a westernized democracy with a capitalist economic system. When westernized dress, skyscrapers, traffic jams, proliferation of American fast food restaurants and love of baseball and Hollywood movies are factored in, most Americans come to view Japan as a kindred spirit. Granted, the Japanese sometimes play the foreign trade game a little too rough and dirty, but they still tend to be seen as a fellow, industrialized democracy.

Belatedly, more astute interpretations of how the Japanese system works have begun to appear. A Dutch reporter who has lived for many years in that country suggests that political power in Japan is manifested in a manner that differs from the American experience:

> It is crucial to distinguish Japan from other nations with governments that are besieged by special interest groups or that cannot make up their minds because of interdepartmental disputes. We are not dealing with lobbies but with a structural phenomenon not encompassed by the categories of accepted political theory. A hierarchy, or rather a complex of overlapping hierarchies, is maintained, but has no top. There is no supreme institution with ultimate jurisdiction over the others . . . .
>
> No essential political decisions to change the priority of unlimited industrial expansion have been made since [the end of the Occupation because] the political mechanism for such a momentous decision does not exist.[3]

There is also a perception that economic decisions in Japan are manifested in a manner different from the American experience. The market mechanism works differently in a country that relies on industrial policy, cartels and programs to reduce the adverse effects of excessive competition. Japan, in the words of Chalmers Johnson, represents a "developmental state" where the setting of domestic and external economic goals is the dominant feature. This is different from the regulatory, or market-rational, state exemplified by the United States. In the latter case, rules and legality are stressed over industrial growth and competitiveness.[4]

Also suggested is the fact that beneath its democratic veneer, Japan has a much more closed society than Anglo-Saxon countries:

> For outsiders, rights to sell goods and to become citizens are carefully circumscribed . . . .
>
> Japan . . . has a very strong sense of national mission and social cohesion. Japanese want to be part of a group that strives to be number one, whether it is their company or their country; they are willing to make considerable sacrifices for that goal. They cannot be faulted for holding such values; indeed, it is more appropriate to criticize Americans for their unwillingness to suffer any personal inconvenience for the common good.[5]

[3]Karel G. van Wolferen, "The Japan Problem," *Foreign Affairs,* Winter 1986–87, pp. 289–290.

[4]Chalmers Johnson, *MITI and the Japanese Miracle* (Stanford, CA: Stanford University Press, 1982), pp. 19–20.

[5]George Soros, "After Black Monday," *Foreign Policy,* Spring 1988, p. 76.

Americans who believe that starting an exporting business to Japan would do well to heed the conclusion of a Japanese professor: "What Americans don't realize is that Japan is closed even to the Japanese."[6] Companies such as Honda, Sony and Kyocera, founded by entrepreneurs outside of the establishment, face an uphill battle. Japanese business groups (the keiretsu) tend to buy each other's goods and services. Long-established personal business relationships are seldom terminated because a foreign supplier offers a cheaper price.

The lack of American appreciation for the differences in the two societies can be summed up in an important historical anecdote. In 1969, perhaps the pivotal factor in inciting President Nixon to retain a hard-line bargaining position in the great textile dispute with Japan, was his belief that the Japanese Prime Minister, Eisaku Sato, had committed himself in an Oval Office meeting to convince Japan's textile industry to agree to "voluntary" export restraints. In fact, Mr. Sato had responded to the President's request that he do so by saying "zensho shimasu." The interpreter provided the correct literal translation: "I will do my best." In normal conversation among Japanese, however, this phrase generally implies exactly the opposite, a polite rebuff of the favor being asked.[7] This illustrates a classic problem in communications because of the very different ways that the Japanese use language to express ideas.

A SECOND BEST U.S. ECONOMIC PERFORMANCE

Until the dollar became significantly overvalued by 1983, the American economy in general, and industrial sector in particular, competed fairly effectively in the world marketplace. In head to head competition with Japan, American industry faltered more often than against any other country. No other country than Japan in the post-World War II period produced more companies that rose to become world-class competitors, often leaving American corporate giants trailing behind. For readers who find second place finishes perfectly acceptable, or concerns about relative Japanese economic dynamism unduly alarmist, the following criticisms of the American economic performance will seem unduly harsh.

Japan's economic miracle has reflected the existence of a positive synergy among a host of economic and cultural factors. These included well-designed, clearly articulated goals (first recovery, then industrial ascendency), zealous national commitment to these goals—often at great and prolonged sacrifice—by a compliant Japanese people and economic policies that were highly supportive of industrial growth and brilliant management innovations in the private sector. In contrast, the American industrial sector languished amidst a lack of clear goals, unsupportive governmental policies, economic and social priorities that conflicted with industrial growth and the enshrinement of the "me first" mentality that hindered pursuit of the common good with an exaggerated emphasis on the cult of individuality.

The United States has experienced a negative synergy over the past two decades. A better economic performance would have reduced the inroads made since the late 1960s by Japanese exports in this market. (However, a better U.S. economic performance would not

[6]Claudia Rosett, "Japan's Policy Feuds Dwarfed by Historic Changes," *Wall Street Journal*, October 19, 1987, p. 31.

[7]See, for example, Clyde Haberman, "Some Japanese (One) Urge Plain Speaking," *New York Times*, March 27, 1988, p. I-3. The nuance of meaning in this phrase was confirmed independently to me by one of my Japanese graduate students.

necessarily have meant increased inroads into the Japanese market by American goods, for reasons to be discussed below, unless a third basic U.S. response shortcoming had been cured.) The result has been a demoralizing, costly and potentially dangerous inability of a growing number of American companies to compete against Japanese imports in their own backyards.

The goal of industrial excellence has been overshadowed by a number of other priorities and diversions. The earliest is the preoccupation with national security inherent in being the strongest military power in the noncommunist world. While Japan's government was successfully nurturing a strong commercial industrial sector, the U.S. government was successfully nurturing a strong military-industrial complex to provide the main defensive shield against Russian aggression. In the 1960s, the costs and wisdom of the Vietnam War absorbed much of the energy which might have gone into considering improved industrial efficiency. Similarly, in the 1970s, attention was diverted from questions of international economic strength to the Watergate scandal and the eventual resignation of President Nixon.

The search for a more just society begun in the 1960s resulted in a tilt away from the pursuit of efficiency in favor one of equity. That there is indeed no such thing as a free lunch for society can be seen in the variety of social programs (civil rights for minorities, equal rights for women, antipollution legislation, work safety rules, etc.) that made for a better and more regulated society, but did nothing to encourage capital formation or higher productivity in the industrial sector.

An examination of monetary and fiscal policies in the United States over the past 20 years suggests the antithesis of Japanese policies meticulously designed to foster industrial growth. Failure to raise taxes in the mid-1960s to pay for the war in Vietnam, and the domestic war on poverty, spawned the abovementioned inflation which accelerated the ascension of Western Europe and Japan to competitive coequals with the U.S. in international trade. Wage and price controls, instead of restrictive macroeconomic policy, were used futilely in the early 1970s to rid the domestic U.S. economy of inflationary pressures. When Paul Volcker finally got serious in 1979 about using tight monetary policy to fight inflation, the result was an escalation of interest rates which discouraged corporate investment and brought on a severe recession.

The excessive erosion of the tax base in the 1981 tax reform act sent the federal budget deficit, real interest rates and the dollar's exchange rate spiraling upward. When the dollar's exchange rate appreciated (because of financial and speculative reasons) to a level in late 1984 that was far above the level of U.S. international commercial competitiveness, the Reagan administration viewed this as a sign of economic strength, not concern. The result was the biggest balance of payment disequilibrium in history. Imports flooded in and exports stagnated in the face of an overvalued exchange rate and inadequate savings to finance the government's budget deficit and private investment.

This 20 year parade of American macroeconomic policy mistakes stands in stark contrast to what has prevailed in Japan: low borrowing costs for corporations, a usually undervalued exchange rate for the yen and a fiscal policy that encourages savings by individuals and investment by corporations. The Japanese had clear goals; the United States did not. Alone among the countries of the world, the United States does not have to pay the old fashioned way for imports. Instead of exporting, we can use our own currency to pay for imported goods.

American management was woefully inadequate to the task of overcoming the poor economic policy hand it was dealt. Companies in basic manufacturing were far more interested in maximizing short-term profits than in modernizing their capital equipment, minimizing production costs or stressing quality control. Top-level management in industrial corporations increasingly consisted of persons with backgrounds primarily in finance, marketing or law, but not in production.

By the late 1970s, a new preoccupation joined the traditional management concern of keeping shareholders happy through profit maximization: the shuffling of paper assets in the merger, acquisition and takeover game. Managers shifted their emphasis on technological and institutional innovations to an emphasis on innovations in accounting, junk bonds and other financial machinations:

> Paper entrepreneurialism . . . attracts some of our best minds and most talented citizens. But it does not create new wealth. It merely rearranges industrial assets. And it has hastened our collective decline.[8]

While American managers were spending more time on seeking acquisitions and avoiding hostile takeovers, Japan's management was concentrating on the production process. They were learning about the virtues of increased market share, moving down the learning curve through mass production, quantitative approaches to quality control and the benefits of government supported research and development.

If the American labor movement had sought collective sainthood, they might have unilaterally sought to end the adverse relationship that until very recently dominated labor-management relations in this country. In reality, our workers looked at their lack of job security, and the world's most generous executive salary and bonus system, and decided to use the political power of unions to secure the biggest wage settlements possible, regardless of increases in labor productivity. The results can be empirically observed in the dismal performance of U.S. unit labor costs relative to Japan until the late 1980s, when the effects of the dollar-yen exchange rate realignment began to take hold.[9] It is no coincidence that excessive wage settlements and inadequate modernization in the automobile and steel sectors made these two industries early candidates for a clobbering from their lower cost Japanese competitors.

The Japanese are NOT supermen who are immune to mistakes and problems. To some extent, Japan's success in besting American producers in the basic manufacturing sector was aided and abetted by pervasive failures in this country. The question of whether history will repeat itself in the high-technology sector will be determined in part by whether the U.S. implements more effective macroeconomic policies and shrewder management techniques. Japan's future ability to dominate international trade in the high-tech sector will also be determined in part by the ability of the United States to correct the third basic shortcoming in the American response to the Japanese economic challenge: ineffectual trade policies.

FAILURE TO GAIN ACCESS TO THE JAPANESE MARKET

For the better part of 20 years, the U.S. government has been steadily negotiating with the Japanese government for the purpose of securing greater access to the market for American goods. On one level, the results have been impressive; Japan has reluctantly launched the greatest unilateral import liberalization program in history. (Unlike Americans, Japanese

[8]Robert B. Reich, *The Next American Frontier* (New York: Penguin Books, 1983), p. 141.

[9]For detailed data, see the author's *Uneasy Partnership: Competition and Conflict in U.S.-Japanese Trade Relations* (Cambridge, MA: Ballinger Publishing Company, 1985).

seem to view import liberalization as a sad, painful, national event necessary to placate the Americans; potential benefits to Japanese consumers tend to be ignored.)

On the second level, never has so much effort produced so small a result: Japan's trade surplus has soared to the biggest in world history ($93 billion in 1987), and its imports of manufactured goods as a percentage of GNP has declined, making it one of the very few industrial countries whose ratio has not increased. Despite official Japanese claims of being an open market, few exporters of manufactured goods in the United States and elsewhere have stopped complaining that securing export orders in the Japanese market is still exceptionally frustrating and difficult.

The Japanese still have layers of informal, often unwritten protective barriers that impede imports of manufactured goods currently made in Japan or—more extraordinarily—merely scheduled for *FUTURE* production in Japan, such as communication satellites.[10] Formal barriers are not necessary. When it comes to promoting the development of targeted industries, Japan is still practicing the infant industry strategy started in the 1950s. The result is that emerging high-tech industries in Japan have the same advantage that basic manufacturing industries did in the sixties and seventies: they can develop and operate in a home market relatively free of import competition.

Failure to achieve empirical export increases from its long standing demands for further market opening measures on specific products has not yet caused any meaningful shift in U.S. trade tactics with Japan, a puzzling indifference to a clear lack of success. The apparent inability or indifference of American producers to follow up on such liberalization measures can only explain a small part of the failure of Japan's import structure to change very much from the period prior to liberalization in the early 1960s to today. There is, in fact, a prima facie case that the Japanese system is simply not hospitable to competitive manufactured imports. At times, sometimes now, informal red tape is installed in the wake of removal of overt barriers. At other times, the removal of such barriers cannot overcome such structural problems as Japan's byzantine distribution system, deep-seated personal or institutional loyalty to existing suppliers and desire to see targeted industries in Japan prosper.

The incredibly constant share of U.S. semiconductors in Japan over a period of years—before and after liberalization—is a primary case of official Japanese marketing opening measures producing no measurable results. U.S. market share in Japan for semiconductors, a relatively liberalized sector, has demonstrated a strange pattern of inertia for many years. "U.S. access to the Japanese market [for semiconductors] has been frozen in the 10 percent range since 1972, even though the U.S. share of all other national markets is near 50 percent or more, and U.S. share in the U.S. is over 80 percent."[11] Despite an intensifying U.S. flirtation with retaliation against alleged protectionism, the Japanese are still shameless in justifying reasons why imports cannot be successful in Japan. Hence, we are told that Japanese skis require special safety standards because Japan's snow is different, and that there are limits on how much American beef can be sold because the Japanese have longer intestines than Caucasians.[12]

[10]"A Made-in-Japan Mistake," *Newsweek*, October 17, 1983, p. 25.

[11]Semiconductor Industry Association, "One Year of Experience Under the U.S.-Japan Semiconductor Agreement," September, 1987, p. 1.

[12]See, for example, "Japanese Are Special Types They Explain," *New York Times*, March 6, 1988, p. IV-4, and "Japanese Ski Makers Freeze Out the Opposition," *Financial Times*, September 4, 1986, p. 1.

The United States and Japanese governments have been content to negotiate symbols, not substance, in the bilateral negotiating process. They have negotiated over symptoms, not causes. They have ignored the pervasive implications that a systemic problem is at the source of the U.S.-Japanese economic disequilibrium. The problem ultimately rests with a relatively weak U.S. economic performance and a Japanese economic-cultural system that has relentlessly pursued industrial growth and efficiency.

This fundamental shortcoming in the ad hoc nature of the bilateral negotiating process is responsible for the failure to find a solution to the disequilibrium, or even to reduce trade frictions. However, these failures have not yet moved either country to try to change the process. The reason is that both sides are still content with the results of their failures to address the systemic problem. The Japanese have been able to maintain their mercantilist trade philosophy: maximizing exports and minimizing imports. The United States has been able to maintain its liberal trade and free market philosophies, its propensity for consumption and its national security goal of preserving its political-military alliance with Japan.

However, nothing has been done to ameliorate U.S. perceptions of Japan as an unfair or adverse trading partner. And nothing has been done to reduce Japan's growing impatience with the seemingly endless succession of demands for trade concessions by its number one trading partner. The absence of results has produced an inexorable compounding of resentment on both sides, an attitude that someday could escalate to unmanageable proportions.

CONCLUSIONS AND RECOMMENDATIONS

There can be no definitive, remedial measures until there is a definitive consensus on the nature of the problem. The thesis of this analysis has been that beyond the theoretical virtue of exchanging real economic resources for depreciating paper money, the United States has responded poorly to the steady increase in Japan's industrial strength. Perhaps more worrisome is the lack of definitive proof that a more effective response is imminent. Even if every assertion about devious Japanese economic activity—dumping, cartels, governmental subsidies, influence buying, etc.—is assumed to be absolutely correct, it is hard to be sympathetic to the ineffectual response to Japan's alleged duplicity of the world's biggest economy and military leader of the noncommunist world. No matter how fair or unfair Japan's trading practices have been, the U.S. policy response has been neither admirable nor adequate.

There are a number of possible courses of policy action, some more costly than others. A hands off approach is possible in the context of waiting for whatever amount of dollar depreciation and yen appreciation is necessary to approximately equilibrate the competitiveness of the two countries' industrial sectors. But dollar depreciation is inflationary: it raises the costs of imports and encourages American producers to raise their prices. And there is no guarantee that Japanese companies will suddenly embrace the use of even significantly cheaper U.S. capital goods, the backbone of this country's export sector.

The United States could impose import barriers on an across the board basis, or on a discriminatory basis against all Japanese goods. However, protectionism would not be a satisfactory or cost-effective cure for this country's more deep-seated economic problems; it would only encourage inefficiency and higher prices from domestic producers relieved of the discipline of competing against foreigners. While alienating our most important ally in the

Pacific, import barriers essentially would be tantamount to metaphorically shooting ourselves in our national economic foot.

The United States must decide exactly what we want of the Japanese. A perfectly balanced bilateral trade account is neither necessary nor probable. However, if genuinely increased market access is desired, we may have to bow to realities and demand a guaranteed quantitative market share for certain commodities in the manner negotiated for semiconductors in the 1986 bilateral accord. We may have to pay the price of short-term retaliatory trade barriers and some internal inefficiencies to achieve over a long term what countless Japanese liberalization measures and promises have failed to achieve: increased U.S. exports of manufactured goods to that country proportionate with the growth in Japan's GNP growth. In the absence of changing buying patterns in Japan, it may be that only a clear and present threat of restricted access to the American market will produce genuine import-expanding responses in Japan.

U.S. demands for reciprocity must be limited to high-tech goods in which we have a comparative advantage; large market shares in overseas markets outside of Japan could be the main test of whether the product was one in which we did have comparative advantage. The vociferous arguments against such a policy advanced by the ardent free traders in this country should be met with a firm argument that any U.S. high-tech industry that cannot compete freely in the world's second largest market will soon face ruinous competition by a protected Japanese competitor—in the manner faced by basic manufactures (steel, consumer electronics, etc.), and more recently, semiconductors.

The most important changes in the United States' response to the Japanese economic challenge must come from within. Weaknesses in economic policies and better performances by American industrial firms must take top priority. However, there is little likelihood of a sense of urgency as long as Japan is looked upon as just another capitalist competitor. Too many Americans are engaged in a wishful thinking exercise when they view Japan's economic miracle as waning because of its alleged inability to innovate (as opposed to copying other countries' technological discoveries), or because the younger generation will opt for more leisure time and less work.

The first order of business is for Washington to agree on measures to reduce the federal budget deficit and to encourage more savings. There is an empirically demonstrable proposition in economics that a country whose savings rate is inadequate to finance net government budget deficits and business investment will have a current account (goods and services) deficit in its balance of payments.[13] Until the United States increases its savings rate, reduces in absolute term governmental spending or raises tax revenues, progress in eliminating the multilateral U.S. trade deficit will be painfully slow. Foreign trade barriers are a relatively small factor in the persistence of this deficit for Japan and the world at large.

The tax code should be altered to discourage consumption and encourage capital formation. The first step in the latter process is to reward savings by reducing taxes on interest earned. Increasing the supply of savings will tend to reduce interest rates paid by corporations that borrow money to expand and modernize their plant and capital equipment and finance the development costs of new technologies. Depreciation allowances should be more generous and the investment tax credit should be restored, both as part of an effort to assure that American companies operate with state of the art equipment.

[13]For a fuller explanation of this so-called accounting identity, see U.S. General Accounting Office, "The U.S. Trade Deficit: Causes and Policy Options for Solutions," April 1987, pp. 15–18.

The next administration should formally put to rest the economic canard that the federal government does not have a de facto industrial policy. Admittedly, the latter is disjointed and occasionally inadvertent, but the government does strongly influence many sectors of the economy, such as agriculture, health and housing. Too much federally funded R&D has been devoted to the defense sector, while too little has been allocated for development of technologies with commercial applications (as is given in Japan). While a formal industrial policy is inappropriate for the American system of government (a U.S. version of Japan's Ministry of International Trade and Industry is distinctly *NOT* being recommended here), Washington needs to take a more positive position on its potential contribution to industrial development.

The prototype of this change in attitude is already in progress and merely needs to be enhanced and extended. Japanese technological progress, ironically, is the source of this subtle policy shift. The Defense Department has become increasingly concerned about the rising import dependence of American companies (including defense contractors) on Japanese electronics, computer components like semiconductors, machine tools, fiber optics, composite materials, biotechnology, etc. There does not seem to be anything wrong in principle in encouraging more governmental support for technological progress outside of the weapons and space exploration sectors. Such support can take such forms as partial funding of R&D outlays, waiver of the antitrust law to encourage cooperative corporate product development and stronger protection for patents and copyrights.

A more realistic and better informed attitude in Washington of the changing economics and more effective policies of international competition in the world marketplace as well is necessary but *INSUFFICIENT* for ensuring an overdue resuscitation of U.S. competitiveness. Corporations need to update and improve their tactics, strategies and priorities if they are going to compete without the benefit of import barriers and a depreciating dollar. Without greater risk taking, and with increased attention to the production process (and less to corporate takeovers), business dynamism in this country is likely to give way to flabby "corpocracy." In a 1986 speech, the then Deputy Secretary of the Treasury, Richard Darman, warned of "large-scale corporate America's tendency to be like the government bureaucracy that corporate executives love to malign: bloated, risk-averse, inefficient, and unimaginative."[14]

A new technological revolution is brewing. However, there is no guarantee that U.S. companies will be at its forefront. Computer-integrated-manufacturing and other advances in information processing can offset much of the costs of relatively expensive American labor, but mastery of them will require capital that might otherwise go to dividends and executive bonuses, or to make new corporate acquisitions. If American companies do not match Japan's deep, long-term commitment to perfecting such major new technologies as superconductivity, our future industrial competitiveness may be severely affected.

American corporations must remedy continuing weaknesses in important non-price factors such as design, quality, marketing, innovation, after-sales service and adaptation to consumer preferences in different countries. Most American manufacturers still trail their Japanese competitors in taking as a given that business success requires a truly global production perspective.

---

[14]Richard Darman, "Looking Inward, Looking Outward: Beyond Tax Populism," U.S. Treasury Department Press Release, November 7, 1986, p. 6.

There is no finish line in the economic competition between the United States and Japan. These two countries will be the primary contenders for global, economic leadership into the next century. The Japanese have a hierarchical society that respects those who are on top; it is a society that is collectively dedicated to having its economy become and remain number one. Their task will be made immeasurably easier if the United States continues to play the role of the slumbering, not overly bright giant.

We need to act on the slowly spreading realization that the Japanese surpassed us in basic manufacturing, and now are in the process of doing the same in the high technology and financial services sector. If we do not work harder, we may see Japan taking an insurmountable lead in the development and market-share of many of the high growth manufacturing and services sectors. This situation would be costly to our standard of living, economic sovereignty and position as a world leader.